



Curbing Illicit Financial Flows and Creation of Fiscal Space to Enable SADC to Finance its Regional Programmes Southern Africa Trust 2016

Contents

Ex	ecutive Summary	3
1.	Introduction	4
2.	Quantifying Illicit Financial Flows	6
3.	Trends And Paterns Of Illicit Financial Flows In The SADC Region	10
4.	Revenues That Can Be Collected From Curtailing Illicit Financial Flows	15
5.	Summarizing Observations	18
6.	References	19

Executive Summary

Recognizing the need to mobilise own resources to finance its own development programmes and projects, the SADC has embarked on a resource mobilisation framework. This report contributes to this effort to develop a resource mobilization framework by assessing curbing illicit financial flows as a measure to boost resource mobilization in the region.

The observations that emerge from studying this option of curbing illicit financial flows are the following;

- Accurately measuring illicit financial flows is central to curtailing them. But quantifying illicit financial flows is notoriously difficult because of the secrecy nature of the transactions that underlie them. Because of their illegal nature, these transactions are meant to disappear. As such, no official statistics exist on which they can be measured accurately. Instead, researchers use indirect methods to provide estimates of them. However, researchers are yet to agree on a single methodological framework that can be used to empirically assess the various kinds and forms of illicit financial flows in a comprehensive way. Instead, each method that is used is only suited to uncover a specific form of the illegal activity that is deemed to underlie the illicit financial outflows. Thus, the methods are highly uncertain. To circumvent this, and in the quest to get a broader understanding of illicit financial outflows in a specific country or group of countries, most analyses use hybrid methods that combine various methods.
- Despite this lack of methodological consensus, estimates provided by these various methods have proved useful in characterizing the scale of the problem and its ramifications for economic development of countries that are affected.
- Following on this practice in the literature, this report based its analysis on estimates from a hybrid method implemented by Kar and Spanjers (2015) to illustrate the extent of illicit financial flows in the SADC region. This showed that the scale of the problem is big, with illicit financial flows amounting to US\$309 billion and an average of US\$31 billion per year over a ten-year period from 2004 to 2013. Kar and Spanjers' (2015) estimates however offer only a partial analysis of the problem, as, in their methodology, they are only able to study two conduits of illicit financial flows.
- In term of these estimates, leakages through the balance of payments and misinvoicing of trade generate substantial Illicit financial outflows. However, it is misinvoicing of trade that is the primary method through which capital is illegally transferred out of the region, accounting for about ninety % of the estimates that Kar and Spanjers (2015) have provided.
- Nevertheless, even on this partial discourse, analysis of tax revenue loss showed that the region lost an average of US\$9.5 billion in tax revenue because of the illicit financial flows arising from trade misinvoicing. While this sum is derived from only a partial analysis of the scale of the problem, it serves as an indication of the size of resources that could be retained and directed towards development activities in the region if trade misinvoicing was curtailed. Moreover, this figure represents only funds that can be retained from illicit financial outflows that arise because of misinvoicing of trade. If the whole range of the other forms of illicit financial flows were considered, the scale of funds that could be retained could be substantial. For that, however, further investigations regarding both the magnitude and impact of those other conduits of illicit financial flows is needed.

1. Introduction

1.1 Background

The Southern African Development Community (SADC) has since inception continued to rely on resources from member states and Development Partners to finance implementation of its activities and development projects. However, this model of funding has not worked well. It has proved largely ineffective, and, as a result, many of the activities and projects planned over the years have not been implemented. This is because the Member States' contributions have often proven insufficient, averaging only about 9 % of the total resources required. Instead, it is the Development Partners that have provided the bulk of the resources, about 91 %. However, the donor countries themselves are facing fiscal challenges at home that have necessitated them to reexamine development aid expenditures, and, thus, made reliance on development aid unsustainable and unpredictable.

Yet the increase in regional activities that has occurred overtime and those that are planned in the future require more resources. Estimates, for example, indicate that the SADC will require about US\$260 million to finance regional projects in the next five years and about US\$64 billion to pay for infrastructure projects over the same time. Of the US\$64 billion needed for fund infrastructure projects, the SADC has only US\$43 billion committed to the budget, leaving a financing gap of about 99%.

Thus, it has now been recognized that the dependence on donor resources needs to be reversed and the Member States themselves need to step up and shoulder the bulk of the funding of SADC's activities and projects. Pursuant to this recognition, the 2008 Windhoek Declaration of the SADC Council of Ministers called for and directed the SADC Secretariat to seek alternative sources of income so as to reduce dependence on donor funding. As part of implementing the directive, the SADC Secretariat has commissioned studies to explore various options of alternative sources of income and develop a Resource Mobilization Framework

1.2 Purpose

This report informs the discussion on curbing illicit cross-border financial flows as a measure to to boost resource mobilization in the SADC region, and thereby contributes to the Resource Mobilization Framework. The interest and focus on curbing illicit financial outflows follows from the now substantial evidence that indicates that the outflows of illicit financial flows from the African continent is a persistent occurrence and it has accelerated in recent times. This prevalence of illicit financial flows, and their rapid growth recently, is concerning. The scale of the problem is big. Estimates from various analyses (Kar & Cartwright-Smith, 2010; AfDB & Global Financial Integrity, 2013; AUC & UNECA, 2015) suggest that the scale of illegal money flows from the African continent is very large and dwarf capital inflows, both in the form of foreign direct investment and foreign aid. These analyses show, for example that Africa has lost close to US\$1.8 trillion over a forty-year period, from 1970 to 2009, roughly equivalent to all of Africa's receipts of the official development assistance during the same period and four times Africa's debt. According to AUC and UNECA's (2015) Report of the High Level Panel on Illicit Financial Flows from Africa, currently, about US\$50 billion is lost annually in illicit financial outflows from the continent (Afican Union Commission and UN Economic Commission for Africa, 2014). Within the Southern African region, the estimates show that the region lost about US\$370 billion between during 1980-2009 and the region is losing an average of US\$12 billion annually. This indicates that resources are being lost that could otherwise be used to fund the development of the region. If the illicit resource outflow were stopped or the flight were reversed and repatriated, they could contribute to mobilization

of the much needed funds for development. For this reason, it is essential to take action to curb illicit financial flows.

1.3 Objectives

The terms of reference called for the assignment to address the following objectives:

- Analyse how this option (curbing illicit financial flows) can be narrowed down to a feasible proposal for operationalisation;
- Analyse the technical and legal feasibility conditions for this option;
- Analyse the required conditions for agreement that could be implemented by the Member States;
- Analyse the conditions needed to implement such a mechanism;
- Identify bodies at national level that could be involved in scoping the feasibility of such a mechanism. For example, whether there would be a need to draw on the cross-border expertise from other regional bodies such as the Eastern and Southern Africa 'Anti-Money' Laundering Group (ESAAMLG)
- Analyse the economic and financial impact of the option on the various industries directly affected by illicit financial flows and show how those effects can be minimised;
- Analyse how the illicit financial flows can be minimised, given lack of reliable data, accurate measurement of illicit financial flows, and legal framework for combating the cross-border transfers of illicit money;
- Assess how much of the income will be curbed from this option and how much of the resources can be mobilised using innovative financial instruments;
- Show which parties of the society would benefit more from this option; and
- Illustrate the process and timeframe for the implementation of such mechanisms.

1.4 Approach and Methodology

The approach to the assignment comprised the following activities:

Analysis

As there is already a growing literature that aptly provide estimates of the nature and magnitudes of illicit financial flows out of developing countries, including Africa and the SADC region, the assignment was conducted as a desk study. This involved rigorous examination of the now burgeoning literature on illicit financial flows to establish how curbing illicit financial flows can be turned into an option for mobilizing resources for development, including how much of the income currently being lost to illicit financial flows can be curtailed, methods and initiatives to detect and stop the outflows, and identification of the sectors most prone to illicit financial transactions.

Inception report

An inception report, which highlighted the early impressions and the approach to the assignment, was prepared at the commencement of the mission and delivered to the SADC Secretariat

1.5 Organization of the report

The remainder of the report begins by discussing issues that surround the complexity of measuring illicit financial flows and the methods being used to estimate them, in order to contextualize the examination of questions about the amount of resources that can be curbed from illicit financial flows. Using existing estimates, trends in illicit financial flows in the SADC region over ten-year period are

thereafter examined, highlighting their patterns and how member states are impacted individually. Drawing on this analysis, suggestions are made on the amount of resources lost due to the illicit financial outflows, and, based on that, proposes various options that the SADC can explore to curb illicit financial flows, and how those can be turned into a tool for resource mobilization. The report concludes with some concluding observations.

2. Quantifying Illicit Financial Flows

An accurate measure of illicit financial flows is a key step towards curtailing them. Hence, to contextualize the analysis made in section regarding the scale of illicit financial flows in SADC, this section discusses issues that surround the complexity of measuring illicit financial flows and the methods that have been developed to quantify them.

Quantifying illicit financial flows is a notoriously difficult task because of the secrecy nature of the transactions that underlie them. By their nature, illegal money flows are intended to be hidden. As such, no direct or official measurements usually exist. This is made worse by the lack of consensus on a common definition/understanding of what illicit financial flows should entail. Nevertheless, the usage of the term in the literature is widely understood to mean cross-border transactions involving funds that are transferred, earned, or used illegally (Kar & Cartwright-Smith, 2010). This consorts into four main areas (World Bank, 2016):

- the acts themselves are illegal (for example, corruption, tax evasion); or
- the funds are proceeds of illegal acts of various kinds (for example, smuggling and trafficking in minerals, wildlife, drugs, and people); or
- the funds are used for illegal purposes (for example financing of organized crime); or
- the transfer across borders of the funds itself is in violation of applicable laws, while the funds are ordinarily earned from legitimate sources (Kar & Cartwright-Smith, 2008).

There is hence a whole range of sources of illicit financial flows, culminating into many different aspects of illicit financial flows, which is why pinpointing an accurate or even obtaining a reliable measure of the scale of the problem a difficult task.

There is also no consensus on a methodological framework that can capture all these various aspects and forms of illicit financial flows. Rather, the existing methods are only suited to uncovering a specific form of and different aspects of the range of illicit financial flows - the methods differ on the form of illicit financial flows they can uncover. Each of the methods or approaches looks at different aspects (or form of) of illicit financial flows, not the whole range. This difficulty in measuring illicit financial flows reflects in large measure the fact that, by their nature, these flows are unrecorded, and therefore, generally, data is not available and researchers need to impute it. As such, existing estimates not only provide a partial picture of the true scale of the illicit financial flows, but the methods used to estimate them involve a high degree of uncertainty. The lack of methodological consensus has fuelled debates on whether illicit financial flows are as large a pandemic as some of the numbers point to. Johannesen and Pirttila (2016) elaborate on some of these debates.

Nevertheless, the various methods and approaches use various techniques, including surveys, case studies, interviews, and statistical and model based measurements. An overview of a variety of these methods and approaches is provided by Johannesen & Pirttila (2016), Fontana (2010) and Nicolaou-Manias & Wu (2016), whereas Transparency Coalition (2016) provides an infographic in one way easy to follow. A brief discussion of some of them is as follows.

National income data based approaches

The methods under this grouping examine national income data of countries to identify when it looks like money is leaving the country than what has been reported. They are founded on the principles of double-entry book keeping, which builds the nation accounts so that the same amounts can be generated in a number of ways. Thus, the national accounts must always balance. This means, in principle, that a country's income surplus with other countries, for example, should correspond to changes in its net asset balance with other countries. Therefore, when an explained discrepancy recurs, it may be because of erroneous reporting or simply that income has gone unreported. These methods are thus generate estimating all unregistered capital outflows, and are suitable for estimating illicit financial flows that arise from leakages in a country's external accounts.

The World Bank residual model is the most widely used variant of the methods under this grouping, which is also referred to as the sources-and-uses method (Johannesen & Pirttila, 2016). This assesses the amount of illicit financial flows by comparing total funds actually used by a country against funds it received during a certain period of time as recorded in its balance of payment accounts. The premise is that if the sources of capital inflows exceed the use of the capital inflows, this must be due to capital transfers to foreign countries by private individuals (Johannesen & Pirttila, 2016). As these funds are not captured in public records, this difference between funds coming in and funds being used, "the residual", is considered to be illicit flows. In other words, the unexplained (residual) growth in net liabilities is due to illegal capital flight. In the literature, the inflow of funds is commonly identified as any increase in foreign debt plus foreign direct investments. However, other capital inflows such as portfolio investments also fit the description. An extant example of the usage of this is AfDB and Global Financial Integrity (2013) who have included all the items that make the financial account of the balance of payments. The outflows of funds used, conversely, are seen as those necessary to finance the deficit in the current account of the balance of payments and to add to the country's official reserves, which essentially means the current account deficit and the net increase in foreign currency reserves.

The Hot Money Method identifies illicit financial flows as the net errors and omissions of a country's balance of payments. The logic behind the method is that the balance of payments should, in principle, balance, with all funds received by a country being offset by funds going out or being used. The presence of a record of net errors and omissions a country's balance of payments represents unexplained financial flows, and are therefore considered to be illicit financial flows – to the extent that they reflect unrecorded flows.

In essence, both the Residual model and Hot Money method enables identification of illicit financial flows due to leakages in a country's external accounts, through the balance of payments. All the same, the methods essentially take a broad view. They do not distinguish between which sectors are involved in the transactions. Nor which instruments are used. Rather, all statistical discrepancies between the current and capital accounts are regarded as an expression/representation of illegal capital flight. Nevertheless, despite drawing on the same data, which is the balance of payment statement, the two methods differ in how each processes the data. In the Hot Money Method, the unexplained flows as captured by the net errors and omissions are considered as illicit financial flows, whereas in the Residual model illicit financial flows are identified through a process that involves collecting raw data for each country and purposely calculating the difference between the sources and uses of funds. This distinction is important because the two approaches would generate different estimates, and, at times, this would be huge.

Trade data based approaches

This category of methods uses trade data to detect illegal money transfers through various kinds of manipulations of transfer pricing, trade mispricing and misinvoicing. These are practices that are often used by multinational corporations and seemingly unrelated corporate entities to hide profits from

authorities and transfer these across borders to lower tax destinations, including tax holiday or tax haven destinations. Therefore, they can be a source of illegal money transfers.

The Trade Mispricing Model/Approach is the most commonly used method. This assesses illicit financial flows by examining international trade data for disparities between invoicing of exports and imports. Import and export transactions can be conduits for illicitly transferring funds across borders through manipulation of invoices. The invoice manipulation term is used in two ways. One is in reference to transfer pricing, which is pricing of transactions within one and the same group. The other usage of the term refers to pricing of transactions between entities that are not related, where it is commonly trade mis-invoicing.

Transfer pricing is a common legal practice, which multinational use to transfer goods between subsidiaries. However, transfer pricing pricing can become illegal if the 'arm's length principle", as set out in the OECD guidelines and the UN Tax Committee or, generally, a country's tax regulations. The 'arm's length principle" avers that the price charged in transactions between two subsidiaries must be the same as in instances where the two firms are unrelated parties negotiating in a normal market (Fontana, 2010). When this principle is not observed, transfer pricing is abused and becomes known as "abusive transfer pricing" or trade mispricing, and, hence, illegal, with the resulting transfers of funds becoming illicit flows.

A simple example can illustrate transfer mispricing is as follows. One subsidiary producing goods on a high tax country can avoid paying taxes by selling its products at a loss to a subsidiary in a low tax country. The subsidiary in the high tax country has thus far less taxable revenue, whereas the subsidiary in the low tax country sells the products to final consumers at the market price and yields a profit. In essence, the subsidiary in the high tax country illegally transfers earnings to a subsidiary in a low tax country by mispricing prices.

The case of trade mis-invoincing, conversely, involves unrelated parties, and has to do with the fact that businesses or individuals can collude with an unrelated party abroad to shift money between countries by deliberately falsifying prices on a customs invoice. A simple example to illustrate this is the following. A buyer and a seller collude in a scheme in which the buyer only pays the standard market price for some goods but billed for the goods at a higher price. The seller then deposits the difference in a bank account in a secrecy jurisdiction on behalf of the buyer.

In both cases (transfer mispricing and trade mis-invoicing), the implication is that the resulting funds transfers would not reflect in official statistics, therefore, there will be discrepancies in official trade statistics. Hence, the amount of illicit financial flows is estimated by comparing what a country claims it imported from (exported to) the rest of the world, with what the rest of the world states it exported to (imported from) that given country. These estimates have been aided with data drawn from the IMF's Direction of Trade Statistics (DOTs) database, hence the approach is sometimes referred to as the DOTs method

Direct estimates of proceeds from illegal activities

Various efforts are being made to estimate directly financial flows from illegal activities, by identifying the illegal activity and attempting to quantity the financial income that results from it. These methods use various analyses, including statistics and sheer experiences. Their strength is that they attempt to link financial flows to a specific kind of illegal activity. But, this is fraught with the difficulty of finding the requisite data, given the secrecy nature of the transactions. Hence, a combination of a range of data forms and sources is often used, although this does not seem to completely circumvent this challenge.

Some examples include:

Measuring money laundering. An extant example here is Walker (1995), who has provided estimates of the extent of money laundering generated from crime in and out of Australia – essentially attempting to measure the size of money laundering. In his analysis, Walker examined various crimes and their sources in Australia and estimated the proceeds from them. To determine how much of those proceeds are laundered, the author surveyed opinions of Australian and international anti-money laundering experts to arrive at an estimate, including police specialist's squads, police statisticians, and crime researchers. He found that various crimes in Australia generated between 1 to 4.5 billion Australian dollars, as at 1994, and at least 3.5 billion Australian dollars was believed to have been laundered either in Australia or sent abroad. A follow up report (Walker, 2004), that updates the 1994 results, has found that crime in Australia generates between 2.8 to 6.3 billion Australian dollars, with at least 4.5 billion Australian dollars possibly laundered in Australia or sent abroad.

While Walker's approach is fraught with numerous weaknesses relating to both both collection methods and accuracy of data analyzed (Fontana, 2010), it has nonetheless pioneered development of a rubric of methods collectively labeled the Walker Gravity Model, which is now regarded as the workhorse for empirically measuring the extent of money laundering in a country and its impact on that country's economy. In this regard, the literature has developed several variants that modify the original model and used them to generate new evidence on the extent money laundering in various jurisdictions. UNODC (2011) elaborates on many of these.

Estimating money held offshore and in tax havens. Zucman (2015) has sought to determine the amount of money held offshore, which is often unreported), and the tax loss that has resulted from the non reporting of such wealth to the relevant tax authorities. Zucman's work is motivated by the proliferation of the practice of holding money offshore and in tax havens – by both corporations and high net worth individuals alike - which is now believed to be fast-growing. This a major factor when trying to understand the scale and impact of illicit financial flows, as these funds are kept out of reach of the jurisdictions of their origin, where relevant tax on them would have been levied. This tax loss is a source of illicit financial flows. Examining the differences between assets and liabilities in financial records of offshore financial institutions, Zucman's (2015) has found that about US\$7.6 trillion is held in tax havens as at 2014, of which at least 80 % of this wealth is not declared. This leads the author to estimate that about US\$190 billion is lost annually in uncollected taxes to governments due to the Offshore Wealth. Nevertheless, Zucman's analyses has been criticized, with the critics arguing that the analyses consider only wealth holding by individuals, and in a few tax havens only (Switzerland, Luxemburg and British Virgin Islands). The other tax haven services such as those provided to corporates or banking are not examined. Thus, his estimates are at best conservative, which understates the true value of offshore wealth.

The Tax Justice Network (2012), conversely, has found that the amount of wealth held offshore could be as high as US\$21 – 32 trillion in 2010. If taxed, this wealth would have generated income tax revenues of between US\$190-280 billion. However, a constraint of this work is that its estimates are made based the assumption that all assets that are moved offshore are not declared, which seems to overstate the size of the wealth.

Measuring corporate tax avoidance and profit shifting.

Another line of work has sought to examine the extent corporate tax avoidance and profit shifting practices of multinational corporations into low or no tax jurisdictions, thereby lowering the amount of

taxes they pay. A weakness with this line of work, however, is that none of the studies only look sat different aspects of profit shifting and their effects on government revenues – estimations of the problem in its entirety is not as yet succeed. An UNCTAD (2015) study, for example, has looked to see if taxable profits to developing countries were lower if when money was routed through specific jurisdictions. The estimates suggest that developing countries have been losing as much US\$100 billion is lost annually to profit shifting.

By analyzing whether tax policies in some countries could have a spillover effect on the tax revenues of other countries, Crivelli et al (2015) have found that developing countries lose about US\$200 billion in revenue each year. Their analyses involve comparing actual corporate income tax levels with those that would be collected if the base was proportional to based taxation – which they approximate with the gross operating surplus. Data limitations not only restricts to sort of analysis to a small number of countries, but it also precluded examination of profit sharing involving conduit countries.

Another illuminating study is Cobham and Jansky (2015), who have studied multinationals in the USA to see the extent which these firms were repatriating profits to to jurisdictions where they had little economic interest. Their estimates show that close to US\$130 billion in tax revenues were being lost, with the size of profit shifting having risen to 25-30 % now, compared to only about 5-10 % in the 1990s. As with most studies under this rubric, this study is only able to address an aspect of profit shifting, as it is based on public data aggregated on a national level, whereas company-level aggregated data would have been most useful indicator.

Hybrid model approach

Each one of these methods discussed above only help in shedding light on a particular aspect and form of illicit financial flows. To establish an overall picture of the extent of illicit financial flows in any given country, much of the analysis involve combining methods measure more than one conduit for the illicit financial flows. This is the mostly widely used approach to measuring illicit financial flows currently. An example is Global Financial Integrity whose work combines methods based on national income (the World Bank Residual model) with those based on trade data (Trade misinvoicing models), thereby capturing illicit flows generated through a country's balance of payments (Balance of Payments leakages) and through trade between countries.

3. Trends and Patterns of Illicit Financial Flows in the SADC Region

The ideal is for an examination of a wide-range of the forms of illicit financial flows in order to gain a comprehensive understanding of the scale of the problem in the region. This would require a comprehensive study that would look into all the aspects and and produce estimates on the various forms of illicit financial flows. However, no studies or reports with estimates of that nature were found. This report therefore uses estimates provided by Kar and Spanjers (2015) to highlight the extent of illicit financial flows in the SADC region. In producing these estimates, Kar and Spanjers (2015) use a hybrid methodology that combines the World Bank Residual with a model that captures trade misinvoicing, where the trade misnvoicing looked at is the misstating in the value or volume of an export or import on a customs invoice. Essentially, this allows for examination of only two conduits/sources of illicit financial flows and therefore offers only a partial analysis of the problem, and, therefore only looks at a smaller portion of the range of illicit financial flows. Clearly, this limits the analysis is a major way. Nevertheless, it is the best estimate to work with, given the difficulties in measuring illicit financial flows through the other channels

The illicit financial flows through trade misnvoicing are measured using the Gross Excluding Reversals Method, according to which trade data is examined for gaps between a country's reported exports

and imports with the rest of the world to determine the amount of illicit financial flows that is generated through this source. The resulting estimates of illicit financial flows are presented on a gross basis, whereby illicit inflows (i.e. import under-invoicing and export over-invoicing) are not netted out from illicit outflows (i.e. import over-invoicing and export under-invoicing), hence the use of the term "Gross Excluding Reversals". Only misinvoicing of good trade is examined – misinvoicing of services is excluded because of lack of bilateral trade data in services. Given that services trade is now a big component of world trade, this is a big omission. Hence, the estimates that they provide underestimate the extent of the problem by far.

The illicit financial flows through leakages in the balance of payments, conversely, are measured as the "net errors and omissions" term of a country's balance of payments, consistent with the Hot Money method variant of the World Bank residual methodology. The data used in the analysis covers the period 2004-2013 for 56 developing countries. Data to measure trade misinvoicing are obtained from the International Monetary Fund's (IMF) Direction of Trade Statistics (DOTS), which report annual exports and imports for all pairs of reporting countries. Similarly, data used to analyze balance of payments leakages form of illicit financial flows are taken from the IMF's database of balance of payments statistics, which reports balance of payment of each reporting member states.

Table 1 shows Kar and Spanjer's (2015) estimates of illicit financial flows due to trade misinvoicing and balance of payments leakages. This shows that illicit financial flows in the SADC region are large and increasing. Over the period 2004-2013, illicit financial flows sum up to US\$309 billion, an average of US\$31 billion each year. Accumulation of these flows has happened quickly. After a steady growth during 2004-2006, from US\$18.7 billion to US\$23 billion, the volume of illicit financial flows has grown rapidly, reaching close to US\$39 billion between 2007 and 2009. While illicit financial flows reduced to about US\$34 billion during 2010-2011, most likely reflecting the onset of the global financial crisis, it increased again to close to US\$40billion in 2012, before reducing sharply to close to US\$27 billion in 2013.

Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Cumul ative	Avg	% of total
Angola	0	574	0	1,641	1,236	0	0	17	326	55	3,850	385	1.2
Botswana	1,144	948	939	1,687	1,464	2,027	1,230	1,430	1,568	1,242	13,680	1,368	4.4
Congo, D R	539	583	458	170	0	312	175	0	0	18	2,254	225	0.7
Lesotho	236	248	186	420	438	624	294	353	355	255	3,409	341	1.1
Madagascar	755	412	1,719	179	654	185	246	364	374	184	5,072	507	1.6
Malawi	160	470	405	442	1,022	851	766	1,054	503	824	6,496	650	2.1
Mauritius	303	404	359	462	756	450	719	651	1,100	891	6,093	609	2.0
Mozambique	0	0	362	103	0	23	640	44	994	260	2,426	243	0.8
Namibia	657	678	787	1,610	1,573	2,392	1,673	1,344	1,947	1,264	13,924	1,392	4.5
Seychelles	82	75	4	0	0	0	107	80	110	0	458	46	0.1
South Africa	12,13 7	13,59 9	12,86 4	27,29 2	22,53 9	29,58 9	24,61 3	23,02 8	26,13 8	17,42 1	209,21 9	20,92 2	67.7
Swaziland	499	492	638	1,364	542	659	394	439	494	295	5,817	582	1.9
Tanzania	112	839	36	58	390	308	1,355	606	793	323	4,820	482	1.6
Zambia	1,824	2,106	2,641	3,355	2,603	1,983	2,683	3,712	4,236	3,709	28,853	2,885	9.3
Zimbabwe	306	354	1,792	97	0	214	0	0	0	0	2,763	276	0.9
Total SADC	18,75 3	21,78 1	23,19 0	38,88 0	33,21 8	39,61 5	34,89 6	33,12 2	38,93 7	26,74 1	309,13 3	30,91 3	100.0

Table 1: Estimates of illicit financial outflows from the SADC countries (total

Source: Kar and Spanjers (2015) 1\ no data is reported

Misinvoicing of trade is the main driver of illicit financial outflows. Over the period 2003-2013, trade misinvoicing account for 92 % (US\$284.6 billion) of the total estimated illicit financial outflows (table 2). Leakages through the balance of payments, conversely, account for only a smaller share (about 8 %; US\$24.5 billion) of the estimated illicit financial outflows. The exception is Tanzania, where leakages through the balance of payments are about 85 % of total illicit financial outflows.

	(in millions	of U.S. dollars)	% of total		
	Total	Trade misinvoicing	BoP leakages	Trade misinvoicing	BoP leakages
Angola	3,850	0	3,850	0.0	100.0
Botswana	13,680	12,857	823	94.0	6.0
Congo, DR	2,254	2,005	249	88.9	11.1
Lesotho	3,409	3,014	394	88.4	11.6
Madagascar	5,072	4,129	943	81.4	18.6
Malawi	6,496	5,967	528	91.9	8.1
Mauritius	6,093	5,723	370	93.9	6.1
Mozambique	2,426	2,334	92	96.2	3.8
Namibia	13,924	12,677	1,248	91.0	9.0
Seychelles	458	356	102	77.7	22.3
South Africa	209,219	199,125	10,094	95.2	4.8
Swaziland	5,817	4,723	1,094	81.2	18.8
Tanzania	4,820	739	4,081	15.3	84.7
Zambia	28,853	28,324	529	98.2	1.8
Zimbabwe	2,763	2,660	103	96.3	3.7
Total	309,133	284,634	24,500	92.1	7.9

Table 2: SADC region: Com	ponents of illicit financial	outflows, 2004 - 2013
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Source: Kar and Spanjers (2015)

In terms of the composition of the trade misinvoicing, the majority of the illicit outflow from is due to export under-invoicing. Under-invoicing of experts account for 62 % (US\$176 billion) of the estimated total for trade mis-invoicing (table 3) – import over-invoincing comprise 38% (US\$108 billion). However, there are marked differences on a country by country basis. Import over-invoicing, on the one hand, is the dominant form of trade misninvoicing in the Congo DR, Madagascar, Malawi, Mauritius, Seychelles, Tanzania and Zambia. On the other hand, it is export under-invoicing that is the main form of trade misninvoicing is evenly distributed. This suggests that there are substantial levels of both import over-invoicing and export under-invoicing in the SADC region.

Country	Import Misinvo	icing	Export Misnivoic	ing	Total Trade Misinvoicing Outflows		
	Over-Invoicing (millions of US dollars) (A)	% of total	Under-Invoicing (millions of US dollars) (B)	% of total	(A+B)		
Angola			0		0		
Botswana	3,587	28	9,270	72	12,857		
Congo, DR	2,005	100	0	0	2,005		
Lesotho	1,395	46	1,619	54	3,014		
Madagascar	3,205	78	925	22	4,129		
Malawi	5,844	98	123	2	5,967		
Mauritius	4,521	79	1,202	21	5,723		
Mozambique	1,172	50	1,162	50	2,334		
Namibia	3,666	29	9,011	71	12,677		
Seychelles	204	57	152	43	356		
South Africa	63,046	32	136,079	68	199,125		
Swaziland	1,326	28	3,397	72	4,723		
Tanzania	739	100	0	0	739		
Zambia	16,311	58	12,013	42	28,324		
Zimbabwe	1,197	45	1,463	55	2,660		
Total	108,217	38	176,416	62	284,634		

Table 3: SADC Region; Components of Trade Misinvoicing outflows, 2004-2013

Source: Kar and Spanjers (2015)

At the country-by-country analysis level, illicit financial flows are concentrated in a few member states. South Africa generates the most of the illicit financial flows in the region, at a sum total of US\$209 billion (67.7 % of total flows) (chart 1; table 1). Zambia follows with US\$28.8 billion (9.3 %), Namibia with US\$13.9 billion (4.5 %) and Botswana with 13.7 billion (4.4 %). Together, these four member states account for 86 % of the total estimates of illicit financial flows in the region.





Source: Kar and Spanjers (2015)

However, when scaled as a %age of GDP, it is Zambia and Lesotho that top the list, at an average of 18.6 % and 18.9 % respectively (table 3; chart 3). Swaziland follows at 16.2 % of GDP; Namibia at 14.4 % of GDP; Malawi at 11.8 % of GDP, and Botswana at 11.7 % of GDP.

Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Average
Angola	0.0	2.0	0.0	2.7	1.5	0.0	0.0	0.0	0.3	0.0	0.7
Botswana	12.8	9.5	9.2	15.4	13.3	19.6	8.9	9.3	10.7	8.4	11.7
Congo, D R	5.2	4.9	3.2	1.0	0.0	1.7	0.9	0.0	0.0	0.1	1.7
Lesotho	18.7	17.6	12.5	25.1	26.4	36.0	13.1	13.9	14.7	11.2	18.9
Madagascar	17.3	8.2	31.2	2.4	7.0	2.2	2.8	3.7	3.8	1.7	8.0
Malawi	4.6	12.8	10.1	10.0	19.2	13.7	11.0	13.2	8.4	15.2	11.8
Mauritius	4.7	6.5	5.7	5.5	8.8	4.7	7.3	5.9	9.8	7.5	6.6
Mozambique	0.0	0.0	4.4	1.1	0.0	0.2	6.1	0.3	6.5	1.6	2.0
Namibia	9.9	9.3	9.9	18.4	18.5	26.9	14.8	10.8	15.0	9.9	14.4
Seychelles	9.8	8.1	0.4	0.0	0.0	0.0	11.0	7.8	10.4	0.0	4.8
South Africa	5.3	5.3	4.7	9.1	7.9	10.0	6.6	5.5	6.6	4.8	6.6
Swaziland	17.6	15.5	19.7	40.2	16.6	18.3	8.7	8.8	10.1	6.5	16.2
Tanzania	0.7	5.0	0.2	0.3	1.4	1.1	4.4	1.8	2.0	0.7	1.8
Zambia	29.3	25.3	20.7	23.9	14.5	12.9	13.2	15.8	16.6	13.2	18.6
Zimbabwe	3.8	4.6	25.0	1.4	0.0	2.6	0.0	0.0	0.0	0.0	3.7

Table 4: Illicit financial outflows from SADC countries: 2004-2013 (% of GDP)

Source: Estimates based on GDP data drawn on International Monetary Fund, World Economic Outlook Database, April 2016



Chart 2: Illicit financial outflows from SADC countries: Average; 2004-2013 (% of GDP)

Source: Kar and Spanjers (2015)

4. Revenues that can be collected from curtailing Illicit Financial Flows

The above section discussed estimates of illicit financial flows in the SADC region provided by Kar and Spanjers (2015). Those estimates show that the SADC region experienced illicit financial outflows flows due to misinvoicing of trade and leakages in the member states' balance of payments amounted about US\$309 billions and averaged about US\$31 billion annually over a ten-year period from 2004 to 2013.

This section provides an analysis of the potential loss of revenue to the member states' governments resulting from this outflow of illicit capital, and, in so doing, determines how much of the illicit financial flows could potentially be retained if the the underlying illegal activity driving the illicit outflows is curtailed. This is done by estimating the loss of tax revenue due to member states of SADC as a result of the illicit financial outflows.

In the estimates that Kar and Spanjers' (2015) provides, the total estimates of illicit financial flows are a sum of a measure generated by the trade-misinvoicing model, which are derived from comparing partner countries trade data; and the World Bank Redual model, which estimates the gap between a country's sources and uses of funds.

Making a case for estimating tax revenue loss is a clear cut issue when it comes to trade minsinvoicng. These are practices that corporations often use shift profits to lower tax destinations. The practices can involve trade transactions between related parties (within one and the same group) and between unrelated parties (between unrelated parties). To that extent, they represent a channel through which legitimate profits are transferred abroad illegally. It is therefore a reasonable assumption to say that domestic corporate taxes would have been payable on this money that was illegally moved abroad were it declared to the government.

The case of the implied tax revenue loss pertaining to estimates due to the World Bank Residual model is, however, less clear cut. Estimates of illicit financial flows due to this model are essentially unrecorded flows but the source or form of the illegal activity that underlie them is not distinguished. In essence, the illegal activity that underlie the flows are not observable, only the funds are. This creates difficulties to ascribe a tax revenue loss to the financial outflows whose illegal activity that underlie them can not be observed. For this reason, tax revenue loss analysis due these flows is not made here, consistent with the methodology in Baker et al (2014) and Qureshi and Mahmood (2016).

The analysis of the tax revenue loss is made using corporate tax rates by country, which are used to estimate the amount of tax revenue lost. These are obtained from KPMG's Corporate Tax Rates Tables and Trading Economics (https://tradingeconomics.com). Many countries in the regions, however, have a range of corporate tax rates for different industries and sizes of businesses, which makes it difficult to select a uniform rate for a specific country. This is resolved by selecting the highest corporate rate, consistent with the methodology in Hollingshead (2010). The rates are shown in table 5.

Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Angola	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0
Botswana	25.0	25.0	25.0	25.0	25.0	25.0	25.0	22.0	22.0	22.0
Congo, D. R	40.0	40.0	40.0	40.0	40.0	40.0	40.0	40.0	40.0	35.0
Lesotho	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Madagascar	23.0	23.0	23.0	23.0	23.0	23.0	23.0	23.0	23.0	23.0
Malawi	25.0	25.0	25.0	25.0	25.0	24.0	33.0	33.0	30.0	30.0
Mauritius	25.0	25.0	25.0	25.0	22.5	15.0	15.0	15.0	15.0	15.0
Mozambique	32.0	32.0	32.0	32.0	32.0	32.0	32.0	32.0	32.0	32.0
Namibia	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	33.0
Seychelles	40.0	40.0	40.0	40.0	40.0	40.0	33.0	33.0	33.0	33.0
South Africa	37.7	37.7	36.9	34.6	34.6	34.6	34.6	34.6	34.6	28.0
Swaziland	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Tanzania	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Zambia	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0
Zimbabwe	30.9	30.9	30.9	30.9	30.9	30.9	25.8	25.8	25.8	25.8

Table 5: Corporate tax rates in the SADC region: 2004-2013 (%)

Source: KPMG Corporate tax rates; Trading Economics (https://tradingeconomics.com)

Estimates of the tax revenue loss to member states' governments due to the illicit financial flows are obtained by applying the country specific corporate tax rate to the estimated illicit outflow for that country, so as to measure the implied tax revenue loss due to it. The results of this exercise are shown in table 6, which shows the total tax revenue loss that can be attributed to illicit financial flows due to trade misnvoicing. This indicates that the SADC region as a whole lost a total of US\$94.6 billion and an average of US\$9.5 billion per year over the ten-year period from 2004 to 2013.

Table 6: Tax Revenue Loss due to trade misinvoicing outflows, average; 2004-2013 (millions of dollars)

Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Sum	Avg
Angola	0	0	0	0	0	0	0	0	0	0	0	0
Botswana	220	237	235	422	366	367	308	315	345	273	3,087	309

Congo, D R	215	216	176	0	0	125	70	0	0	0	802	80
Lesotho	59	62	47	105	77	91	74	88	87	64	754	75
Madagascar	166	95	368	17	147	38	20	61	10	0	920	92
Malawi	40	117	101	110	207	165	253	292	151	247	1,683	168
Mauritius	76	101	90	115	170	67	108	98	110	134	1,068	107
Mozambique	0	0	116	33	0	0	205	0	318	75	747	75
Namibia	223	230	267	547	535	730	473	443	487	362	4,299	430
Seychelles	33	30	2	0		0	35	26	3	0	129	14
South Africa	4,58 5	5,13 8	4,60 3	9,42 9	7,78 7	7,97 9	7,79 7	7,95 2	8,63 3	4,87 8	68,78 0	6,878
Swaziland	150	135	121	200	152	181	118	132	139	88	1,417	142
Tanzania	0	0	11	18	0	18	18	87	71	0	222	22
Zambia	638	699	851	1,15 1	906	691	930	1,28 8	1,47 1	1,28 8	9,913	991
Zimbabwe	95	109	554	30	0	34	0	0	0	0	822	82
Total SADC	6,50 0	7,16 8	7,54 0	12,1 78	10,3 47	10,4 86	10,4 07	10,7 81	11,8 24	7,41 0	94,64 2	9,464

Source: Author's calculations from Kar and Spanjer's (2015) estimates

Chart 3 shows the time series trend in the tax revenue loss over the same period. This shows that tax revenue loss due to trade misnvoicing has risen substantially, remaining in the rand of US\$10 billion a year during 2007 and 2012.



Chart 3: Tax revenue loss to SADC region due to trade misinvoicing; 2004-2013 (million of US dollors)

In sum, a summary of the the analysis of tax revenue loss due to illicit financial flows is the following: Illicit financial flows due to trade misinvoicing implied a loss in tax revenues to member states of an average US\$9.5 billion annually over the period 2004 to 2013. This signifies the amount of resources that could be retained and redirected towards development projects were trade misinvoicing practices curtailed.

5. Summarizing Observations

The observations that arise from the examination of curbing illicit financial flows as an option for mobilizing resources to support SADC development programmes are the following:

Accurately measuring illicit financial flows is central to curtailing them. However, quantifying illicit financial flows is notoriously difficult because of the secrecy nature of the transactions that underlie them. Because of their illegal nature, these transactions are meant to disappear. As such, no official statistics exist on which they can be measured accurately. Instead, researchers use indirect methods to provide estimates of them. However, researchers are yet to agree on a single methodological framework that can be used to empirically assess the various kinds and forms of illicit financial flows in a comprehensive way. Instead, each method that is used is only suited to uncover a specific form of the illegal activity that is deemed to underlie the illicit financial outflows. Thus, the methods are highly uncertain. To circumvent this, and in the quest to get a broader understanding of illicit financial outflows in a specific country or group of countries, most analyses use hybrid methods that combine various methods.

Despite this lack of methodological consensus, estimates provided by these various methods have proved useful in characterizing the scale of the problem and its ramifications for economic development of countries that are affected.

Following on this practice in the literature, this report based its analysis on estimates from a hybrid method implemented by Kar and Spanjers (2015) to illustrate the extent of illicit financial flows in the SADC region. This showed that the scale of the problem is big, with illicit financial flows amounting to US\$309 billion and an average of US\$31 billion per year over a ten-year period from 2004 to 2013. Kar and Spanjers' (2015) estimates however offer only a partial analysis of the problem, as, in their methodology, they are only able to study two conduits of illicit financial flows.

In term of these estimates, leakages through the balance of payments and misinvoicing of trade generate substantial Illicit financial outflows. However, it is misinvoicing of trade that is the primary method through which capital is illegally transferred out of the region, accounting for about ninety % of the estimates that Kar and Spanjers (2015) have provided.

Nevertheless, even on this partial discourse, analysis of tax revenue loss showed that the region lost an average of US\$9.5 billion in tax revenue because of the illicit financial flows arising from trade misinvoicing. While this sum is derived from only a partial analysis of the scale of the problem, it serves as an indication of the size of resources that could be retained and directed towards development activities in the region if trade misinvoicing was curtailed. Moreover, this figure represents only funds that can be retained from illicit financial outflows that arise because of misinvoicing of trade. If the whole range of the other forms of illicit financial flows were considered, the scale of funds that could be retained could be substantial. For that, however, further investigations regarding both the magnitude and impact of those other conduits of illicit financial flows is needed.

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