Impact of Illicit Financial Flows on DOMESTIC RESOURCE MOBILIZATION: Optimizing Revenues from the Mineral Sector in Africa
The recent furor over the Panama Papers has galvanized global attention on the impact of illicit financial outflows on domestic resource mobilization. However, renewed impetus for change will require complementary analytical and strategic work and effective concerted actions. This is a summary of a follow-up report to the landmark Report of the High Level Panel on Illicit Financial Flows from Africa, commissioned by the African Union and the Economic Commission for Africa. Based on four country case studies, this report demonstrates the level of vulnerability of the mining sector of Africa to sophisticated cross-border corporate practices which erode the tax base of its countries.

The report adopts a policy-oriented approach, systematically examining risks points of illicit financial leakages along the mineral value chain. The selected countries – Democratic Republic of Congo, South Africa, Tanzania and Zambia - reflect an inclusive range of policy, institutional and economic realities. They are all mineral-dependent economies, albeit at different stages of economic development and structural transformation. Their experiences reflect the diversity of the continent.

The resource potential of Africa is enormous, confirming that the continent has endless opportunities to finance its development priorities. In fact, mineral endowments represent some of the best assets for mobilizing revenues for growth and structural transformation. Even with collapsed prices and depressed markets, the extractive sector remains a significant source of fiscal revenues for many countries, accounting for more than 70 per cent of African exports. While extensive swaths of Africa’s territory remain unexplored, the continent hosts an estimated 30 per cent of the world’s mineral reserves and produces an even greater share of key precious and base metals, as well as gemstones, including platinum group metals (54 per cent), diamonds (78 per cent) and chromium (40 per cent).

Translating the abundant wealth into sustained riches for all citizens, however, remains a challenge. Country experiences suggest that without specific policies to address key governance challenges, the contribution of the extractive sector to broad-based socio-economic development will remain suboptimal.

However, besides equity and transparency, African countries are facing an even greater challenge of ‘fairness’. Mineral-rich countries are not collecting the type of tax revenues from their resources that their production value would suggest. Tax efforts in resource-rich African countries have remained below the African average. Cross-border illicit financial leakages drain away much-needed resources that would otherwise be available to finance development priorities. The case-study countries collectively bear one of the largest burdens of illicit financial flows from the continent. Estimates by ECA show that, over the period 2000-2010, more than half (56.2 per cent) of the IFFs from Africa came from the extractive sector and this was highly concentrated in a few countries. The High Level Panel originally estimated that over $50 billion leave the continent annually, and this was considered a conservative estimate. In fact, according to Global Financial Integrity, the continent bears the most disproportionate burden of unrecorded cross-border financial outflows as a percentage of gross domestic product (GDP), at approximately 8.6 per cent of GDP.

Domestic resource mobilization and illicit financial outflows are at opposite ends of the goal to build effective ‘developmental States’. Policy and compliance gaps in regulatory regimes along the mineral value chain create loopholes for illicit financial outflows, undermining countries’ potential to mobilize much-needed domestic resources for their development.

Good governance is key to mobilize adequate domestic resources and plug loopholes that facilitate illicit financial outflows. It entails the ability to formulate and implement effective strategies, policies, laws and regulations for mobilizing optimal revenues from the mineral sector. At a minimum, this involves minimizing illicit financial flows and, at best, entirely eliminating resource mobilization-inhibiting practices along the mineral value chain. Governance of domestic resource mobilization is also shaped by institutional and political economy factors, at both the national and international levels. Incentives for illicit financial
leakages stem from policy and compliance gaps allowing from tax evasion and weak state institutions. Corrupt tax administration may also undermine the enforcement of policies to curb illicit capital flows.

Key Findings

The report demonstrates that inhibitive practices related IFFs and domestic resource mobilization in the mineral sector are increasingly widespread and complex. They are also global in nature. However, design and compliance gaps in countries’ institutional frameworks transform tax evasion and avoidance opportunities into harmful cross-border IFFs. The risks vary along the mining value chain, in terms of exploration, exploitation, transportation and marketing. Different minerals face different levels of revenue leakage risk.

Most countries lack a whole-of-government policy consistency framework. While there is increasing awareness of multinational companies’ tax avoidance practices in the sector, no comprehensive working definition of illicit financial flows exists in any of the mineral regimes studied. The case-study countries have incorporated various anti-avoidance measures into their policies, laws and regulations targeting specific aspects of illicit financial flows, such as transparency and accountability, as well as corruption and money laundering. Meanwhile, the trade and investment incentives designed to encourage foreign direct investment in the sector are overly generous and misaligned with revenue mobilization objectives. Due to tax exemptions in the sector, for example, tax authorities are losing more than $1.6 billion a year in foregone tax revenue in Zambia.

Specifically:

- Policies and legislation are creating loopholes along the entire mining value chain
- Bridging the information gap, particularly regarding geology, remains key to effective compliance
- A Balanced mix of tax instruments is key to optimal resource mobilization
- Good governance remains key to domestic resource mobilization
- Capacity remains a binding constraint

Policy Recommendations

Curbing IFFs from the extractive sector requires collective action at all levels. Below are some proposals for tackling the complex challenge of corporate tax avoidance, as well as suboptimal domestic resource mobilization in the African mining sector. These are provided in much greater detail in the report itself. The recommendations are presented at the global, regional and country level.

Global

- Establish inclusive, transparent global governance frameworks to curb IFFs: The global community must take firm collective action to increase access to information, identify particular IFF risks, include stronger mandatory disclosure requirements, and explore a UN-established global mechanism for repatriation of proceeds from tax evasion and avoidance.
- Increase technical support for African countries: global partners should step-up and coordinate efforts to strengthen capacity of African countries, through means such as South-South initiatives and in accordance with the Addis Ababa Tax Initiative, United Nations Agenda 2030 and African Union Agenda 2063.

Regional

- Establish progressive African leadership to promote international tax cooperation: The AUC should support countries’ consistent, coordinated and proactive commitments to tax transparency, with specialized organizations providing specific support to mineral-rich African countries, such as ATAF, AMDC, ECA and others, along with strengthened involvement of Regional Economic Communities while supporting existing frameworks such as EITI and exploring the possibility of a Pan-African Metal and Mineral Exchange.
- Reduce and stem illicit financial flows by consistently enhancing the capacity
of African countries: The Africa Mining Vision (AMV) must be a guiding principle for designing African policies to stem outflows, and the AU should ensure that capacity building targets treaty negotiations and other vital elements of this. Pooling of resources and expertise through peer-learning will be vital in this, with a structured platform to promote collaboration between customs agencies, tax authorities, law enforcement and ministries of mines.

**Country**

- Ensure policy consistency for effectively stemming IFFs: countries need common working definitions for tackling IFFs, with state-centered efforts given the scale of the outflows and the challenges that exist, while using the AMV as a basis for much needed reforms broadly and specifically regarding minerals. Governments should focus on progressivity and stability in their approach to mineral taxes, while clamping down on transfer mispricing with tougher legislation based on arms’ length principles. Other approaches such as limiting excessive interest on loans deducted by companies, reviewing existing double taxation treaties, requiring companies to publish beneficial owners and those of subsidiaries when bidding for concessions or licenses, should also be explored.

- Strengthen capacity to implement an effective, forward-looking approach: Governments should embrace international initiatives while also strengthening capacity to negotiate and implement new agreements and mechanisms, providing tax authorities with greater resources and staff to undertake systematic audits along the mineral value chains, while modernizing administration and IT systems and stepping up investment in geological information, with support to civil society organizations for their involvement as well.