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REPORT 1

STATE OF ILLICIT FINANCIAL FLOWS IN SOUTH AFRICA

A SCOPING EXERCISE

1. INTRODUCTION

1.1. Background

Illicit financial outflows are broadly defined as "all unrecorded private financial outflows involving capital that is illegally earned, transferred, or utilized, generally used by residents to accumulate foreign assets in contravention of applicable capital controls and regulatory frameworks" (GFI,2013). According to recent estimates from Global Financial Integrity, SA has lost more than 100.7 billion dollars over for the period 2002-2011. South Africa is ranked number 13 in terms illicit out flows among developing countries. At continental level, illicit financial out flows continue to deny Africa much needed capital for its development. A recent estimate by Global Financial Integrity (GFI) and the African Development Bank on illicit outflows suggests that Africa lost US$1.2-1.3 on an inflation-adjusted basis over the period of 1980-2009.

In light of the above, there has been increasing efforts to do something about illicit financial flows in Africa. The High-Level Panel on Illicit Financial Flows from Africa was established following a resolution of the 4th Joint Annual Meetings of the ECA/AU Ministers of Finance, Planning and Economic Development in Africa in March 2011. The Panel has adopted a plan of action which provides a space for CSO actors to support the initiative. In addition, the Tax Justice Network in Africa (TJN) is coordinating a network of 25 members focussing on tax justice and illicit financial flows at national levels. The Nairobi Declaration on Taxation and Development equally calls on the G2O, the UN, African governments and other international state and non-state actors to challenge tax leakages, and financial secrecy offered by offshore financial centres. In addition, discussions under the post 2015 MDGs have spotlighted the importance of domestic resource mobilization by curbing illicit financial flows.

The South African revenue service commissioner in his presentation to standing committee on finance (SA parliament) has underlined that South Africa faces a very high risk in terms of illicit out flows. He elaborates: "In part because of our world-class financial systems, along with the large extractive industry of mining and resources, the presence of large multinational corporations, and our open economy and tradable currency, South Africa is at very high risk of this"[1]

African Monitor through its Development Support Monitor and advocacy on financial transparency has been advocating for policy and practise change to reduce Illicit out flows from Africa. This work in South Africa is motivated by the magnitude of the outflows; and the need for South Africa to close its financing gap for urgent development programmes like job creation and infrastructure development.

1.2. South African Knowledge Base on Illicit Outflows

South African research on financial outflows has focused more on capital flight rather than illicit outflows. There is substantial literature on capital flight from South Africa which focuses on the magnitude and factors affecting capital flight from South Africa during the last days of apartheid and post-apartheid periods (Ben w. Smit, 1991; Zavareh Rustomjee, 1991; J.W Fedderke and W Liu, 2001; Seeraj Mohamed and Kade Finnoff, 2004). A study by Mohammed and Finn (2004) estimated capital flight

[1] Address by commissioner of the south African revenue service to the standing committee on finance on the presentation of the sars strategic plan 2013/14-2017/18 and the 2013/14 sars annual performance plan 14 may 2013

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from South Africa to reach 6.6 percent of GDP per year for the period 1980 to 2000. Their findings indicate that capital flight as a percentage of GDP was higher after the democratic elections in 1994, even though, there was much more political and economic instability during the period before the democratic elections.

There is not much research done to uncover key aspects of the illicit financial flows phenomenon particularly focused in South Africa. However, there is sizable research work focused at a contintal and sub-regionallevels (Boyce and Ndikumana; Global Financial Integrity; AFDB; Peter Reuter; World Bank). This research has shed some light on the phenomenon, estimated the magnitude illicit outflows from developing countries and attempted to uncover the underlying factors.

1.3. What are Illicit Outflows?

Illicit outflows according to United Nations Economic Commission for Africa based on the research by (Reuter, 2012; Baker, 2005; and Kar, 2011) defines illicit outflows "as money that is illegally earned, transferred, or utilized. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit". The recent report by Global Financial Integrity and African Development Bank defines illicit outflows as "all unrecorded private financial outflows involving capital that is illegally earned, transferred, or utilized; generally used by residents to accumulate foreign assets in contravention of applicable capital controls and regulatory frameworks". Illicit outflows differ from the ordinary capital flight, which is movement that is recorded and mostly earned from criminal, corrupt and commercial activities.

Illicit financial outflows is composed of (1) the proceeds of theft, bribery and other forms of corruption by government officials; (2) the proceeds of criminal activities including drug trading, racketeering, counterfeiting, contraband, and terrorist financing; and (3) the proceeds of tax evasion and laundered commercial transactions.

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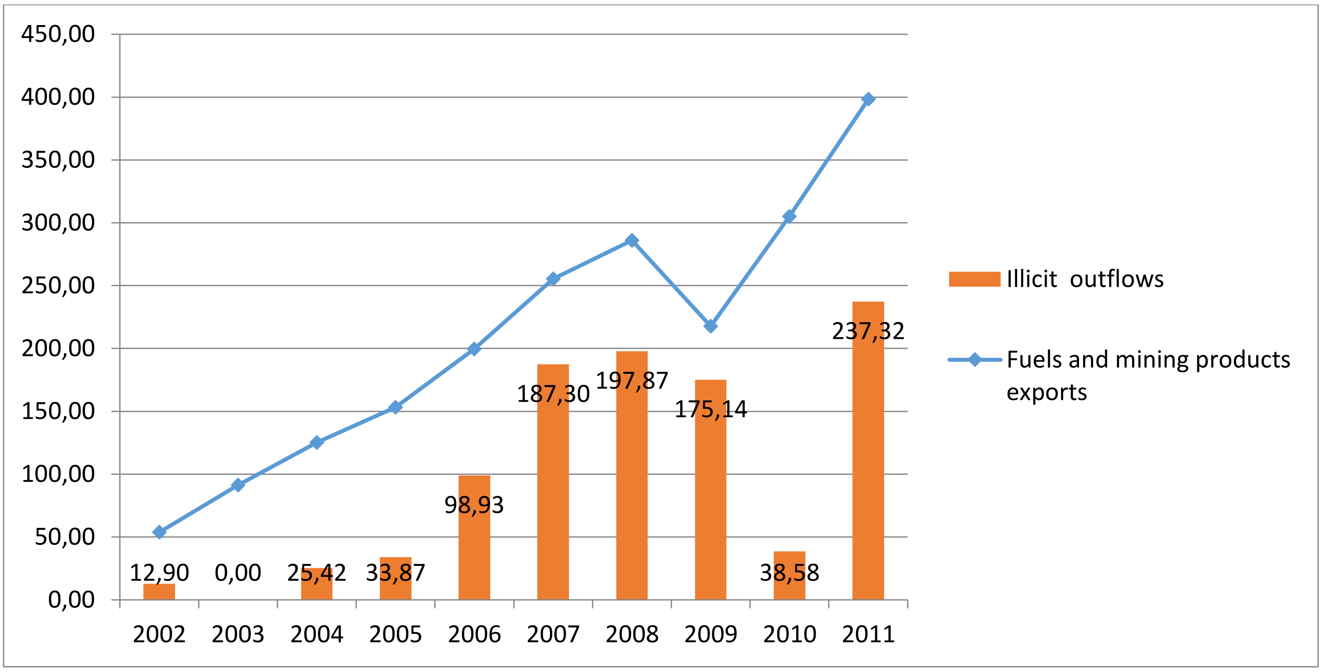
The most important component of illicit outflows is trade mispricing that is the mis-invoicing of international trade transactions with the ultimate purpose of diverting financial resources. Trade mispricing outflows have two components: export under-invoicing and import over-invoicing. In the first component, exporters understate their export revenues on their invoices and request their trading partners to deposit the balance in a foreign account. In the second component, importers overstate import expenditures, overpaying foreign exporters and asking them to divert the excess funds to a tax haven or a bank in an advanced country.

2. Quantifying Illicit Financial Outflows in South Africa

South Africa is heavily affected by illicit financial outflows, according to data released by Global Financial Integrity. Between 2002 and 2011, South Africa lost a cumulative 1,007 billion rands to illicit outflows. South Africa has a long history of financial outflows. An earlier report shows that South Africa has been experiencing huge illicit outflows starting from the last years of the apartheid period and political transition. It is interesting to see post 1994 the trend continued. It has reached 23.7 billion rands in 2011. As shown in the figure below the resource outflows has increased from 2004 to 2008, followed by two years decline. In 2011 it reversed drastically to reach to 237 billion outflows.

Figure 1: South Africa-illicit Financial Flows[2] (SA Rands - billions)

[2] **HMN+GER Non-normalized**



Source: WTO and Global Financial Integrity, 2013

Trade mispricing accounts for over 80% of the illicit outflows (GFI, 2013); and change in magnitude of trade mispricing is directly related to change in volume of trade (UNECA,2011). In the South African case, a similar pattern is observed (see figure above). A simple calculation of correlation between South African exports and illicit outflows shows a strong positive (0.78) correlation and the correlation becomes stronger (0.88) when the illicit data is lagged by one year. This simply means that the incident of illicit outflows increases with increases in export trade.

3. Impact of Illicit Outflows on Development Progress

3.1. SA's Developmental Challenge

South Africa needs to mobilize resources both from domestic private and public sources to move to **a** higher growth path. South Africa still faces high level**s** of poverty, unemployment and inequality. Therefore, special focus needs to be placed

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on raising domestic resources, which would include national savings by firms and households. In addition, more effective tax collection is needed to increase public resources, as well as the rationalizing of government expenditure. Illicit flows constitute a major source of domestic resource leakage, which drains foreign exchange, reduces tax collections, restricts foreign investments, and inevitably reduces the capacity of the country to address urgent developmental problems like worsening unemployment, inequality and poverty.

Even if there has been a moderate increase in gross domestic saving and investment in South Africa, it falls far below the average for emerging markets and developing economies. Plugging the resource outflows in the form of illicit outflows could to a certain degree bolster domestic saving and investment.

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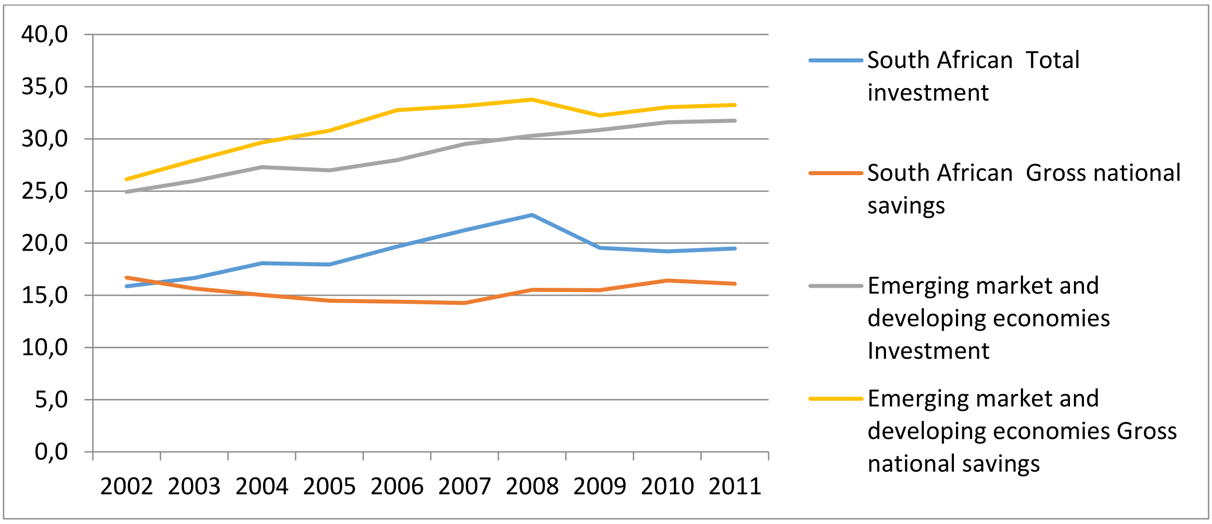
Figure 2: Gross Domestic Saving and Investment (percentage of GDP)



Source: IMF- 2014

There is empirical evidence that illicit outflows deprive African countries essential savings and reduced domestic investment. Ndikumana (2013) explains that illicit financial flows amount to a depletion of domestic savings – both private and public savings – which reduces domestic capital formation. He shows an econometric estimation in case of South Africa, if the illicit outflows were plugged, the country could have grown by an additional (potentially) 0.9 percent per annum for the period 2000 to 2010[3].

3.2. Public Revenues

The illicit outflows related to tax reduce public revenues available for development. It also counters the progressiveness of the tax system as high net worth individuals and corporate companies resort to avoid tax through illicit resource transfers, which has direct implication on economic inequality.

[3] Average economic growth was 3.6 per annum for the period of 2000- 2010

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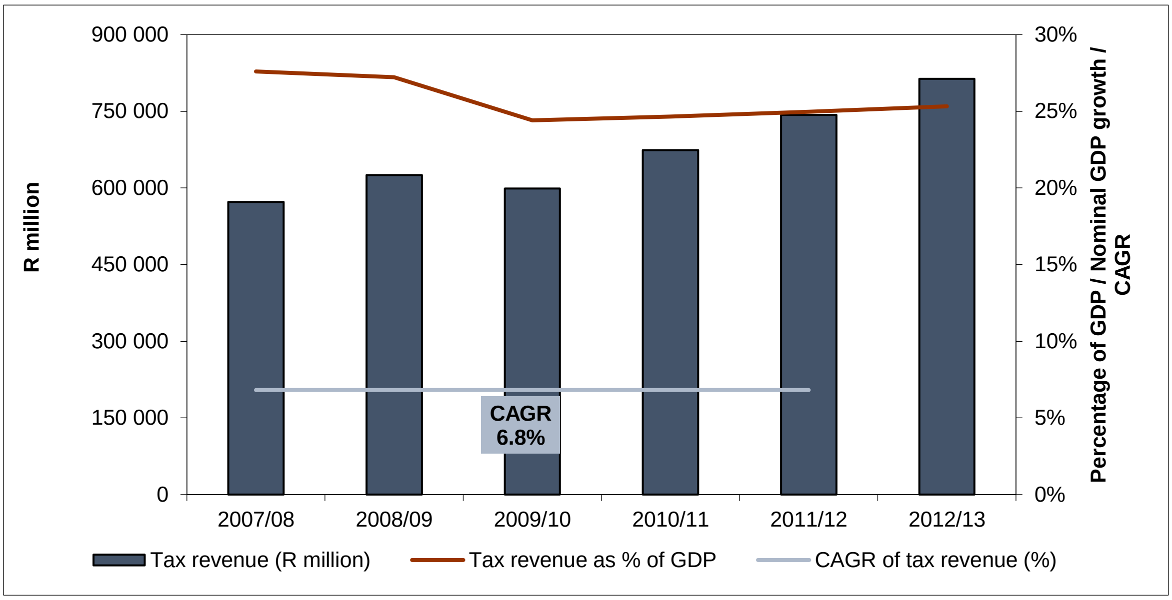
The tax revenues in South Africa have increased by 9.5 percent reaching 813,826 million rand in the 2012/2013 financial year. Taxes have been increasing after a sharp decline experienced in 2009/2010 due to the global recession. The tax to GDP ratio still hovers on its long term 25% of GDP despite a significant potential to increase tax revenues. The compound annual growth rate is 6.8% per year.

Figure 3: Tax revenue in South Africa



Source: South African treasury, 2013

In terms of composition of tax collected, 34% tax is collected from personal income tax, 19% in the form of corporate income tax, 26% is value added tax (VAT), and 19% is in other forms of tax. In the last financial year there has been a marked shift in terms of tax composition, with significant decrease in corporate income tax and an increase both in personal income as well as VAT taxes. This raises a concern as there is growing evidence that highlight the tendency of VAT to be regressive (André Decoster,, et al ,2010; *Go, Delfin S.;2005).*

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The national treasury report notes "Corporate Income Tax (CIT) was responsible for much of the contraction as companies' profit waned in the face of declining global and domestic demand. Assessed losses that were accumulated in the past by some companies were available to be offset against their taxable income in later years. The tax-to-Gross Domestic Product (GDP) ratio declined to its long-term average, well below pre-financial crisis levels" (National Treasury, 2013).

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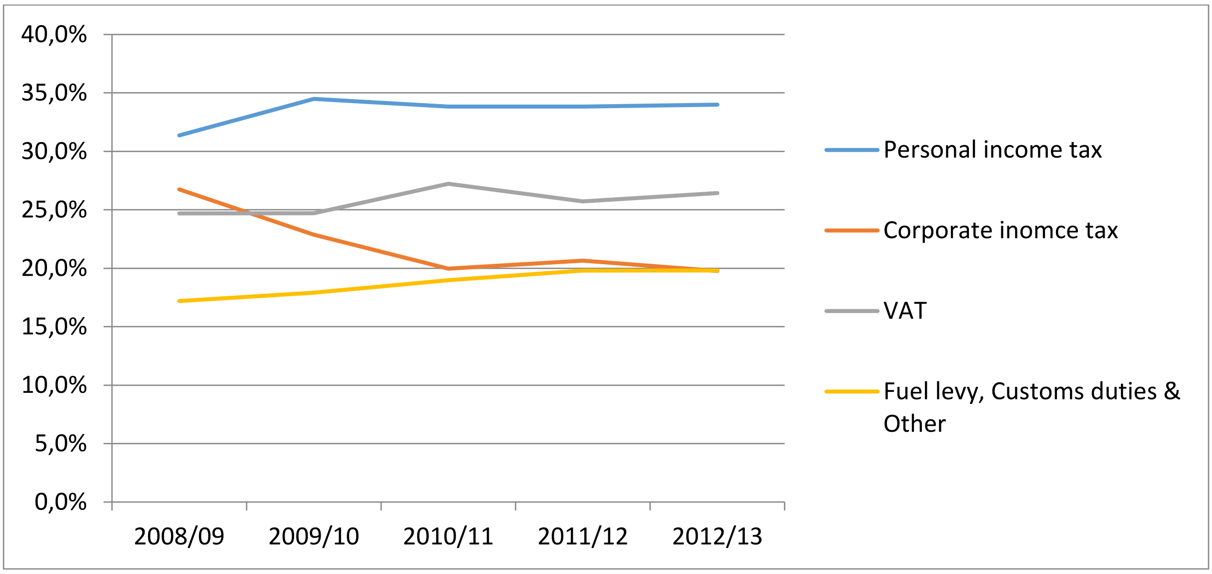
Figure 4: Composition of tax revenue- 2008/1013



Source: SARS 2013.

The loss of tax revenues due to the erosion of the South African tax base through illicit out-flows is to be expected. It is mostly the higher net worth individuals and corporate tax entities that are involved in tax motivated illicit outflows. On personal income tax - high net worth individuals are the likely beneficiaries of illicit outflows. Hearson observes that "access to the types of financial advice and overseas connections needed to avoid or evade income tax is probably restricted still further to the wealthiest within the population" (2014:26).

The corporate tax evasion is more pervasive. The UNECA report notes that most significant perpetrators of trade mispricing are multinational corporations (MNCs). This is due to their strong global presence and influence, which facilitate the illicit transfer of funds. The South African Revenue Services (SARS) notes that the world-class financial systems, along with the large extractive industry of mining and resources, the presence of large multinational corporations, and open economy and tradable

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currency, exposes South Africa to a very high risk for tax motivated financial outflows [4].

The SARS Commissioner, in his report to parliament's finance committee, has noted that SARS has detected an increase in the use of cross-border structuring and transfer pricing manipulations by businesses to unfairly and illegally reduce their local tax liabilities[5]. There are indications that major South African firms among the top three by market capitalisation at the Johannesburg stock exchange has been implicated in other countries – for instance Glen Core, SAB Miller, Anglo American.

Research by Action Aid shows how SAB Miller – a South African multinational company - has been implicated on tax evasion in countries like Ghana. It estimates that SAB evaded taxes amounting to £20m a year from African countries. Glen Core has been under investigation in Zambia, UK and Italy for similar charges[6]. A number of subsidiaries of Anglo American are registered in multiple tax havens[7]. These are examples of a number of anecdotal evidences that point to South African firm's involvement on illicit outflows. However this demands for South African CSOs to work more on investigative research to find solid evidence.

4. The Case For Immediate Action

The continuous resource outflow in the form of illicit outflows have denied South Africa scarce resources that are investment capital and public revenues. The dramatic reduction of these outflows could contribute to employment creation via increased

[4] http://www.iol.co.za/business/news/tax-evasion-remains-a-risk-says-sars-1.1515785#.Uu4hXfmvVyU
[5] http://www.africanbusinessreview.co.za/money_matters/tax-evasion-costs-south-africa-billions
[6] http://oecdwatch.org/cases/advanced-search/issues/casesearchview?type=Issue&search=en_Tax%20Evasion%20by%20Glencore%20and%20First%20Quantum%20Mining%20in%20Zambia
[7] http://www.actionaid.org.uk/sites/default/files/doc_lib/collateral_damage.pdf

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investment in the economy and investment on human capital though increased public spending. The over one trillion rand[8] that has left the county over the last 10 years could have reduced unemployment and increased public spending on health and education in the country.

The development benefits of reducing outflows thereby strengthening of domestic resource mobilisation and enhancing macroeconomic stability could increase economic growth and attract more investment to South Africa.

The National Development Plan aims to reduce the level of unemployment from 25% to 6% by 2030, and it estimates the gross Investment needs to increase from current 17% to 30% by 2030. Thus, if South Africa is going to reduce poverty though accelerated employment creation, there is needs to increase domestic saving and investment. Stopping the leakage of the countries saving through illicit outflows could contribute towards achieving this elusive development goal of reducing unemployment in South Africa.

Public revenues lost due to illicit outflows (assuming at 29% of corporate income tax) could be roughly one third of the total amount[9]. Under this simple illustrative assumption, South Africa could easily increase its health spending or partially finance it's the ambitious national health insurance (NHI) initiative which requires R125 billion in 2012 to R214 billion 2020 and R255 billion in 2025 (Policy on National Health Insurance, 2011). These are only few examples of the apparent development benefits that could be generated from reducing the illicit out flows.

5. Conclusion

[8] Between 2002 and 2011, South Africa has lost a cumulative 1,007 billion Rands to illicit outflows)
[9] This hypothetical and it is only for illustrative purposes

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South Africa is among the top 20 countries in the world affected by illicit out flows. For a capital scarce country which has been struggling to find a solution for the high level of unemployment, poverty and inequality, it presents a huge drawback. There are indicative figures estimated by Global Financial Integrity and African Development Bank that gives a rough indication of the severity of resource leakage in the country. The country has lost over a trillion rands to illicit outflows. Authorities have been claiming albeit vaguely, that they have detected certain level of illicit resource transfers. However they publish the amount or the perpetrators of illicit out flows.

Illustrative computations shows South African growth rate could have increased by more than 20% (i.e. additional 0.9% GDP growth estimated by Ndikumana 2013). South Africa could have easily achieved the target investment rate projected by the National Development Plan to reduce unemployment to 6% from current 25 percent. In terms of Public revenues, plugging tax motivated illicit outflows could make the ambitious national health insurance possible.

There is strong case for South African CSOs and think tanks toactively promote awareness and build a local knowledge base on illicit out-flows. Given that the existing academic literature is confined to capital flight and there is only very limited investigative journalism on illicit outflows, there is also a need for localised research. Most advocacy and media work has been based on estimation provided by Global Financial Integrity. There is a need for more effective popularization and advocacy work based on local information and knowledge base.