Understanding Illicit Financial Flows

Akina Mama wa Afrika

1. What are Illicit Financial Flows?

Illicit Financial Flows (IFFs) are the movements of money or capital from one country to another that are illegally earned, acquired, transferred or utilized.

Capital being transferred is considered illicit when: First, the act of transferring it across countries is illegal (Money Laundering, Cash Smuggling). Second, it is the result of an illegal act (Drug Trade, Tax Evasion). Lastly, if it is used to finance an illegal activity (Organized Crime, Terrorism).[1]

Note:

While IFFs are a result of illegal activities, some activities contributing to the practice may circumvent that definition as they are not technically illegal but illicit. This means that although the activities are legal, they are not ethical or moral. Tax avoidance is one such example. Here multi-national corporations use the tax code to facilitate the process of paying as little tax as possible, to the detriment of the communities in which they generate revenue. It is seen as unethical because these corporations that are already incredibly wealthy do not pay their fair share of taxes while poorer people living in those communities have to pay taxes due them, no matter the cost. Because governments lose revenue by multinationals not paying their fair share, the next best option is rigorous regressive taxation that impacts poor and vulnerable groups the most.

2. Categories

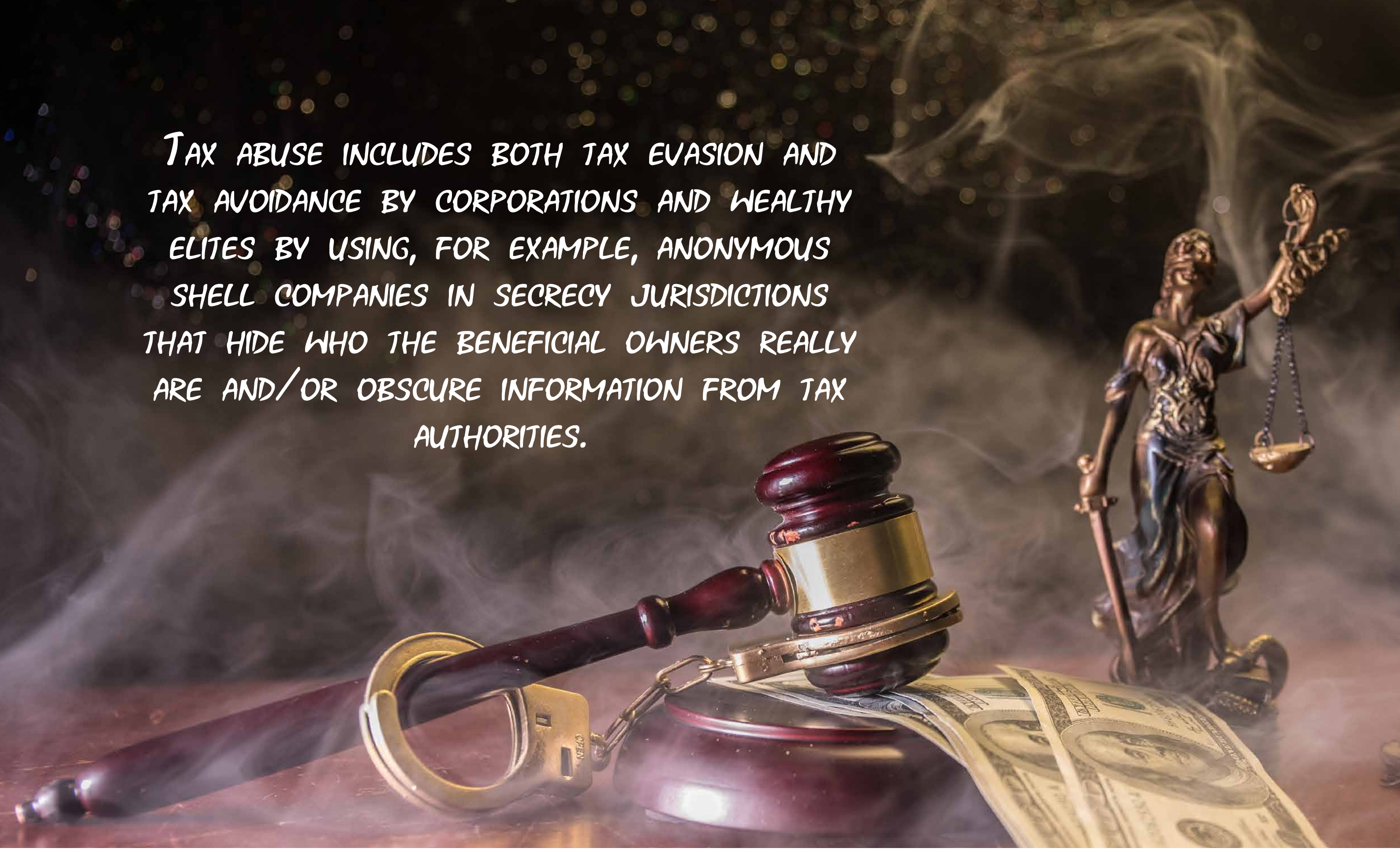
IFFs manifest in three main categories[2]

Proceeds from commercial activities: Often resulting from policy incentives, in principle, commercial activities refer to investment in productive activities, job creation and the transfer of managerial and technological skills. The commercial activities trigger the largest component of illicit financial flows through the use of 'abuse transfer pricing, trade mispricing, misinvoicing of services an intangibles and using of unequal contracts, all for the purpose of tax evasion, aggressive tax avoidance and illegal export of foreign exchange. Tax abuse includes both tax evasion and tax avoidance by corporations and wealthy elites by using, for example, anonymous shell companies in secrecy jurisdictions that hide who the beneficial owners really are and/or obscure information from tax authorities.

Proceeds from corrupt dealings: For example, bribes by corporations to secure public contracts/permits or false declaration of corporate profits in order to evade tax payment, especially by extractive industries such as mining and oil exploration. Corruption provides officials and their counterparts in the private sector with funds that can be transferred out of their countries, which are considered to be illicit financial flows.

Proceeds from criminal activities: For example human and drug trafficking, arms sales, poaching, etc. Bank secrecy rules usually conceal the origins of this illegally obtained money by making transfers through foreign banks or legitimate businesses in a process known as "money laundering".

1 A Scoping Study on Illicit Financial Flows Impacting Uganda
2 Attiya Waris for AWID, Illicit Financial Flows: Why we should claim these resources for gender justice, FEMNET, Research paper on Gender Dimensions of IFFs



3. Channels for IFFs

Although a number of channels for IFFs exist; including corruption, criminal activities, the informal sector, and digitalised economies, among others, this section will focus on loss of resources through aggressive tax avoidance mechanisms which contribute the highest percentage to IFFs. Some of these tax avoidance methods include;

1. Base Erosion and Profit Shifting (BEPS)

According to the OECD, BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments such as interest or royalties. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level.

a. **Abusive Transfer pricing,** Abusive transfer pricing takes place when a multinational corporation takes advantage of its multiple structures to shift profit across different tax jurisdictions. This is a situation where companies affiliated with each other (for example subsidiaries)agree on what price to charge a product in disregard of actual market prices in order to reduce on their tax burden. Companies charge a higher price to divisions in high-tax countries (reducing profit) while charging a lower price (increasing profits) for divisions in low-tax countries. For example if a multi-national company made soap as its core product but also had a subsidiary that provided transport services, in order to reduce on how much taxes they pay, they will price the cost of transportation high (in order to reduce on pre-tax profit in a high tax jurisdiction or low in a low tax jurisdiction since the low tax rate will not impact too much on high profits.

According to the 2018 UNECA study on the Global Governance Architecture for Combating Illicit Financial Flows the amount IFFs from Africa are estimated to now involve sums of upwards of $100 billion per year.

b. **Thin Capitalization,** This is a situation where a company uses debt financing (loans) to reduce on their profit and therefore their corporate tax obligations. Under this practice, a subsidiary in a lower-tax jurisdiction lends (sometimes at inflated interest rates) to a subsidiary in a higher-tax jurisdiction. The taxable earnings of the subsidiary in the higher-tax jurisdiction are reduced through the loan repayments, while those of the subsidiary in the lower-tax jurisdiction are increased. Here, it is important to first understand how profits are derived. A profit is a company's annual revenue minus expenses which may include salaries, interest payments on loans, cost of conducting research, etc. Before a corporate tax is levied, all these expenses are deducted from the company's revenue. Higher expenses mean lower profits and therefore lower taxes paid. In this particular case, companies will borrow money from their subsidiaries in low tax jurisdictions.

2. Double taxation Treaties (Agreements)

Double taxation treaties determine which country has the right to tax corporate profit when a company has subsidiaries in two or more countries. When a company invests in Uganda, and generates outputs and profits from this business in Uganda, you might think that Uganda would be the country to tax these profits. However, double taxation treaties can be a way that a company ensures that it is either taxed in a country where the taxation rate is lower, or that it is not taxed anywhere. The effect of double taxation treaties is therefore sometimes referred to as double non-taxation. (SEATINI, Double Taxation Treaties in Uganda)

African countries technically renounce their right to withhold taxes on financial resources channelled out of their countries when they conclude double-taxation agreements with tax; this provides an incentive for firms and others to exploit cross-border accounting and intragroup transactions to shift their earnings into a form in which taxation rights accrue to the other jurisdiction, if the rate of tax is lower, In this way, tax havens substantially erode the tax bases of African countries (African Civil Society Circle, 2015).

3. Trade misinvoicing

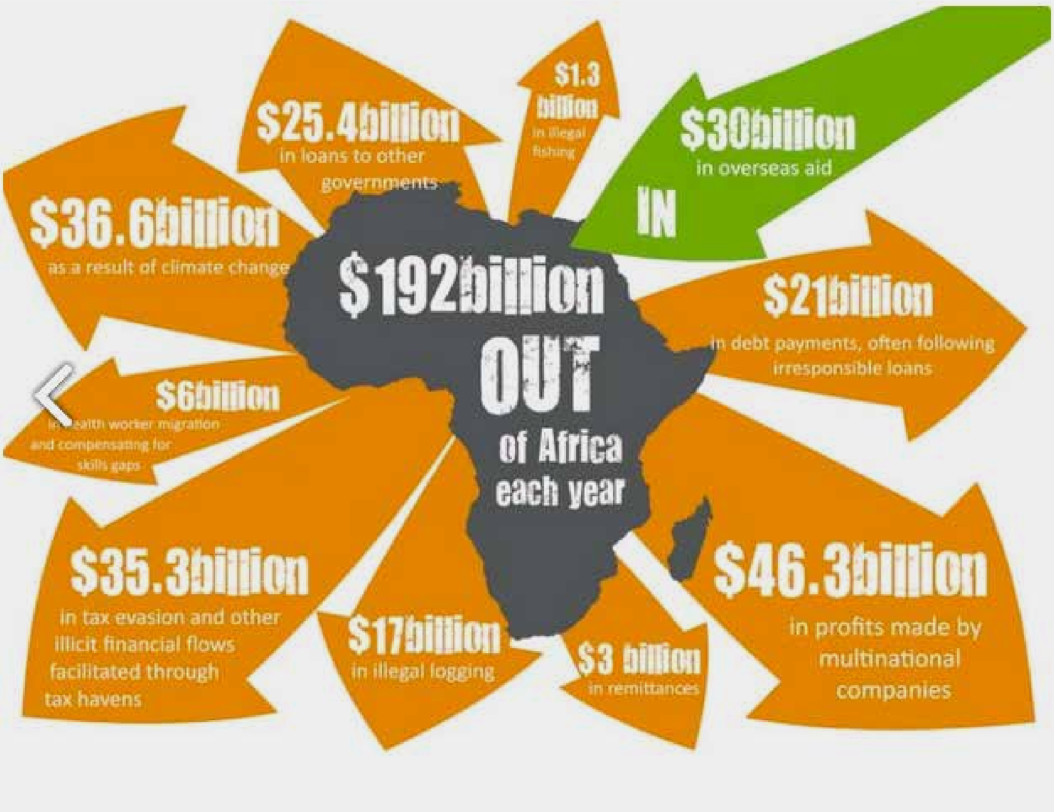
This is the deliberate falsification of the value, volume and/or quality of an international transaction of goods or services by at least one party to the trade. It involves the act of misrepresenting the price or quantity of imports or exports in order to hide or accumulate money in other jurisdictions. The motive could, for example, be to evade taxes, avoid customs duties, transfer a kickback or launder money. Additional concerns involve misinvoicing of services and intangibles, such as intellectual property fees, management fees or paxyments for overseas education, medical tours and foreign insurance. Information and communication technologies are making it possible to transfer large sums of money swiftly and easily. It is very difficult for authorities to monitor those transactions or to determine their validity and legality in terms of price, quality and quantity. Unfortunately, in this area, Governments of Africa also lack adequate tools, information and staff.[3]

4. Scale of IFFs in Africa

It is difficult to estimate the exact scale of IFFs because of the system of secrecy that enables the practice. The Mbeki High Level Panel on Illicit Financial Flows from Africa released a report in 2015 that showed that the continent loses an estimated 50 billion US dollars annually to IFFs. Commercial tax evasion accounts for 65% of IFFs, the revenue from criminal activities such as human trafficking and drug trade, 30% and flows from public corruption; 5%.[4] According to the 2018 UNECA study on the global governance architecture for combating illicit financial flows the amount IFFs from Africa are estimated to now involve sums of upwards of $100 billion per year.

In Uganda, IFFs account for annual losses of over 500 million US dollars.

Figure 1 A representation of the capital flows from Africa.



Source: AllAfrica.com, Africa Struggling to Tackle Illicit Capital Flows

3 Report of the High Level Panel on Illicit Financial Flows from Africa
4 FEMNET Factsheet: What are the gender dimensions of IFFs?

5. Enabling factors for IFFs

a) **An exclusionary and exploitative global financial system rigged to favour wealthy Northern countries.** The international financial system we know today – i.e. the compendium of legal agreements, institutions, and economic actors that together facilitate international flows of capital for investment and trade – was largely shaped by colonial interests that persist to date in new forms. (AWID). The system is controlled by Northern states influenced by corporations whose interests they also look to protect. African countries tend not to be represented in such organizations. The Organization for Economic Cooperation and Development (OECD), a membership platform dominated by the world's wealthiest nations is charged with developing and providing oversight on tax policy. Although countries can now engage with OECD, they do not have the same bargaining power. During the 2015 Financing for Development Conference, developed countries including the US, UK, thwarted attempts by the G77 (developing countries gathered under this umbrella) to create an intergovernmental body under the auspices of the United Nations that would provide a framework for addressing tax injustices at the global level. This was envisioned as a way to remove tax rule-making from the tight influence of the world's developed countries, through the OECD, giving developing countries a say, and broadly democratizing the process.

b) **Tax wars.** In a phenomenon known as the race to the bottom, developing countries compete amongst each other to attract large amounts of Foreign Direct Investment (FDI) by offering creative tax incentives and exemptions in a bid to reduce the cost of doing business for corporations. However in slashing taxes, developing countries drive their economies to the bottom of the pit as their revenue reduces with each incentive. This phenomenon is not by accident but rather the machinations of global financing entities like the World Bank and the International Monetary Fund. The advent of Structural Adjustment Polices encouraged developing economies to liberalize and adopt the language of "open for business" in order to attract investment and to also receive funding from these Bretton Woods bodies. This meant that countries had to loosen policies (including tax policies) that protect good and humane business practices in favour of corporations interested in profit. . This often results in double standards in tax regimes, making developing countries more vulnerable to IFFs taking place.

c) **Tax havens or secrecy jurisdictions.** Tax havens operate under a shroud of secrecy, shielding the ownership of corporations and their valuation from public scrutiny. Tax havens also have very low rates of taxation which is why they become attractive for Corporations. Tax havens like the Bahamas, Belize, Bermuda, and the British Virgin Islands, the Cayman Islands, Hong Kong, and Mauritius house companies for the purpose of tax planning.

d) **Globalisation.** increased interaction among people companies, and governments of different nations, in a process driven by international trade and investment and aided by information technology has made illicit financial flows inevitable because of the emerging global business models. Companies are now characterized by mergers and acquisitions as corporations try to expand their reach and business footprint across the world by taking over local businesses. If a company in the UK wanted to enter the chicken business in Uganda, instead of opening completely new operations, they would simply take over a local company, which opens new channels for IFFs. Furthermore, the merging of companies has led to the emergence of big and wealthy companies such as Amazon, Apple, Microsoft, Walmart, etc whose revenue is more than some countries' GDP. These companies have the power to change tax laws in their favor that allow them to pay as little as possible on corporate tax.

e) **Weak mechanisms and institutions for preventing illicit financial flows.** African Governments tend to employ law enforcement and regulatory agencies to prevent or reverse IFFs. Those agencies are the police, financial intelligence units, anti-corruption agencies, public procurement agencies, customs agencies, revenue services and other specialized or general agencies. The weakness of accountability mechanisms allow those involved in such flows to perpetrate them unpunished. Actors involved in IFFs in the public, private and criminal sectors are often able to perpetrate such flows from behind a veil of secrecy, or, even when their actions are uncovered, to escape punishment. Unfortunately, preventing IFFs faces significant challenges stemming from lack of knowledge, poor data, corrupt practices, capacity constraints and limitations in enforcement capabilities (African Union and ECA, 2015).

6. Sectors prone to IFFs in Uganda[5]

Mineral and natural resource wealth (extractives). The extractive sector is particularly vulnerable to IFFs. Evidence shows that extractive industries tend to be large contributors to illicit flows, through intentionally mispricing the value of the natural resource, disguising the volume or quality of the resource extracted, and by manipulating the prices of inputs to artificially reduce revenues in the extracted country (the difference in value being deposited in an overseas bank account). The sector is characterised with harmful practices i.e. Use of tax havens, transfer pricing, money laundering, preferential tax regimes, tax fraud, undeclared hedge funds, corporate loss through aggressive tax planning, bribery, corruption and exploitation of local communities and domestic economies.

State Owned enterprises (SOEs). Having SOEs, coupled with a low capacity to oversee them, leaves room for IFFs. The global average is 17 SOEs per country. Uganda currently has 22 SOEs, which is a relatively large number given the size of Uganda's economy and its technical ability to effectively and efficiently run institutions. Uganda's SOEs need to be subjected to timely public scrutiny to close down the opportunity of illicit funds flowing through them or being caused by actors within SOEs.

Financial Sector. Having a large financial sector is also known to contribute to illicit financial flows, on the basis that financial intermediaries such as banks can facilitate the absorption of these illicit flows, especially if they are not closely monitored by regulators. A larger financial sector is inherently harder to monitor, which necessarily gives more space for channelling wealth illicitly. Uganda's financial sector is not large by global standards (24 commercial banks), but it is highly concentrated: the top four banks control 55 percent of banking assets in Uganda. About 87 percent of commercial banks in Uganda are subsidiaries of foreign owned banks, including nine of the ten largest banks in the country. In cases of low supervision by regulators in Uganda, it would be especially easy for these commercial banks to facilitate absorption of illicit funds from or through Uganda and into other countries via their global network of branches.

Customs. An example of customs fraud is trade misinvoicing, this is the practice of under-reporting or over-reporting values on import and export invoices and is the largest source and conduit of illicit financial flows. It involves buyers and sellers presenting fraudulent documentation to customs officials. The value of their trade is falsified by under or over invoicing their trade documents to be less or more than the actual market value in order to circumvent the payment of customs duties, to hide transfers or wealth between the importing or exporting countries or to evade controls on foreign exchange (Times Live, 2015).

5 Ibid 1

Informal sector. The debate on illicit financial flows in Uganda cannot be discussed in isolation of the informal economy nexus, as underground channels provide a good blend for illicit activities, including illicit financial flows. The conundrum here is the blurriness in the distinction between 'licit' and 'illicit' in the context of a large informal sector that also provides livelihoods for a majority of the citizens. Not all that transpires in the informal sector is bad. Nearly 50 percent of the economy is informal in Uganda, which means that a significant portion of economic activity takes place outside the watch of government and is therefore difficult for government to monitor and regulate.

LOST RESOURCES THROUGH IFFs OFTEN CANNOT BE USED LEGITIMATELY AND END UP FUELLING CRIMINAL ACTIVITY, INCLUDING ILLEGAL ARMS TRADE, HUMAN TRAFFICKING OF WHICH 49 OF VICTIMS ARE WOMEN AND 21 ARE GIRLS

Gambling. An emerging area with huge opportunity for illicit financial flows is the gambling industry. Uganda's gambling industry has surged in growth over the last two decades, with tax revenue collections growing from UGX 0.24 billion in 2002/3 to UGX 11.1 billion in 2013/14. While increased revenue is nominally good for the government, it is worth noting that a large gambling sector may increase the risk of IFFs. This is because gambling is one of the alternative methods of laundering money, thanks in part to the large volumes of cash these businesses tend to handle.

7. Gendered impacts of IFFs

IFFs drain critical resources from communities that could be invested in critical areas of development. This impact is felt most heavily by women in those communities. The gendered dimensions of IFFs manifest in the following ways;

a) Impact on delivery of social services

With a shortfall in revenue collection to finance the budget, there is a reduction in spending in key areas such as education, health care, cares facilities, which has a direct impact on women and women-headed households that are more vulnerable to national budget constraints.

b) Unemployment and under investment in the economy

According to 2016 ILO figures, in many regions in the world, in comparison to men, women are more likely to become and remain unemployed. They have fewer chances to participate in the labour force and – when they do – often have to accept lower quality jobs. Women are typically the first to lose their jobs and/or accept shorter hours and bad working conditions to keep jobs19.

c) Regressive fiscal policies

Regressive and Indirect tax mechanisms have a particularly negative effect on informal workers and people living in poverty – the majority of whom are women – as they spend a large part of their income on taxes for the essential goods and services they consume to sustain livelihoods, perpetuating the cycle of poverty and aid dependence. The mobile money tax imposed in Uganda further marginalised women who had historically been excluded from financial services provided by tax. The new regressive tax reduced women' use of mobile money services.

d) Reliance on debt and development cooperation

Budget shortfalls indicate that states have to increasingly rely on aid and debt in order to fund development initiatives. As states borrow more, so do their obligations to servicing loans at the expense of public services that women benefit from. In Uganda, the 2019/2020 has interest payments at about 4 times the amount dedicated to health and 3 times the amount dedicated to education.[6]

e) Threat to Women's Peace and security

Lost resources through IFFs often cannot be used legitimately and end up fuelling criminal activity, including illegal arms trade, human trafficking – of which 49% of victims are women and 21% are girls24 – and other activities undermining peace and human rights. Other conflicts are fueled by illegal exploitation of mineral wealth such as diamonds in Liberia and Sierra Leone. In all these situations of conflict, women and children bear the brunt in the from of rape and difficulty to accessing food and water for the family.

f) Lack of resources for women s rights and gender justice

Without enough resources mobilized from the tax base, there is very little resources dedicated to tacking women's rights work. Research shows that only 1% of development work funding goes to funding women's rights. This became particularly acute after the 2008 financial crisis. Again, in situations of resource constraints, women suffer the most.

g) Increased inequalities

With corporations accumulating more wealth because of tax dodging, there is an increase in inequalities across the board. The first is in access to resources between women and men. Men own 50% more of the world's wealth than women and control over 86% of corporations. Furthermore, in 2018, 26 people owned the same wealth as 3.8 billion people who make up half of humanity. (OXFAM). That most of this inequality is resource driven and that men own most of the resources means that men and corporations get to decide what is good for women.

Uganda s gambling industry has surged in growth over the last two decades, with tax revenue collections growing from UGX 0.24 billion in 2002/3 to UGX 11.1 billion in 2013/14.

6 https://budget.go.ug/dashboard

Plot 222 Mama Africa Close,
Off Kiwatule Road, Ntinda Kigoowa
P.O.BOX 24130, Kampala-Uganda
Tel: +256 414 543 681
Email: amwa@akinamamawaafrika.org
Website: www.akinamamawaafrika.org
Facebook: Akina Mama wa Afrika, **Twitter:** amwaafrika