

**Impact of Illicit Financial Flows on Domestic
Resource Mobilization:
Optimizing Africa's Mineral Revenues**

March 2015

DRAFT

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List of Acronyms and Abbreviations

AfDB	African Development Bank	PWYP	Publish What You Pay
AML	Anti-Money Laundering	RGI	Resource Governance Index
AMV	African Mining Vision	STEAL	Systems of Tax Evasion and Laundering
AU	African Union	SWF	Sovereign Wealth Fund
CAP	Common African Position	UN	United Nations
CIF	Cost of Insurance and Freight	UNECE	United Nations Economic Commission for Europe
DAC	Development Assistance Committee	USD	United States Dollar
DRM	Domestic Resource Mobilization	WP.6	Working Party on Regulatory Cooperation & Standardization Policies
DTA	Double Taxation Agreements		
ECA	Economic Commission for Africa (United Nations)		
EITI	Extractives Industry Transparency Initiative		
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group		
EPZ	Export Processing Zone		
FDI	Foreign Direct Investment		
FOI	Freedom of Information		
FOB	Free on Board		
GDP	Gross Domestic Product		
IIAG	Ibrahim Index of African Governance		
IFF	Illicit Financial Flows		
IMF	International Monetary Fund		
KPCS	Kimberly Process Certificate System		
MDG	Millennium Development Goals		
MNCs	Multinational Corporations		
NEPAD	New Economic Partnership for Africa's Development		
ODA	Official Development Assistance		
OECD	Organization for Economic Cooperation and Development		
OGP	Open Government Partnership		
PFM	Public Financial Management		
PPP	Public Private Partnership		
PSA	Production Sharing Agreement		

1. Introduction

1.1 Over the last decade, the economic performance narrative for Africa has been increasingly optimistic in light of its sustained impressive growth rates. However, this narrative continues to be tainted by several challenges, which continue to hinder the continent's sustainable and inclusive development. Indeed, there are growing concerns with respect to the colossal amounts of financial resources, which illicitly flow out of Africa every year. It is obvious that such Illicit Financial Flows (IFFs) reduce the levels of resources available to African countries to finance their development objectives.

1.2 While IFFs occur in many countries around the world, their social and economic impact on Africa is far more severe given its smaller financial resource base and markets. IFFs impact adversely on both public and private domestic expenditure and investment. In concrete terms, this implies fewer hospitals and schools, less roads and bridges and fewer power plants. Furthermore, many of the activities, which generate the illicit funds, are criminal. Whilst financial crimes such as money laundering, corruption and tax evasion are damaging to all countries, the effects on developing countries are particularly corrosive.¹

1.3 It is in this context that IFFs out of Africa are becoming a growing concern given the scale and negative impact of such flows on Africa's governance and development agenda. By some estimates, illicit flows from Africa could be as high as USD 50 billion per annum. In fact, conservative estimates have shown that without IFF from the continent, Africa's Gross Domestic Product (GDP) would have been at least 16% higher.²

1.4 IFFs include practices such as transfer mispricing, falsified invoicing and round tripping. Tax abuse by Multinational Corporations (MNCs) places a disproportionate burden on smaller domestic firms, which are typically responsible for most employment in African countries. This is confirmed by the Progress Report on IFFs from Africa, presented in March 2014 at the Seventh Joint Annual Meetings of the ECA/African Union Conference of Ministers of Finance, Planning and Economic Development. The Report highlights that commercial activities, such as tax evasion, aggressive tax avoidance and harmful tax holidays, were by far the largest component of IFF.

1.5 It cannot be emphasized enough that the loss of funds through IFF reduces revenues as well as the fiscal and other benefits from the mineral sector and other economic sectors. In addition, it also considerably weakens African countries' ability to mobilize resources generated to fund development plans for the structural transformations of their economies. The opportunity for companies in the mineral sector in particular to minimize their tax costs through IFF practices is an incentive for them to move their profits out of Africa, where they operate. This in turn reduces the extent to which mining companies in Africa will re-invest their profits through greater value-adding linkages on the continent. The most obvious effects are the loss of investment capital and revenues that could be used to finance public services including infrastructure, education and health.

1 OECD, Illicit Financial Flows from Developing Countries: Measuring OECD Responses. Available at: http://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf

2 Available at: http://www.uneca.org/sites/default/files/uploaded-documents/COM/com2014/com2014-hlp_panel_on_illicit_financial_flows_from_africa-english.pdf

1.6 It is against this background that the Macroeconomic Policy Division (MPD) and the Africa Minerals Development Centre (AMDC) at the United Nations Economic Commission for Africa undertook a study on the impact of illicit financial flows on domestic resource mobilization in the mining industry. The purpose of the study is to enable the ECA to gain a deeper insight into the challenges of IFF in Africa. The Study is also intended to support mineral exporting African countries to gain deeper appreciation of the nature and magnitude of IFF related policy gaps and challenges. It is envisaged that this work will increase collaboration and cooperation among African countries, their regional economic communities (RECs) and external partners in addressing the challenges posed by IFFs.

1.7 In order to obtain empirical data, the ECA commissioned four country studies in Zambia, Tanzania, the Democratic Republic of Congo (DRC) and South Africa. The study assesses the policy and regulatory frameworks and practices related to IFF and Domestic Resource Mobilization (DRM) in the mining sector in the four countries in order to elucidate the main sources of revenue leakages. These countries were selected because of the significant importance of the mineral sector to their respective economies as well as the diverse tax challenges that they face. These sample countries also allow for wider coverage of different mineral types. The Democratic Republic of Congo is a diversified mineral producer with copper, gold, diamonds and coltan while Tanzania and Zambia are principally gold and copper producing countries respectively. A further consideration was given to the fact that there exists a considerable body of literature on these countries to allow for both in-depth analysis and comparative inquiry.

1.8 The key findings of this study were generated through two principle methods of inquiry: literature review and primary data collection through a survey administered in the four sample case countries. The study-report is presented as follows. Chapter 1 provides an introduction to the study. Chapter 2 addresses the importance of DRM along with its challenges and opportunities. The third chapter provides a definition of IFF, its estimated magnitude in Africa, causes and consequences for the governments of the Democratic Republic of Congo (DRC), Tanzania, South Africa and Zambia. The fourth and fifth chapters examine the regulatory and policy frameworks, which have been put in place in the 4 countries for domestic resource mobilization. These chapters also examine the gaps in the tax and fiscal frameworks for the mining sector to determine the sources of leakages for domestic resource mobilization and illicit financial flows. The final chapter proposes policy recommendations that should be implemented in African countries to combat IFFs.

2. Domestic Resource Mobilization (DRM) for Africa's Structural Transformation

This Chapter examines the importance of Domestic Resource Mobilization (DRM) for mineral-rich Africa to successfully achieve its structural transformation. Section 2.1 examines the challenges and opportunities for oil-exporting and mineral-rich countries in attaining inclusive development. It concludes by advocating that these countries should change the sectoral composition of their economies to reduce their over-dependence on their mineral sectors. Thereafter, section 2.2 highlights the finiteness of mineral revenues and examines the importance of traditional and non-traditional approaches of DRM for mineral-rich countries. The chapter then ends by assessing the role of good governance towards ensuring sufficient domestic resources for structural transformation.

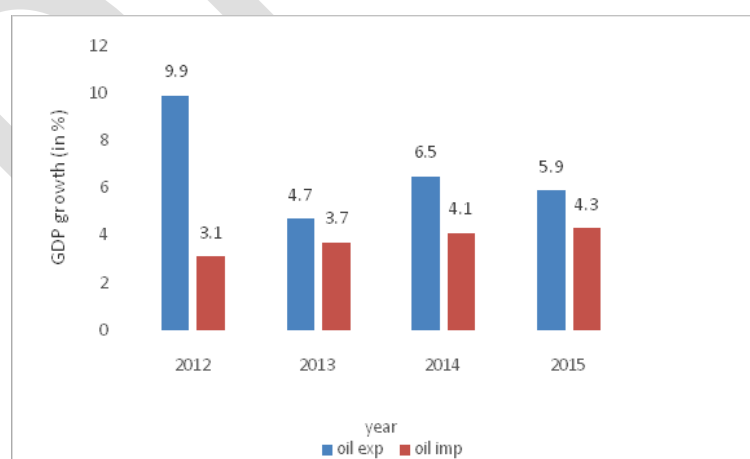
2.1 Structural Transformation in Mineral-rich Africa

Challenges for Mineral-based Inclusive Development

2.1.1 Natural resource-driven inclusive development is a potentially viable option for Africa. At the global level, Africa has about 12% of the world's oil reserves, 42% of its gold and 80-90% of chromium and platinum group metals. Africa also has deposits of ores that are of much higher grade than anywhere else in the world (e.g. copper in the DRC, and gold in Ghana). In addition, the continent is expected to become a prominent source of fossil fuel exports and is expected to overtake the Middle East as the largest net exporter of liquid natural gas in the next two decades.³ In fact, there are constantly new discoveries of natural resources being made in different African countries, oil in Eastern Africa and more recently in 2015, natural gas in Mozambique.

2.1.2 Oil-exporting African countries have been the main drivers of the continent's growth. In 2012 and 2013, oil-exporting African countries registered economic growth of 9.9% and 4.7% respectively. This increase in growth is projected to continue with Gross Domestic Product (GDP) estimated to reach 6.5% in 2014 and 5.9% in 2015 (see figure 1).

Figure 1: GDP growth (in %) for oil-exporting and oil-importing African countries (2012-15)



Source: Economic Report on Africa, 2014

2.1.3 In spite of strong growth rates, many African countries are afflicted by the paradox of plenty, whereby mineral-rich economies perform worse than mineral-poor countries in

³ ECA and AU, 2013. Economic Report on Africa, Making the Most of Africa's Commodities: Industrializing for Growth, Jobs and Economic Transformation. Addis Ababa: Economic Commission for Africa, P. 8.

terms of social development.⁴ The dichotomy between the wealth of nations, in terms of resources and the poverty of the people in Africa has been the subject of many debates. According to the literature, the paradox of countries endowed with mineral resources is that they demonstrate lower development outcomes - the so-called 'resource curse'.⁵ The resource curse also manifests itself in terms of the Dutch disease (see Box 1).

Box 1: Dutch disease effects in resource rich African countries

The term "Dutch disease" was coined to describe the appreciation of the Guilder, following the discovery of natural gas in 1959. The subsequent increase in petroleum exports resulted in a significant crowding out of other exports. This created a disincentive to expand the domestic manufacturing sector and reduced its overall contribution to economic growth. The phenomenon has affected several mineral rich African countries, especially in their first decade of exploration and export of minerals. Algeria, Angola, Chad, Gabon, Guinea and Nigeria are some examples of countries that have been afflicted by the Dutch Disease.

Nigeria is the largest oil producing country in Africa. Before 1970, agriculture accounted for over 50% of the country's total exports. The country was the largest exporter of groundnuts and second largest exporter of cocoa. However, since 1974, crude oil export accounts for over 96% of its exports. Nigeria has been suffering from the Dutch disease and the challenge is still present. Yet it is important to note that Nigeria is striving to diversify its economy.

Angola is the second largest producer of oil in Africa. Oil has the largest share in the country's export and accounts for 85% of GDP. Moreover, in 2011 oil and gas revenues contributed to 79% of government revenues. It is interesting to note that most people are employed in subsistence agriculture while half of the country's food is imported. In the presence of real exchange rate appreciation, the country is also confronted with a challenge to create competitive manufacturing and industry products vis-à-vis cheaper imports.

Equatorial Guinea has been confronted with the Dutch disease since the country started exporting hydrocarbons. Before the exploration and export of oil, the agricultural sector, especially cocoa and coffee, accounted for 60% of GDP. However, since 2001 cocoa and coffee account for less than 9% of the GDP. Current trends show that the country is not bereft of the Dutch disease as the contribution of minerals represents 87.3% of GDP, while agriculture stands at 4.6% and services at 8.1%.

Algeria is the world's sixth largest exporter of natural gas. Oil has been the backbone of the country's economy, accounting for 97% of total exports, 70% of government revenues and 30% of GDP. The country continues to struggle to develop the manufacturing and industrial sectors as well as to diversify the economy away from its reliance on oil export.

Source: various sources

2.1.4 Although recent studies suggest that from 2000 to 2012, mineral resource exporting countries in Africa experienced faster growth than the non-mineral exporting ones, there were no corresponding improvements in social indicators for those countries.⁶ Indeed, progress continues to be slow in resource rich countries, as measured by the Millennium Development Goals (MDGs). In fact, three mineral-rich African countries (Nigeria, DRC and Tanzania) accounted for 47% of the total poor on the continent in 2010.⁷ Among the 23 mineral-rich African countries, 13 (i.e. 56.5%) are in the Low Human Development Index (HDI) category, while the remaining are in the Medium HDI category. For instance, mineral-

4 Waris, A. and Kohonen M. 2011. Linking Taxation to the Realisation of the Millennium Development Goals in Africa <<http://eadi.org/gc2011/waris-109.pdf>> accessed 16/12/2014

5 Ross, M.L. 1999. The Political Economy of the Resource Curse. *World Politics*, Vol.51, No.2, pp. 297-322.

6 IMF. 2012. Sub-Saharan Africa: Sustaining Growth amid Global Uncertainty, *Regional Economic Outlook*.

7 ECA, AU, AfDB, UNDP, 2014. MDG 2104 Report; assessing progress in Africa toward the Millennium Development Goals: Analysis of the Common African Position on the Post-2015 Development Agenda.

rich countries such as the DRC, Mozambique, Liberia and Guinea continue to score the lowest Human Development Indicators.

2.1.5 In addition, mineral rich economies experience frequent boom and bust cycles, due to revenue volatility. Revenues from natural resources are unsustainable due to fluctuations in global commodity prices. This volatility can further lead to imprudent fiscal policies as shown by the widening of fiscal deficits of mineral rich African economies, from 5.0% in 2012 to 5.5% in 2013. Growth in mineral-rich African countries remains highly vulnerable to external shocks. Since there is need to improve the quality of growth on the African continent, by ensuring that it is far more inclusive, it is imperative for mineral-rich African states to change the sectoral composition of their economies such that labour is absorbed in sectors with high productivity. Equally important to diversify their tax base and reduce their overdependence on the highly volatile mineral prices for revenues. It is therefore, evident that mineral revenues need to be allocated in order to develop other economic sectors.

2.1.6 At present, 38 countries in Africa - 70% of the continent - have mineral resources. A country is considered mineral-rich when 20% of its total exports are derived from mineral resources and it is considered oil-exporting when oil exports are at least 20% higher than their oil imports.⁸ In this regard, 10 African countries⁹ including the DRC, can be classified as oil exporters and 13 as mineral-rich including Tanzania, Zambia and the Republic of South Africa.¹⁰

2.1.7 Historically, minerals belonged to the State, but with increased privatisation, many African countries are also privatising the mineral extraction process and allowing for the sale of mining rights and licenses. It is also important to recall that the process of working the mines in most African countries requires that a company be registered nationally, however shareholding can be outside the continent.

2.1.8 Currently most mineral resource based companies on the African continent are either privately owned by companies registered in other African countries such as South Africa or Mauritius or countries outside Africa such as China, Canada, USA, France, Switzerland and the UK (see Box 2).

⁸ ECA and AU, 2014. Economic Report on Africa: Dynamic Industrial Policy in Africa. Addis Ababa, Economic Commission for Africa.

⁹ Algeria, Angola, Cameroon, Chad, Congo Republic, Côte d'Ivoire, Equatorial Guinea, Gabon, Libya, and Nigeria.

¹⁰ Botswana, Burkina Faso, Central African Republic, Democratic Republic of Congo, Guinea, Mali, Namibia, Niger, Sierra Leone, Tanzania, Zambia, Zimbabwe and South Africa.

Box 2: Examples of Ownership of Mining Companies in Africa

In **Zambia**, the mines were all nationally owned until 20 years ago when privatisation took place partially and the government reduced its ownership to 20%. This includes mining companies like Kansanshi Mines Plc where government has 20% ownership and First Quantum, an Australian Mining Company holds 80%. The law was subsequently revised in 2009 and fully private mining companies were allowed to be set up. Foreign Companies are registered in South Africa, Canada, China, India and Zambia itself.

In the **DRC**, artisanal and small-scale mining companies constitute the majority of mining operations. The government allows partial ownership of mining companies by foreign corporations, but local companies can also be fully state-owned. The largest is the "Générale des Carrières et des Mines" (Gécamines), founded since 1966, which produces copper and cobalt. Gécamines publishes little information on its operations, subsidiaries, or revenues. Its financial statements are audited, but are not regularly reviewed by Parliament.

In **Tanzania**, mining has traditionally been in the hands of foreign-owned MNCs. The State Mining Corporation (STAMICO) is entirely government-owned, but has been largely inactive in recent years. So far, STAMICO has only taken part in one joint venture and no information is available on its future operations. The company is audited annually, but does not publish reports on its operations or revenues. Foreign companies are registered in Ghana, Italy, South Africa, UK and Canada.

In **South Africa**, mining is conducted primarily by locally-owned private mining companies, which are themselves MNCs, which operate in Tanzania, Zambia and the DRC. There is also a state-owned mining company, Alexkor. This State Corporation does not own any shares in privately held mining companies and operates its own mines. Several mining companies are registered on the London Stock Exchange as well as the New York Stock Exchange, but it is unclear if these are foreign held companies.

Source: primary country data

Optimizing Africa's mineral sector for inclusive development

2.1.9 There is strong potential to improve the quality of growth to ensure inclusiveness in mineral-rich Africa, through beneficiation as well as value addition. It is to be noted that some countries intrinsically link beneficiation to value addition, whereas the African Union's 2009 African Mining Vision (AMV) distinguishes between the two. Beneficiation is a transformative process whereby extracted raw ore is converted into a highly concentrated product (e.g. a mineral) to improve its physical properties.

2.1.10 Mining extraction dates back to the prehistoric period in Africa - radiocarbon dating confirms that the oldest known mine was found in Swaziland dating 43,000 years ago.¹¹ Post-independent mineral-rich African states witnessed an evolution in mining methods with deeper mines and the use of open pit mines in Zambia, South Africa and Botswana. The expansion of these mines has tremendously increased the provisional capacity of minerals to the world. The mines near Hotazel in South Africa provide about 75% of the world's manganese and the Debswana mine in Botswana on its own provides 30% of the world's gem diamonds.

In addition to beneficiation, which does not fully exploit the value of the mineral ore, African mineral sectors have a strong potential for value-addition. Within the mineral sector, value addition comprises of a range of activities, which includes smelting and refining as well as craft jewelry and metal fabrication.

¹¹ Swaziland Natural Trust Commission, "Cultural Resources - Malolotja Archaeology, Lion Cavern," Retrieved August 27, 2007

2.1.11 African countries have undertaken beneficiation using different instruments with varying level of success. At present, only a small number of mineral producers in Africa (e.g. South Africa and Botswana) have been able to add and sustain value to their mineral ores. In 2000, the Kenyan government tried to ensure that a titanium processing plant should be made part of contractual negotiations. However after over 10 years of discussions the result was the simple extraction of the ore for export without technology transfer, employment creation nor even investment in infrastructure all of which had been initially tabled.¹² Currently, the government of Zimbabwe has decreased the export of raw platinum minerals and is encouraging foreign platinum producers to construct a major refinery plant to allow for the processing of platinum. The government of DRC has been indecisive about the implementation of a value addition policy as it has twice delayed its intended ban on the export of cobalt and copper. Such ambiguity can deter investor confidence and impede the flow of investments in the short-term.¹³ This notwithstanding, most mineral-rich African countries are cognizant of the potential in terms of additional revenues and employment opportunities that can be gained from value addition.

2.1.12 Among mineral rich African countries, the experience of South Africa in relation to beneficiation and value-addition is a notable example that can and should be duplicated in other African countries (See Box 3). In spite of some progress, it remains a serious challenge for African producers to shift to mineral-based value addition, given the uncertainty in supply perceived by resource extractive Multinational Corporations (MNCs). MNCs in the mining industry are concerned that some of the mineral producers do not possess enough mining volume to make the refining of mineral ore profitable.

2.1.13 Many mineral-rich African countries are also afflicted by erratic and insufficient electricity provision and would thus be unable to supply mineral refineries, which consume large levels of energy. In order to address this challenge, currently some African countries provide electricity subsidies to mining companies, for example Zambia where the electricity cost for mineral companies is reduced by over 50%. Some mining companies in Zambia indicate that the country may not possess enough smelting capacity to process all its copper,¹⁴ however, First Quantum Ltd. In Zambia invested in the largest smelter in the world to process ore domestically at its mine in 2014 and it is already operational.

2.1.14 Mineral-producing states in Africa must plan the evolution of their mineral sector to allow for value addition and offer assurances to the private sector of their feasibility to enable this shift. In this regard, Namibia has taken this forward, as set out in its Fourth National Development Plan by prioritizing logistics, tourism, manufacturing and agriculture.¹⁵

12 Waris, A. 2009. Taxation and a Clean and Healthy Environment: A Case Study of the Mining of Titanium in Kenya in, N. Chalifour et al (Eds) 2009. Critical Issues in Environmental Taxation. International and Comparative Perspectives Volume V (Oxford University Press) Chapter 21.

13 'Mineral Beneficiation in Africa: the Elephant in the room', Fasken Martineau, July 28, 2014

14 Africa's push to add value to minerals now a riskier gamble', Reuters, March 6, 2014, <http://in.reuters.com/article/2014/03/06/mining-beneficiation-africa-idINL6N0LV3N220140306>

15 Republic of Namibia, 2012. Fourth National Development Plan (2012-2017) http://www.npc.gov.na/?wpfb_dl=37 (accessed 15/2/2015)

Box 3: Beneficiation and value-addition experience of South Africa

South Africa's success in using its minerals, metals and precious stones to achieve diversification and value addition has seen the country attain the status of an important hub in the global mining value chain. The country's mining companies are key players in the global industry, with their high levels of technical and production know-how.

The legal and regulatory framework of South Africa promotes value addition. For instance, the Metal Act (2005), Article 6. (1), grants priority to applicant mining companies, which ensures that value addition is included in their production. Furthermore research tax incentives have been offered in amendments of Section 11D of the Income Tax Act (1962) so as to encourage companies to invest in research and development, specifically in regard to science and technology. The Government also developed a minerals beneficiation strategy in 2011 to transform its iron, carbon, steel, stainless steel, aluminum, and gold extractive sectors from largely resource-based to knowledge-based ones. South Africa's beneficiation strategy developed overarching structures and frameworks, implemented through State intervention to promote value addition within its mining sector.

Downstream activities are already well developed and high local content and industry linkages have been achieved as evidenced by the fact that downstream industries use locally produced cement, steel, liquid fuels, electricity, polymers and plastics. Revenues from mining circulate throughout the economy targeting sectors as diverse as financial services and housing. Therefore, through beneficiation and value addition structural transformation creates employment opportunities for broad based segments of society and ultimately development in mineral rich African countries.

Sources: Various Sources

Importance of structural transformation in mineral-rich Africa

2.1.15 Given that minerals and the revenues which they generate are finite, it is critical for African mineral-rich countries to tailor their economic policies in order to utilize these revenues to improve the productivity of non-mineral related sectors. A sectoral change in mineral-rich Africa can happen through structural transformation.

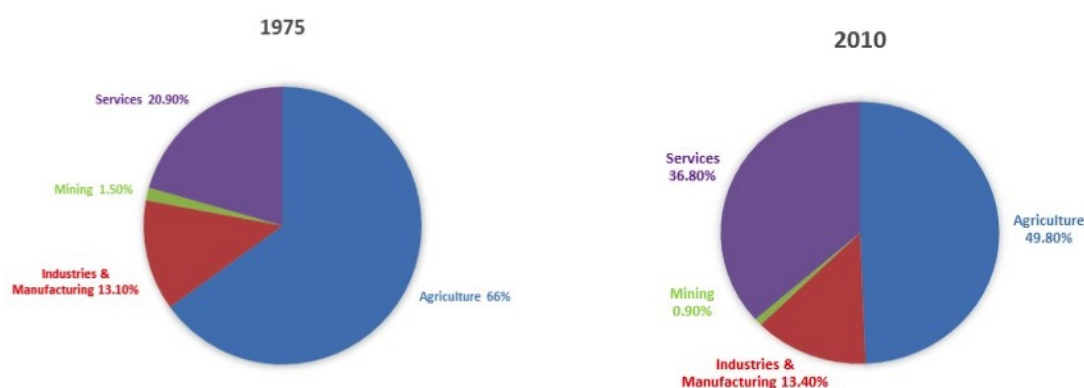
2.1.16 The Economic Commission for Africa (ECA) highlights that structural transformation is *"the change over time in the sectoral composition of output (or GDP) and that of the sectoral pattern of the employment of labor as an economy develops."*¹⁶ In the context of mineral rich countries, structural transformation can be specifically defined as *"...the reallocation of mineral revenues, especially through new investment, from low to higher productivity activities, typically from agriculture to industry and modern services, leading to higher economy-wide productivity and progressively raising income"*.¹⁷

2.1.17 Empirical evidence confirms that economic growth, generated principally by primary commodities, has an adverse effect on inclusiveness as the extraction of mineral and oil commodities are highly capital-intensive. This results in limited employment creation potential within the mineral sector (See figure 2). In this regard, the same sectoral patterns in mineral-poor Africa are observed in mineral-rich Africa, whereby employment remains more concentrated in the agricultural sector. While mining share of employment has dropped, it has not translated into job-creating industrial transformation which has stagnated since 1975. For example mining share of employment has even contracted from 1.5 % in 1975 to 0.90% in 2010.

¹⁶ ECA and AU, 2011. Economic Report on Africa: governing development in Africa-the role of the state in economic transformation. Addis Ababa: Economic Commission for Africa. p.5

¹⁷ ECA and AU, 2014. Economic Report on Africa: Dynamic Industrial Policy in Africa. Addis Ababa: Economic Commission for Africa. p. xii.

Figure 2: Employment by sectors (%) in African countries for 1975 and 2010



Source: Economic Report on Africa (2014)

2.1.18 With the adoption of the Africa Mining Vision (AMV), in February 2009, the African Union (AU) Heads of State and Governments advocated for “transparent, equitable and optimal exploitation of mineral resources to underpin broad-based sustainable growth and socio-economic development”. This includes fostering a transparent and accountable mineral sector in which resource rents are optimized and utilized to promote structural transformation of African economies.¹⁸ In other words, AMV clearly recognizes that optimal mineral revenues – collected and administered through sound governance practices – can be the key engine that drives the structural transformation. In 2012, the African Development Forum (ADF-VIII) on “Governing and Harnessing Natural Resources for Africa’s Development” put mineral resources’ exploitation at the centre of development policy and practice.¹⁹

2.2 DRM in mineral-rich Africa

Auto-financing structural transformation

2.2.1 Africa, as a continent, can mobilize its own resources in order to significantly finance its structural transformation agenda. Indeed, the continent has the potential to generate more than USD 520 billion annually in tax revenues and more than USD 168 billion annually in mineral royalties.²⁰ The generation of own-resources is not a new concept. Thirteen years ago, the framework document of the New Partnership for Africa’s Development (NEPAD) emphasized the need for Africa to strengthen DRM.

2.2.2 The concern of development financing was also addressed by Heads of State and Government in Mexico in 2002. The Monterrey Consensus on Financing for Development of the United Nations²¹ concluded that Overseas Development Assistance (ODA) would remain

¹⁸ <http://africaminingvision.org>.

¹⁹ See ADFVIII Consensus statement. http://new.uneca.org/adfviii/home_adf8.aspx.

²⁰ ECA & NEPAD, 2013. Mobilizing Domestic Financial Resources for implementing NEPAD National and Regional Programmes & Projects – Africa Looks Within. Final draft study report for 29th Session of NEPAD Heads of State and Government Orientation Committee, Addis Ababa, 25 May 2013, p. 2.

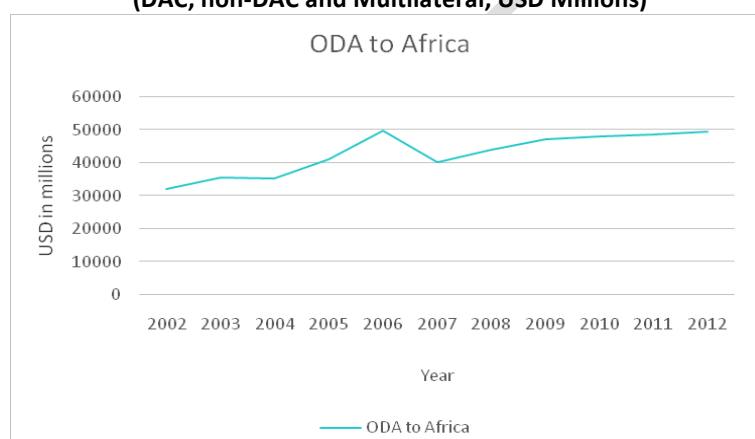
²¹ United Nations, 2003. Monterrey Consensus of the International Conference on Financing for Development: The final text of agreements and commitments adopted at the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002.

insufficient to meet the Millennium Development Goals (MDGs): it was thus deemed critical to define new development strategies, to be financed primarily by domestic resources.

2.2.3 ODA flows, from Development Assistance Committee (DAC) and non-DAC countries as well as from multilateral donors, to Africa are decreasing incrementally. The trend (see figure 3) reflects the adverse effects of the global financial crisis on ODA. Indeed, only in 2013 aid commitments by DAC donor countries accounted for 0.3% of their gross nation income while in the same year Scandinavian countries aid commitments only exceeded the 0.7% target to Africa.²² However, it is important to note that Africa continues to be the largest recipient of ODA.

2.2.4 There is thus a need for all African countries, including mineral-rich ones, to mobilize domestic resources through traditional and innovative methods, whilst ensuring that mobilized resources are retained domestically for developmental investment. DRM also guarantees ownership of a country's development agenda and ensures that resources are not tied to strict aid conditionality frameworks.²³

Figure 3: Total ODA to Africa from 2002 to 2012 (DAC, non-DAC and Multilateral, USD Millions)



Source: OECD database, 2014

Understanding Domestic Resource Mobilization (DRM)

2.2.5 DRM is commonly defined as “*generation of savings domestically and their allocation to socially productive investments within the country*”, in contrast to mobilizing external resources through Foreign Direct Investment (FDI), ODA, trade and debt relief. The principal sources of domestic resources are private savings and government revenues. This study will focus on both private and public domestic savings, since they are equally critical sources of revenues in the mineral sector.

2.2.6 Taxation is the most popular approach towards mobilizing public domestic resources. There are huge amounts of untapped illicit money flowing out of Africa that include tax evasion, which is estimated to be as high as USD 1.8 trillion over the past 39 years.²⁴ A recent study indicates that a 0.44% increase per annum in the tax to GDP ratio

22 UN Millennium Project, 2014. <http://www.unmillenniumproject.org/press/07.htm>

23 ECA, N.D. Public Financial Management: Domestic Resource Mobilization. Addis Ababa: Economic Commission for Africa.

24 GFI. 2009. Illicit Financial Flows from Africa: Hidden Resource for Development < http://gfintegrity.org/storage/gfip/documents/reports/gfi_aficareport_web.pdf > accessed 16/12/2014. See also Froburg and Waris. 2012. Bringing Back the Billions: how Africa and Europe can end illicit capital flight. 32 Global Studies

could mobilize additional public revenues of USD 22.5 billion each year.²⁵ In this context, the key challenge is to increase the tax to GDP ratio. However, in spite of the potential, only few mineral rich African countries, namely Botswana, DRC and South Africa, have high tax revenue to GDP ratios of 36%, 31% and 27%, respectively. Most other mineral rich African countries have a tax to GDP ratio of less than 10%.²⁶ In addition there are discussions at the international level on setting up global funds, through international taxation, either using existing international taxes such as carbon or tobacco tax, or by creating new taxes, which would be potentially earmarked for the MDGs as well as specific needs such as health.²⁷

2.2.7 Another way of mobilizing domestic resources in mineral rich African countries is through domestic savings. However, for many African countries, since 2008, gross domestic savings have been consistently lower than the gross domestic investment. This can be largely attributed to the global financial crisis of 2008/09. Domestic savings have fallen short of the continent's investment needs: in 2007, domestic savings accounted for around 23% of GDP while investments accounted for less. In 2011, gross domestic savings dropped to 16% of GDP and investment increased to roughly 23%.²⁸

2.2.8 It is observed that African countries with mineral and energy rents, which comprise a large share of the Gross National Income, typically have negative saving rates. Some oil-exporting countries, such as Angola and Nigeria, have in some cases registered low or even negative savings rates. It is critical for mineral-dependent countries to have positive domestic savings to sustain consumption and ensure investments. Botswana and Ghana have achieved positive economic growth, which has been partly supported by their positive savings rates.²⁹

2.2.9 The decline in domestic savings resulted in an increase in foreign debt as a share of GDP, from 22.7% in 2010 to 24% in 2013. Certain African regions such as East and Southern Africa have the highest debt-to-GDP ratios equalling 31.8% and 33.5% in 2013 respectively. This increase in external borrowing is due to countries attempting to reduce their financing gaps, as a result of the declining domestic savings and external capital flows. Therefore, some mineral-rich African countries have witnessed a sharp increase in debt over the past four years such as Angola and South Africa.³⁰

2.2.10 In addition to the above-cited approaches of mobilizing resources domestically, there are also innovative methods, which include Sovereign Wealth Funds (SWF), infrastructure and Diaspora bonds Public Private Partnerships (PPPs) and pension funds (see Box 4).

25 Abugre, Charles and Antieno Ndomo, n.d. Structural Transformation and the Challenge of Financing Africa's Post-2015 Development Goals. Nairobi, Kenya.

26 ECA, N.D. Public Financial Management: Domestic Resource Mobilization. Addis Ababa: Economic Commission for Africa. P. 15 and UNECA, NEPAD Planning and Coordinating Agency, 2014. Mobilizing Domestic Financial Resources for Implementing NEPAD National and Regional Programmes & Projects: Africa Looks Within p. 120. See also Waris and Kohonen (2012)

27 Waris, A. International Taxation and Global Solidarity in Reader on Global Social Protection (March 2013) Germany (Ed. Jens Holtz)

28 Calculations based on World Development Indicators, 2013b.

29 African Development Bank. 2007. African development report 2007: natural resources for sustainable development in Africa. Oxford: Published for the African Development Bank by Oxford University Press. p 106-107

30 United Nations, and African Union. 2014. Dynamic Industrial Policy in Africa: Economic Report on Africa 2014. New York: United Nations. p 20-21.

Box 4: Non-traditional approaches to raising domestic resources

Sovereign Wealth Funds (SWFs) are structured to eliminate inefficiency in resource wealth management, ensure less political interference and a professional approach to portfolio allocation and performance attribution. At least eleven resource-rich African countries already have SWFs, namely: Algeria, Angola, Botswana, Chad, Equatorial Guinea, Gabon, Ghana, Libya, Nigeria, Sudan, and Saõ Tome and Principe.

Infrastructure and Diaspora bonds are another possible source of DRM. The first country to have explicitly issued a Diaspora bond was Ethiopia. This was done in order to address the country's electricity shortages. The bond was issued in 2011 to finance the Grand Renaissance Dam project, which cost USD 4.8 billion. However, it has been indicated that the money raised from this bond is mainly from the domestic market. There are lessons to be learned from the Ethiopian bond, notably whether the Diaspora is actually reachable as well as continued marketing of the bond.

Public Private Partnerships (PPPs) are a contractual arrangement between the public and private sectors to achieve agreed goals. Such arrangements occur in many economic sectors including mining, energy generation, telecommunications, transport, industries and services. Previously, the mining sector was owned exclusively by the public sector in Africa. However, the mining industry is capital intensive and needs advanced technology, skilled personnel and corporate social responsibility. In this regard, partnering with the private sector offers these benefits for mineral rich African countries. In Botswana, the government partnered a 50/50 joint venture with De Beers in diamond mining. In Zimbabwe the government has partnered with three mining companies namely Mbada, Anjin and DMC in Chiadzwa diamond mining. As a result, the partnership in both countries increased productivity and wealth creation as well as employment creation. Accordingly, partnering with the private sector must be seen as a 'must', rather than an exception in mineral rich African countries.

Pension funds are also increasingly seen as an innovative way of mobilizing domestic resources. There is great potential for pension funds in mineral rich African countries. South Africa, for instance, has Africa's largest pension fund with an asset worth of USD 85.5 billion. The funds are invested in equities, fixed-income investments and retail, corporate and industrial properties and black economic empowerments in the country. The total value for pension funds in Nigeria is USD 14 billion, while in Namibia it is USD 6.1 billion. Botswana is able to collect US 5.6 billion dollars from its pension fund. Ghana has collected USD 677 million from its pension fund and has been able to successfully channel these funds into long-term investments to finance its critical infrastructure challenges such as roads, health and education. However, it is important to note that regulatory and management structures in most mineral rich African countries are still at the infancy stage.

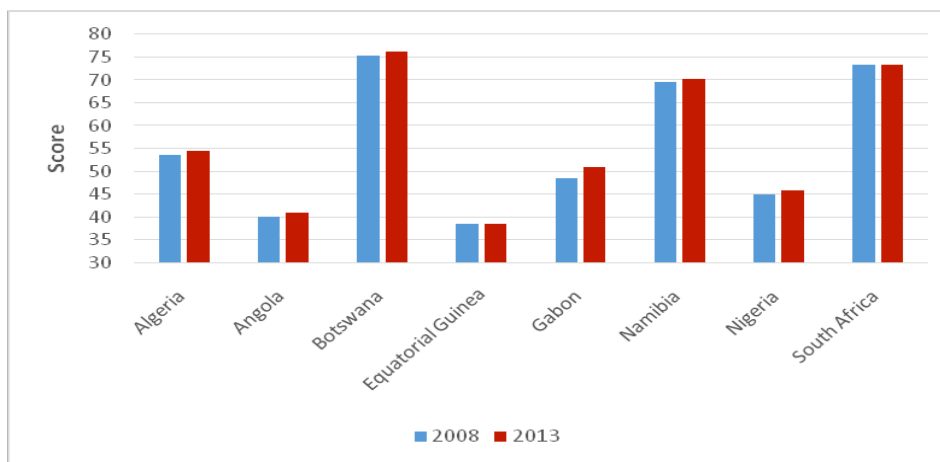
Sources: various sources

2.3 Importance of Good Governance for DRM in Mineral-rich Africa

2.3.1 It is undeniable that oil-exporting and mineral-rich countries need to ensure a robust set of macroeconomic policies to avoid the resource curse. However, this in itself is not sufficient. The inability to mobilize optimal resource rents and allocate them in an efficient, transparent, accountable and equitable manner remain crucial to the sustainable development of the extractive sector in those countries.

2.3.2 In terms of governance trends, the Ibrahim Index of African Governance (IIAG), which provides a yearly comprehensive assessment of the quality of governance in African countries, indicates that there have been minor improvements in the performance of mineral-rich states (see figure 4). These notwithstanding, certain countries, notably Botswana, Namibia and South Africa, have consistently maintained a good governance performance, which is also reflected in the countries' development patterns.

Figure 4: Quality of governance in selected natural resource rich African countries



Source: Ibrahim Index of African Governance, (<http://www.moibrahimfoundation.org/interact/>)

2.3.3 In addition, analysis of the four country case studies elicited the following issues as being areas of specific concern in the context of governance. All four countries shared concerns of poor management of public finances and the country's resources as well as poor redistribution of resources of the country as well as corruption at all levels of the state. South Africa specifically identified the issue of apartheid and the legacy of a divided society while Zambia mentioned human rights. In addition, the DRC also expressed concerns over the persistence of armed conflicts and insecurity; tribalism and political patronage and the extreme politicization of the services of the army, security and public services.

2.3.4 Successful harnessing of extractive resources for growth, poverty reduction, and social development depends on good governance and sound management practices. Good governance is a fundamental precondition in ensuring the sustainable mobilization of domestic resources for structural transformation. For African countries, the African Union's New Economic Partnership for Africa's Development (NEPAD) strategy articulates the principles of good governance. For mineral-rich countries, the two dimensions of governance that are the most critical are political governance and economic governance.

2.3.5 The State has an instrumental role to play in ensuring good governance for DRM, which is required to implement structural transformation. Governments need to ensure that the adequate policy mix is in place as well as the relevant institutions to ensure a country's successful development. Such a state is commonly defined by the literature as a 'developmental state'. This term came about following the successful industrialization of East Asian countries during the 1960s. These countries were able to drive their development, by maintaining trust and a collaborative relationship between the political elite, civil service and private sector. In addition, they maintained a strong commitment to developing and strengthening infrastructure, human capital and financial management.

2.3.6 A developmental state is defined as one that "*...has the capacity to deploy its authority, credibility and legitimacy in a binding manner to design development policies and programmes for promoting transformation and growth...*".³¹ In mineral-rich Africa, developmental states are even more critical since it would ensure that domestic resources

³¹ ECA & AU, 2011. Economic Report on Africa 2011: Governing development in Africa – the role of the state in economic transformation, United Nations Publication, p. 7

are adequately mobilized from the mineral and non-mineral sectors, whilst providing a visionary leadership to decrease the dependence of countries on minerals and/or oil.

Political stability for DRM in mineral rich Africa

2.3.7 The political economy literature concurs that inadequate political governance has afflicted many mineral-rich countries. Although the cause for political strife is often linked to the lack of management of ethnic diversity, since the 1970s several civil wars and conflicts on the African continent have been associated to resource wealth.³² This has been observed notably in Angola (1975-2002); the DRC (1996-97); and Sierra Leone (1991-2000). Moreover, resource-rich countries are not confined to conflict only within their national boundaries, as “hidden” economic stakeholders also capitalize by smuggling out the minerals and there is sometimes manipulation by external powers.³³

2.3.8 In seeking to achieve the goal of democratic, representative and accountable governance, it is essential that States maintain peace and security as well as establish sufficient electoral and oversight institutions. In this regard, the ECA advocates that good political governance in Africa implies ensuring political representation and civil participation is promoted so that all citizens are involved in all political processes.³⁴

Good economic governance for increased DRM

2.3.9 Public Financial Management (PFM) is also an integral process of improving DRM in mineral-rich African countries. In this regard, fiscal and monetary stability are essential prerequisites for a good management of mineral revenues, in light of the disruptive effects of revenue volatility in a resource-based economy. Countries that have successfully managed natural resources revenues (e.g. Botswana and South Africa) have taken efficient savings and investment decisions, in order to mitigate the impact of volatile revenue streams on fiscal budgets.

2.3.10 Currently, too many African countries, including mineral rich ones, have significant shortfalls in the transparency and accountability of budgetary revenues and expenditures. In addition, there are loopholes in the legal and regulatory frameworks of the extractives industry, which exacerbate corrupt practices. One daunting challenge for many mineral-rich African countries continues to be the financial resources that are drained illicitly from their national territories. IFF are carried out through trade mis-invoicing, transfer pricing, as well as illicit transfers of funds to offshore financial and banking centres.

2.3.11 The widespread problem of tax evasion by MNCs in extractive industries is a serious threat to Africa’s sustained development. There is evidence that extractive sectors are associated with high levels of IFF. According to Rodgers (2006), some oil and mineral exporting countries are perceived as being among the most corrupt. He uses statistical data by diamond-producing-and-importing countries, through the Kimberley Process Certification Scheme, to state that global production was nearly twice as large as previously estimated, underlying smuggling, underreporting, and tax evasion.³⁵ ECA also conducted a study on

³² ECA, UNDP, 2013: African Governance Report III: Elections and the Management of Diversity, Oxford University Press

³³ African Development Bank, 2007: African Development Report: natural resources for sustainable development in Africa. Chapter 4, p. 97 -144

³⁴ ECA, Democracy and Good Political Governance. <http://www.uneca.org/aprm/pages/democracy-and-good-political-governance>

³⁵ Rodgers E. J. A. 2006. Conflict Diamonds: Certification and Corruption: A Case Study of Sierra Leone. Journal of Financial Crime 13, no. 3; p. 267-76

Illicit Financial Flows (IFF) from Africa measuring trade mis-pricing which showed that more than half (56%) of the IFF from the African continent over the period 2000-2009, arose from oil, precious metals and minerals, ores, iron and steel, and copper.³⁶ However the countries studies all registered difficulties not only in accessing public information but also specific technical data to enable an update and more accurate assessment of the quantification of losses at the country level.

2.3.12 Significant illicit capital outflows undermine Africa's resource-rich economic transformation by draining tax revenues and foreign exchange resources, thus stifling growth and socio-economic development. The African Commission on Human and Peoples' Rights recognized in its resolution in 2013 that illicit capital flight undermined the ability of African states to implement the African Charter on Human and Peoples' Rights as well as their MDG obligations.³⁷

2.3.13 In addition, the Common African Position (CAP) on the post-2015 development agenda recognizes the importance of curtailing "*Illicit Financial Flows and fight corruption in a way that ensures the efficient and effective use of resources and domestic long-term financing, such as insurance, pension schemes and capital market instruments.*"³⁸ The report further notes that "*to promote and enhance the efficiency of innovative financing mechanisms, we must: develop mechanisms to harness and invest remittances; reduce remittance transfer costs and enhance their effective management; and strengthen long-term, non-traditional financing mechanisms.*"³⁹

2.3.14 In order to strengthen good governance and address challenges related to corruption including IFF, key international and regional governance initiatives have been established. At international level, the most well-known ones are the *Extractive Industries Transparency Initiative (EITI)*, the *Kimberley Process Certification Scheme* and Publish What You Pay (PWYP) Campaign. In addition, there is also the Open Government Partnership (OGP), which is highly relevant to mineral-rich African countries.

2.3.15 The EITI is an international initiative that maintains a standard in extraction of a country's oil, gas and mineral resources. In order to be recognized by the EITI, governments and companies are expected to meet certain standards. These standards relate to full disclosure of taxes and other payments made by oil, gas and mining companies made to governments on an annual basis. The overarching objective is to improve governance in mineral rich countries including promoting transparency and accountability in the payments and receipts of revenues generated from the extractive industry. At present, 24 African countries have joined the EITI, but of which only three countries have completed the validation process (i.e. Liberia, Nigeria and Ghana).

2.3.16 The KPCS, launched in May 2000, aims to promote transparency and accountability in the diamond trade. It requires member states to certify that diamonds mined within their borders are conflict-free. Eleven African countries are members to the process. The process has helped to reduce conflicts and civil wars as well as improved revenues in diamond rich African countries. The Publish What You Pay (PWYP), which is an initiative, launched in

36 UNECA, The State of Governance in Africa: The Dimension of Illicit Financial Flows as a Governance Challenge. Third Meeting of the Committee on Governance and Popular Participation, Addis Ababa, Ethiopia 20 and 21 February 2013 (E/ECA/CGPP/3/2) http://www.uneca.org/sites/default/files/uploaded-documents/CGPP/cgpp-3_illicit-financial-flow-english_final.pdf (accessed 16/4/2015) p.8

37 ACHPR, Resolution 236 of 2013: Resolution on Illicit Capital Flight from Africa (23 April 2013) <http://www.achpr.org/sessions/53rd/resolutions/236/> accessed 16/12/2014

38 CAP. 2014. Common African Position on the Post-2015 Development Agenda. Addis Ababa: African Union p.23

39 Ibid

2002, by a coalition of civil society groups, calls for “*the mandatory disclosure of payments made by oil, gas and mining extractive companies to each national government*”.⁴⁰ There are at present 26 countries that have joined this Initiative. By encouraging private firms to “*publish what they pay*” to governments, the initiative enables citizens in resource rich countries to hold their governments accountable.

2.3.17 The OGP is an international platform, which seeks to promote transparency, accountability and civic partnership in its member states. It was established in 2011. For countries to participate in the OGP, they must meet the minimum standards of its eligibility criteria. The eligibility criteria are assessed by an evaluation of a country’s performance in four main areas: access to information, fiscal transparency, citizen engagement and public official’s asset disclosure. States that score 75% and above in the evaluation are able to join. Once approved to join, states must follow the requirements of the OGP, which includes defining a national action plan with civil society, incorporating the OGP’s commitments therein and preparing annual self-assessment reports.⁴¹

2.3.18 OGP currently has 65 member States, of which only eight are African: Ghana, Kenya, Liberia, Malawi, Sierra Leone, South Africa, Tanzania and Tunisia. Out of the eight African countries, only three are mineral-rich.⁴² The very low number of African countries, particularly the mineral rich countries, which have joined this Partnership, is concerning. The reason for this low membership of African countries, is that many are unable to meet the OGP’s requirements. The above-mentioned instruments have contributed to improved governance in the extractives industry in Africa. However, several studies have shown that in many countries, these instruments remain stand-alone and/or parallel structures, which are not sufficiently embedded in national policy and decision-making processes. Moreover, these instruments lack the comprehensive approach taken by African-owned instruments and mechanisms for the promotion of developmental mining for structural transformation and inclusive growth.

2.3.19 In the past decade, several African initiatives have been promoted in order to strengthen inclusive governance mechanisms for mineral resources’ management. The African Peer Review Mechanism (APRM), as an African-owned mechanism, offers an opportunity to improve Africa’s governance standards in the extractives sector and the management of Africa’s mineral resources. As a home-grown peer review process it creates mutual accountability and benchmarking amongst African States. It also encourages public discussions with all stakeholders through an inclusive, participative and consultative process that has the potential of ensuring domestic accountability. Furthermore, by including a specific chapter on extractive industry governance to its country review questionnaire, the APRM has made a significant step towards deepening the ownership of natural resources governance.

2.3.20 A further step forward was also made when the 17th Summit of the Committee of Heads of State and Government participating in the APR Forum, approved the revised APRM Self-Assessment Questionnaire, which includes detailed questions and indicators for the

⁴⁰ See Publish What You Pay Campaign website. Available at <http://www.publishwhatyoupay.org/en/resources/new-report-history-and-achievements-publish-what-you-pay-coalition>

⁴¹ “How it works”, Open Government Partnership, Available at <http://www.opengovpartnership.org/how-it-works/requirements> (assessed January 28, 2015)

⁴² “Eligibility criteria”, Open Government Partnership, Available at <http://www.opengovpartnership.org/how-it-works/eligibility-criteria>, (assessed January 28, 2015)

management of extractive industries.⁴³ The quality and depth of the consultations that the APRM provides for, as well as the efforts to link its National Plans of Action with budget frameworks, offer an opportunity to move discussions on governance beyond rhetoric to results and action-oriented compacts that can promote structural change.

2.3.21 Since 2009, the AMV has advocated for an effective governance of the mineral resources sector on the African continent. These governance areas include: (a) peace, security and political stability; (b) clear, transparent, predictable and efficient legal and regulatory frameworks to ensure mineral wealth creation; (c) fair and equitable fiscal regimes to facilitate equity in the distribution of benefits and (d) credible public participation to enhance ownership and shape shared development outcomes.

2.3.22 The AMV identifies effective and innovative fiscal regimes as an integral component of a developmental and well-governed mining sector that aims at apportioning “rent” fairly between the investor and the country in which the minerals are located. According to the Vision, while investors should be compensated through a rate of return for investment risk, the host government should receive commensurate returns from the exploitation of its non-renewable resources.

2.3.23 It is worth recalling that the AMV also recognizes the need to ensure active participation and consultation of all relevant stakeholders in the management of mineral resources. Lesson learned from AMV implementation at country level have shown that participatory approaches have contributed in enhancing quality, ownership, and sustainability, in addition to empowering targeted beneficiaries, and promoting greater transparency in the management of revenues.

2.3.24 Nevertheless, in line with AMV, visionary leadership and multi-stakeholder participation, increased transparency and accountability in the mineral sector are perceived as key elements for the achievement of wider goals in terms of structural transformation and inclusive economic growth. In other words, good economic and political governance have been recognized as critical factors in facilitating the structural transformation of mineral rich Africa.

Governance institutions for DRM in mineral-rich Africa

2.3.25 Institutional weaknesses and/or lack of capacities among African mineral-dependent States remain one of the underlying factors in the mismanagement of revenues. Many of these States have an unsatisfactory performance record, as per the Resource Governance Index (RGI), which provides a comprehensive assessment of the quality of supervision and regulation of countries’ exploitation of their resources.

2.3.26 Several mineral-rich African countries lack technical expertise within their revenue collection agencies and this was confirmed by all 4 country case studies. They are thus unable to accurately calculate the profit levels of mineral extractive companies.⁴⁴ In addition, countries’ tax filing is not always fully computerized if at all, which implies inconsistent tax records and additional administrative costs. There is also a lack of expertise in current methods of tax auditing, monitoring, regulation and resource exploitative frameworks to develop the mineral sectors connections to the domestic economy. However

⁴³ <http://aprm-au.org/sites/default/files/Revised%20APRM%20Eng%20Questionnaire%206%20Aug%2012.pdf>.

⁴⁴ World Bank Group, 2013. Financing for Development Post-2015, p 10.

in Zambia, an agreement with Norway has resulted in extensive training in mining audits and the revenue staff is now better able to conduct independent investigations.

2.3.27 In this regard, political commitment to broaden tax base and improve tax administration is important. It is to be recalled that some mineral-rich African countries, including South Africa, Tanzania, Uganda and Zambia, have established partially independent tax agencies to address the issue of tax administration.⁴⁵ However, this independence is limited and most policy directives remain under the Ministries of Finance in the respective states. This implies that any legislative and regulatory changes should be done under the auspices of the Ministry itself and where there is a lack of political will basic regulations could get blocked at different stages.

2.3.28 The 2013 Resource Governance Index (RGI), which measures transparency in oil, gas and mining in the 58 countries that collectively produce 85% of the world’s petroleum, 50% of its diamonds and 80% of its copper reveals that 80% of these countries “fail to achieve good governance in their extractive sectors”.⁴⁶ They ranked countries as set out in the table below with African countries predominantly falling below the average standard.

Table 1: Scores for resource governance of selected African mineral rich countries

Country	Minerals	Composite Score* (2013)	Rank
Zambia	Copper	61	Partial
South Africa	Diamonds, Gold & Oil	56	Partial
Tanzania	Gold, Copper, Silver, Diamonds & Natural Gas	50	Weak
Botswana	Copper, Diamonds, Gold & Nickel	47	Weak
Gabon	Manganese, Uranium, Oil & Phosphate	46	Weak
Nigeria	Oil	42	Weak
Angola	Gold, Diamonds & Oil	42	Weak
Democratic Republic of Congo	Cobalt, Coltan, Copper, Diamonds & Gold	39	Fail
Algeria	Oil	38	Fail
Zimbabwe	Diamonds	31	Fail
Libya	Oil	19	Fail

Source: Resource Governance Index 2013, <http://www.resourcegovernance.org/rgi/report#fig1>

* Resource governance is measured in 4 areas: institutional & legal setting; reporting practices, safeguards & quality controls and enabling environment.

45 See UNECA, NEPAD Planning and Coordinating Agency, 2014. Mobilizing Domestic Financial Resources for Implementing NEPAD National and Regional Programmes & Projects: Africa Looks Within. p. 16.

46The 2013 Resource Governance Index, available at: http://www.resourcegovernance.org/sites/default/files/rgi_2013_Eng.pdf last accessed on February 2015.

2.4 Conclusion

2.4.1 In many mineral-rich African countries, oil and mineral revenues do not reach the poorer strata of the population. In this context, it is essential for governments to ensure good natural resources governance for inclusive development. However, given that mineral revenues are finite, it is equally critical for mineral-rich African states to mobilize domestic resources through taxation and non-taxation approaches, whilst urgently addressing the daunting challenge of IFF. It is evident that without sufficient domestic resources, ensuring meaningful sectoral changes in these African economies will not be possible.

DRAFT

3. Impact of IFF on DRM in Africa

This Chapter examines the impact of the continued Illicit Financial Flows (IFF) on Domestic Resource Mobilization (DRM) in Africa. Section 3.1 sets out the types of practices found globally as well as those practices either in or associated with mineral-rich African countries. Section 3.2 presents the estimated magnitudes of IFF in Africa. Section 3.3 thereafter discusses the resulting impact of continued IFF on the DRM of mineral-rich African States generally and with specific reference to the four country case studies.

3.1 Typology of IFF practices in mineral-rich Africa

Definitions of IFF

3.1.1. There are several definitions that have been put forward to describe the concept of illicit financial flows. Kar & Freitas (2012) describe IFFs as “*funds that are illegally earned, transferred, or utilized and cover all unrecorded private financial outflows that drive the accumulation of foreign assets by residents in contravention of applicable laws and regulatory frameworks*”.⁴⁷ Jansky (2013) explains the term by classifying IFF into three groups: illegal (or criminal), individual illicit, or corporate (commercial) illicit.⁴⁸ This classification is similar to the one used by Baker (2005), but differentiates between financial flows related to legal commercial activities and those related to criminal activities. Baker further distinguishes the flows related to legal commercial activities according to the three channels through which they leave poor countries: (a) mis-pricing of goods traded between independent parties, (b) distortion of transfer prices charged on goods traded within a multinational firm, and (c) fake transactions. When assessing IFF in the extractive industries sector, it would be important to examine the three dimensions.

3.1.2. There is a debate within the literature regarding the use of the term “illicit” and whether it captures the real nature of the funds flowing out of the country of origin. This study purports that the term ‘illicit’ is the plausible term to use since it captures the essence of IFF. It refers to activities, which go against the established rules, while the activities that generate the revenues may not be strictly illegal in all cases.⁴⁹ For example, there may be cases of contracts involving a legal transfer such as a natural resource export, but which are a part of money laundering as a result of a corruption deal between officials and foreign companies. The sources of these IFF can be both illegal (e.g. through drug trafficking) and legal (e.g. through legitimately generated funds, which are transferred illicitly to another country in order to avoid tax obligations in the country of origin). Baker (2005) estimates that over 60% of total illicit flows arise from legal commercial transactions. This finding is of particular importance to this study since the relationship between governments and Multinational National Corporations (MNCs) is based on legally enforceable contracts.

47 Kar, D. & Freitas, S., 2012. Illicit Financial Flows from Developing Countries 2001-2010. A December 2012 Report from Global Financial Integrity. Available at: <http://iff.gfintegrity.org/iff2012/2012report.html>

48 Jansky, P. & Prats, A., 2013. Multinational corporations and the profit-shifting lure of tax havens. Christian Aid Occasional Paper, (Number 9). Available at: <http://www.christianaid.org.uk/Images/CA-OP-9-multinational-corporations-tax-havens-March-2013.pdf>

49 Reuter, P., 2012. Draining Development? Controlling Flows of Illicit Funds from Developing Countries. Available at: <http://openknowledge.worldbank.org/handle/10986/2242>, at page 7.

3.1.3. This study-report adopts the definition by the High Level Panel on Illicit Financial Flows from Africa (HLP) as follows: “*money illegally earned, transferred or used*”.⁵⁰ MNCs are arguably the major source of IFF. A large proportion of IFF comes from Corporations that strive to maximize profit and avoid/evade taxes. There are motivations other than tax avoidance/evasion in shifting income abroad, such as the threat of expropriation or confiscation of private property, economic and political uncertainty, financial repression, or devaluation. Thus far, no African country has independently defined IFF for practical application in the mining or in other sectors. A country-specific definition would provide legal clarity in calculating the collection of taxes.

Identified IFF practices

3.1.4. Extensive research work conducted recently aims at unpacking the methods and practices used to facilitate IFF. Global Wealth Chains (GWC) are being analyzed to understand IFF practices. In addition GWC help to determine the actors involved, but also the practices they use to facilitate IFF.⁵¹ GWC are defined as “*transacted forms of capital operating multi-jurisdictionally for the purposes of pecuniary wealth creation and protection*”. GWC change according to: (i) the complexity of transactions, (ii) regulatory liability and (iii) innovation capacities among suppliers of products used in wealth chains.

3.1.5. GWC can be articulated in various ways, depending on the complexity of the transactions and the types of relationships between suppliers, clients, and regulators. The Systems of Tax Evasion and Laundering (STEAL) specify that there are five types of wealth chains: market, modular, relational, captive, and hierarchy (see Box 5). These links in the chain range from simple ‘off-the-shelf’ products, shielded from regulators by advantageous international tax laws, to complex innovative financial products provided by large financial institutions and corporations.

Box 5: Types of Global Wealth Chains (GWC)

- Market wealth chains occur through arms length relationships with low complexity in established legal regimes.
- Modular wealth chains offer customized services and products within well-established financial and legal environments, which restrict supplier and client flexibility. Products involve complex information, but can be exchanged with little explicit coordination.
- Relational wealth chains involve the exchange of complex tacit information; requiring high levels of explicit coordination and offer rely on trust networks.
- Captive wealth chains are where lead suppliers dominate smaller suppliers by dominating the legal apparatus and financial technology.
- Hierarchy wealth chains are vertically integrated and highly complex, whereby a high degree of control is exercised by senior management.

Source: STEAL

3.1.6. Individuals and institutions that engage in IFF make use of the laws in different countries, which allow for the secret/confidential movement and receipt of resources (see Box 6). These flows are facilitated mainly through the principle of bank secrecy, which

50 Report of the High Level Panel on Illicit Financial Flows from Africa. Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development. Available at: http://www.uneca.org/sites/default/files/publications/iff_main_report_english.pdf, page 23

51 Seabrook, L. and Wigan D. 2014. Global wealth chains in the international political economy 21 (1) RIPE

allows the movements to take place without knowledge of the different governments where the resources may either be criminally acquired and may include undeclared income and profits. It should be noted that these secrecy provisions make it impossible to assess and to accurately measure the magnitude of IFF.

Box 6: Main IFF Practices

Transfer mis-pricing

Multinational groups of companies are often complex structures with hundreds of subsidiaries, a substantial number of which may be located in tax havens where no or very low taxes are paid and secrecy is applied. Profits are allocated between subsidiaries through internal trading, a complicated process which is hard for tax authorities to police. It is estimated that 60% of international trade is now intra-firm trade between subsidiaries of the same multinational. Transfer pricing involves determining the sales prices between different entities within the multinational. In most countries this must be done using the 'arm's-length principle' i.e. the price must be equivalent to the open market price that would apply between unrelated and independent companies. Normally, trading parties want the best price for themselves. But when two companies that trade belong to the same MNC, they do not want the best price for the individual company, but a price that creates the best overall result for the MNC. The companies may therefore allocate the profit between the two subsidiary companies in such a way that a minimal amount of tax has to be paid. When a MNC is deliberately manipulating its prices in order to shift profits to low tax jurisdictions, this is known as transfer mispricing.

Falsified invoicing

Falsified invoicing can be carried out in several ways, all of which have a common feature in that the import or export of goods are not reported honestly or are even completely falsified. A company in a developing country that is importing goods can inflate the price it declares that it has to pay to the foreign supplier, so that it can report lower profits and therefore pay less tax. The reverse can also happen. A person exporting goods from a developing country could deliberately undervalue what is being sold, at least in official documents, so that profits are once again hidden. Since it is often based on verbal agreements between buyers and sellers, falsified invoicing is difficult to detect and is widespread. It is, for example, estimated that 60 % of trade transactions in Africa are mispriced by an average of more than 11%.

Round-tripping

Round-tripping means that a company that has shifted profits from a developing country towards a tax haven reinvests part of the profits in the same developing country. This time it is being considered as Foreign Direct Investment (FDI) and thus it can benefit from favorable fiscal conditions like tax holidays offered by the host country. Round tripping allows not only for tax evasion and avoidance, but also takes advantage of the tax exemptions that many developing countries grant to incoming investment. Similar ways are also used to recycle money coming from criminal activities into the legal economy.

Sources:

Kapoor, S. (2006), Exposing the myth and plugging the leaks, in impossible architecture, Social Watch SOMO (2008), Taxation and Financing for Development
Simon J. Pack and John Zdanovic, 2002 and 2006, cited from Eurodad (2008), Addressing Development's Black Hole: Regulating Capital Flight

3.2 Magnitude of IFF in Africa

Methods for measuring IFF

3.2.1. There are several empirical models, which have been used to estimate both the magnitude of IFF and their economic implications for developing countries, including those in Africa. These methods are: Hot Money Method, Dooley Method, World Bank Residual Method and International Monetary Fund (IMF) Direction of Trade Statistics (DOTS)–based Trade Mispricing Method. The latter two remain the most widely used.⁵²

3.2.2. The Hot Money Method records IFF through net errors and omissions in payment balances. The Dooley Method relies on privately held foreign assets reported in the Balance of Payments that do not generate investment income. The World Bank Residual Method estimates IFF as the difference between the source of funds (external debt and FDI) and the use of funds (current account deficit and reserves). The Trade Mispricing Model assesses IFF by looking for disparities arising from over-invoicing of imports and under-invoicing of exports, after adjusting for ordinary price differences. In this model, imports are generally recorded after adjusting for the cost of insurance and freight, while exports are usually valued Free-On-Board (FOB).⁵³

3.2.3. These methods attempt to capture the value of illicit flows by contrasting what a country claims it imported from (or exported to) the rest of the world with what the rest of the world states it exported to (or imported from) that given country. It is also possible to combine these models and create a composite measure. For instance, the Global Financial Integrity (GFI) uses the World Bank residual as well as the hot money models and makes adjustments for trade mis-invoicing. The GFI's model estimates that the developing world lost USD 859 billion in illicit outflows in 2010, which is significantly more than the USD 129 billion granted in aid by OECD countries in 2010. Their estimates, suggest that bribery, kickbacks, and the proceeds of corruption continued to be the primary driver of IFF from the Middle East and North Africa, while trade mis-pricing was the primary driver of IFF in the other regions.⁵⁴

3.2.4. On the basis of such methods, Hollingshead (2010) calculates the loss of tax revenue to developing countries resulting from illicit financial outflows. She uses national corporate income tax rates to estimate the tax revenue loss from trade mis-pricing. She finds the average tax revenue loss in poor countries was between USD 98 billion and USD 106 billion annually over the years 2002 to 2006. This figure represents an average loss of about 4.4% of the entire developing world's total tax revenue.⁵⁵

3.2.5. In terms of the magnitude of IFF globally, the latest estimates indicate an average annual loss of more than USD 1 trillion for 2007–2009, with Africa's share being nearly 6%.⁵⁶ However, it is important to note that these estimates do not capture the full magnitude of IFF given the incompleteness of the data and the diverse channels for illicit capital flows, some of which remain highly secretive. Moreover, estimates of IFF can differ considerably

52 Report of the High Level Panel on Illicit Financial Flows from Africa. Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development. Available at: http://www.uneca.org/sites/default/files/publications/iff_main_report_english.pdf at page 90.

53 Kar, Dev, and Devon Cartwright-Smith (2008). *Illicit Financial Flows from Developing Countries, 2002–2006*. Washington, DC: Global Financial Integrity.

54 Kar, D. & Freitas, S., 2012. *Illicit Financial Flows from Developing Countries 2001–2010*. December 2012 Report from Global Financial Integrity. Available at: <http://iff.gfintegrity.org/iff2012/2012report.html>

55 Hollingshead, A., 2010. *The Implied Tax Revenue Loss from Trade Mispricing*. Available at: <http://www.gfintegrity.org/content/view/292/156/>

56 Kar, Dev, and Sarah Freitas (2011). *Illicit Financial Flows from Developing Countries over the Decade Ending 2009*. Washington, DC: Global Financial Integrity.

given the method that is used for calculation, assumptions and data, even when using a similar methodology. For example, a 2011 report by GFI on IFF from developing countries estimates that IFF at the regional and national levels could differ from those published in its 2010 report due to revisions of the underlying data provided by member countries.⁵⁷ In 2006, annual losses from developing countries were estimated to be between USD 443.4 billion (World Bank Residual Method) and USD 1.1 trillion (Dooley Method).⁵⁸

3.2.6. In spite of these significant variations, consensus exists for Africa on the magnitude of IFF, namely that they are high; have increased over time; and oil-exporting countries tend to top the list of African net creditors to the world. Ndikumana and Boyce (2008)⁵⁹, Kar and Cartwright-Smith (2008)⁶⁰ as well as Kar and Freitas (2011)⁶¹ confirm these findings. Although these studies adopt similar approaches for combining residual (accounting for balance of payments and external debt) and trade mispricing methods, they differ in their data sources and assumptions.

3.2.7. According to Kar and Cartwright-Smith⁶², Africa lost about USD 854 billion in IFF over 1970–2008, a yearly average of about USD 22 billion. This cumulative amount is considerable compared with both the external debt of the continent and the ODA received over the same period. Indeed, it is equivalent to nearly all the ODA received by Africa during the period.⁶³ From a different perspective, only one-third of the loss associated with IFF would have been enough to fully cover the continent's external debt, which reached USD 279 billion in 2008.⁶⁴

3.2.8. The ECA uses its own methodology to assess IFF through trade mispricing, which is in effect a slight variation of the IMF's Trade Mispricing Model. The ECA methodology estimates IFF using data for mis-invoicing. It takes the discrepancy between the data reported on imports and on exports of the same trade flow and subtracts the differences between Cost of Insurance and Freight (CIF) and FOB values and the Ad-Valorem equivalent of the delays in the export/import process. The remainder is used as the estimate of the IFF associated with the trade flow. This remainder could obviously be due to mistakes in reporting or discrepancies in nomenclature used by importing and exporting countries. However, assuming that these errors are evenly distributed on either side, they will roughly cancel each other out in the overall estimates of IFF and the overall estimates can be deemed to be fairly accurate.⁶⁵ However, it is undeniable that there are limitations with this methodology since many trade transactions are not recorded, especially in Africa, and so they cannot be captured through mis-invoicing. Moreover, the ECA model only captures IFF in goods, but not in services, because such detailed data are not available for African countries.⁶⁶

57 Kar, Dev, and Sarah Freitas (2011). *Illicit Financial Flows from Developing Countries over the Decade Ending 2009*. Washington, DC: Global Financial Integrity.

58 Kar, Dev, and Devon Cartwright-Smith (2008). *Illicit Financial Flows from Developing Countries, 2002–2006*. Washington, DC: Global Financial Integrity.

59 Ndikumana, Léonce, and James K. Boyce (2008). "New Estimates of Capital Flight from Sub-Saharan African Countries: Linkages with External Borrowing and Policy Options." Working Paper Series No. 166. Amherst, MA: University of Massachusetts Amherst, Political Economy Research Institute.

60 Kar, Dev, and Devon Cartwright-Smith (2010). *Illicit Financial Flows from Africa: Hidden Resource for Development*. Washington, DC: Global Financial Integrity.

61 Kar, Dev, and Sarah Freitas (2011). *Illicit Financial Flows from Developing Countries over the Decade Ending 2009*. Washington, DC: Global Financial Integrity.

62 Kar, Dev, and Devon Cartwright-Smith (2010). *Illicit Financial Flows from Africa: Hidden Resource for Development*. Washington, DC: Global Financial Integrity.

63 OECD 2012 report "Development Aid at a Glance – Statistics by region." Paris

64 ECA and African Union Commission (2009). *Economic Report on Africa 2009: Developing African Agriculture through Regional Value Chains*. Addis Ababa.

65 Report of the High Level Panel on Illicit Financial Flows from Africa. Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development. Available at: http://www.uneca.org/sites/default/files/publications/iff_main_report_english.pdf at page 94

66 Kar, Dev, and Devon Cartwright-Smith (2010). *Illicit Financial Flows from Africa: Hidden Resource for Development*. Washington, DC: Global Financial Integrity.

3.2.9. At country level, Kar and Cartwright-Smith⁶⁷ attempt to include services in their estimates of IFF by using a proxy for services-related IFF derived from the ratio of world trade in services to world trade in goods, but this is a questionable approach. Data inconsistencies negatively affect country results more than global results. This drawback can be relatively controlled through the use of the BACI international trade product-level database. Even if trade mispricing accounts for more than half of IFF, it cannot explain all the IFF pathways. Other pathways are hard to quantify, and as a consequence it is difficult to precisely determine the magnitude of IFF.⁶⁸

Levels of IFF

3.2.10. Jansky (2013) argues that there are mainly two kinds of measures available, either of the volumes of the flows or, of the policies and policy efforts aimed at curtailing IFF. This notwithstanding, the fact remains that empirical evidence on the actual size of the illicit outflows and their determinants remain scarce with most governments relying on the externally produced estimates. One key reason is the laws on banker-client confidentiality on details of the flows, which result in a serious lack of data globally.

3.2.11. Early research done mostly by Non-governmental Organizations (NGOs) and some academics starting in the year 2000, provided some of the first estimates of IFF. It has helped reveal assets held off-shore and associated government revenue losses by using various methodologies that succeeded in highlighting the importance of IFF and bringing these issues to wider attention. Among the first were Transparency International, Baker's Global Financial Integrity (GFI), followed by Christian Aid and Tax Justice Network.

3.2.12. Transparency International States that corrupt Heads of States in poor countries have been responsible for large amounts of IFF out of their countries during their respective tenures in office.⁶⁹ Their list includes Mobutu Sese Seko President of Zaire (now the DRC) between 1965–97, who allegedly embezzled USD 5 billion when the country's GDP per capita was USD 99 and Sani Abacha, President of Nigeria between 1993–98, who allegedly embezzled USD 2 to 5 billion at a time when the GDP country's GDP per capita was USD 319.⁷⁰

3.2.13. Cobham (2005), states that proportions equivalent to the shares of world GDP (20%) would imply a loss to poor countries of around USD 51 billion per annum.⁷¹ Henry (2012) estimates that global super-rich elite had at least USD 21 trillion hidden in tax havens by the end of 2010 and that poor countries could be losing USD 189 billion in associated tax revenue every year. Henry estimates that at least USD 6 trillion of poor country wealth is held offshore by individuals, depriving poor countries governments of annual tax receipts of between USD 64 and USD 124 billion.⁷²

67 Kar, Dev, and Devon Cartwright-Smith (2010). *Illicit Financial Flows from Africa: Hidden Resource for Development*. Washington, DC: Global Financial Integrity.

68 Report of the High Level Panel on Illicit Financial Flows from Africa. Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development. Available at: http://www.uneca.org/sites/default/files/publications/iff_main_report_english.pdf at page 95

69 Transparency International, 2010

70 Transparency International, *Global Corruption Report 2004*

71 Cobham, A., 2005. *Tax Evasion, tax avoidance and development finance*. Queen Elizabeth House, Serie documents de travail. Available at: <http://www3.qeh.ox.ac.uk/pdf/qehwp/qehwps129.pdf>

72 Henry, J.S., 2012. *The Price of Offshore Revisited*. Tax Justice Network & Christian Aid (2008) *Death and taxes: the true toll of tax dodging*. Christian Aid. Available at: <http://mini-leaks.com/wp-content/uploads/2013/01/paraisos-fiscales.pdf>

3.2.14. Baker (2005) estimates that more than USD 540 billion flows out of poor countries each year, due to a combination of tax evasion, fraud in international trade, drug trafficking, and corruption.⁷³ Motivated by the objective of recovering what assets might be illegally already held abroad, Tax Justice Network estimates that the value of assets held off-shore lies in the range of USD 11 - 12 trillion and suggests that the global revenue losses, resulting from wealthy individuals holding their assets untaxed offshore, may be as much as USD 255 billion annually.⁷⁴

3.2.15. Case studies and related research by Boyce and Ndikumana (2012)⁷⁵ show that the mineral sector in Africa is highly vulnerable to IFF. Reliance on extractive industries for revenue and export earnings by many African mineral-rich countries generally implies that the sector has a high degree of discretionary power and political influence. This is the source of the secret and unequal contracts that African countries sometimes enter into with multinational mining companies. These contracts in turn undermine efforts to promote transparency and accountability in the extractives industry.⁷⁶ For instance, in Guinea, the ore from one of its mines is estimated to be able to generate revenues of up to USD 140 billion over the next twenty years, although a concession was granted in 2008 by the government at the time to a multinational for only USD 165 million. A new government terminated this concession for reasons, which included allegations of corruption, after it was discovered that half of the rights to the concession had been sold to another multinational for USD 2.5 billion. Since then, the Guinean government has re-awarded the concessions for USD 20 billion to three other mining firms. The disparity in the values illustrates the potential losses of financial flows from unequal contracts in the extractive sector of any continent, including Africa.⁷⁷

3.2.16. Under-reporting production and under-pricing minerals appear to be two major channels for tax evasion in the mining sector, in part because of uneven and inadequate enforcement by tax authorities. Corruption and collusion within a broader context where oversight and accountability are lacking also facilitate such practices.⁷⁸ A recent case in Kenya illustrates loss of revenue as a result of under-pricing of goods. In the case of Karuturi, a MNC dealing in the export of roses, a tax audit by the Kenya Revenue Authority revealed undeclared taxes through transfer mispricing amounting to USD 40 million, which amounts to 1% of Kenya's total tax collection.⁷⁹ This issue has affected several African countries (see Box 7).

73 Baker, R. W. 2005. *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free- Market System*. Hoboken, NJ: John Wiley & Sons.

74 Tax Justice Network, 2005. *The Price of Offshore*. Available at: http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf

75 Boyce, James K., and Léonce Ndikumana (2012). *Capital Flight from Sub-Saharan African Countries: Updated Estimates, 1970–2010*. PERI Research Report. Amherst, MA: University of Massachusetts Amherst, Political Economy Research Institute

76 Boyce, James K., and Léonce Ndikumana (2012). *Capital Flight from Sub-Saharan African Countries: Updated Estimates, 1970–2010*. PERI Research Report. Amherst, MA: University of Massachusetts Amherst, Political Economy Research Institute and Cobham, Alex (2012). *Tax Havens and Illicit Flows*. In *Draining Development? Controlling Flows of Illicit Funds from Developing Countries*, P. Reuter, ed., pp. 337–372. Washington, DC, World Bank

77 ECA and African Union Commission (2012). *Illicit Financial Flows from Africa: Scale and Development Challenges*. Addis Ababa.

78 Philippe Le Billion, *Extractive sectors and illicit financial flows: What role for revenue governance initiatives?*, U4 Issue, October 2011 No. 13

79 Tax Justice Network, *Karuturi guilty of tax evasion*. Available at: <http://www.grain.org/article/entries/4698-karuturi-guilty-of-tax-evasion>

Box 7: Specific Examples of the Magnitude of IFF in country case studies

The Democratic Republic of the Congo is among the countries that are most affected by the illegal exploitation of resources. Several Congolese commissions and UN panels of experts have documented illegal mineral exploitation and exports, some of which even finance armed groups in the DRC. Even in the diamond sector, which comes under international monitoring through the KPCS, about 30% to 50% of the value of production is reported to be exported without proper declaration or valuation and about USD 23.7 million may have been embezzled from a USD100 million signature bonus for a copper mining contract.

Tanzania currently loses through illicit flows due to trade mis-invoicing. More than USD 8 billion in domestic capital has been drained out of the economy illegally from 2002–2011, and government coffers may have missed out on an average of USD 248 million per year from trade-based tax evasion.

In South Africa, from 2005 to 2012, diamond exporters, primarily De Beers, appear to have downplayed the market value of their rough diamond exports by USD 3 billion, according to an analysis of declarations in corporate filings under the KPCS, the rough diamond tracking system used to keep conflict gems off the world market. The same undervalued gems were then sold at market prices around the world.

In Zambia, from 1995 one mine specifically failed to declare gold it extracted together with the copper. In another incident, a leaked report, prepared at the request of the Zambia Revenue Agency (ZRA), confirmed how the Glencore's Mopani Copper Mines (MCM) used transfer mispricing, as well as overestimated operating costs and underestimated production volumes, to declare no profits, and rob Zambia's exchequer out of millions of dollars, while making a fortune. ZRA confirmed that the contents of the report had not yet gone through the whole audit process, making the numbers quoted to be overly exaggerated. Subsequently, it has been claimed that some tax was collected from the company as a result of the audit.

Source: primary country data.

3.2.17. IFF undermines the maximization of government revenues through tax evasion practices, including transfer mis-pricing and mis-invoicing. African governments have been particularly vulnerable to this, in part because of “*inadequate institutional capacity to ensure tax compliance*” according to the Africa Tax Administration Forum (ATAF).⁸⁰ In turn, this significantly reduces the contribution of mineral resource revenues to national development.

3.2.18. The Africa Progress Panel, chaired by former UN Secretary General Kofi Anan, reports that in Uganda, the government lost USD 400 million in capital gains tax, a figure equivalent to more than its national health budget, when a minerals company sold its license.⁸¹ Similarly, the Africa Progress Panel examined a selection of five deals relating to DRC between 2010 and 2012. It was found that the DRC lost USD 1.36 billion in revenues from the under-pricing of mining assets sold to offshore companies operating in tax havens. This is almost double the country's combined annual budgets for health and education in 2012, with each citizen of the DRC losing the equivalent of USD 21, or 7% of average income.⁸²

3.2.19. ActionAid further indicates that between 2007 and 2012, despite annual sales of over GBP 60 million, SAB Miller's brewery in Ghana registered overall losses. This was

80 ATAF (African Tax Administration Forum). 2010. African Tax Administration Forum e-Newsletter, no. 1. <http://www.oecd.org/dataoecd/42/51/45879507.pdf>.

81 Africa Progress Panel, 2013. Equity in Extractives, <http://africaprogresspanel.org/publications/policy-papers/africa-progress-report-2013/>

82 Africa Progress Panel, 2013. Equity in Extractives, <http://africaprogresspanel.org/publications/policy-papers/africa-progress-report-2013/>

achieved through strategies that included receipt of GBP 8.5 million loan from a subsidiary in Mauritius with an 18% interest rate, enabling the company to move GBP 400,000 of its profits to the tax haven where it paid a rate of just 3% tax.⁸³ ActionAid have also highlighted that in 2009, Barclays Bank paid less than 10% of its profits in tax⁸⁴ and in 2010 they estimated that SAB Miller was shifting GBP 100 million of profits from Africa into tax havens, with an estimated tax loss of GBP 20 million.⁸⁵

3.2.20. Estimating IFF remains a serious issue given the lack of publicly available data within states. For instance all four country case studies did not have actual data or statistics that would allow to provide even rough estimates on financial outflows and inflows. As a result they rely on accidental discoveries and tips rather than the methods discussed above. This lack of capacity of developing country authorities to make assessments that will result in an actual discovery and quantification of illicit movements of funds will continue to cripple revenue authorities.

3.2.21. Many revenue authorities in Africa report that the ability to determine transfer mispricing remains through whistleblowers or tip-offs. This includes Kenya, Rwanda and Zambia all of whom have mainly collected or investigated IFF on the basis of tip-offs. In Zambia, the chairperson, of Vendata, owners of one of the largest mine in the country, was quoted as saying that he makes about ½ a billion annually from operations in Zambia, whilst the mining company is making losses and no revenues were been remitted to the treasury.

3.3 Impact of IFF on DRM in mineral-rich Africa

3.3.1. IFF from African countries represent a higher burden, as a percentage of GDP, than in other developing regions.⁸⁶ Researchers and economists argue that Africa's staggering loss of financial resources through IFF seriously obstructs the continent's efforts at poverty alleviation and economic development.⁸⁷

3.3.2. IFF through transfer pricing causes brutal tax base erosion through profit shifting, loss of revenue for public expenditure programs, reduction of investment in social capital, switching of tax burden between factors of production and increased tax administration costs.⁸⁸ The basic challenge for many African countries is to map the transactional relationships relevant to the business activities of the subsidiary of a MNE. Without being familiar with the extent of the group within which suspect transactions may occur, it is difficult to detect transfer pricing. Modern MNEs have established corporate structures that are complex and are quite difficult to understand without studying detailed organograms.⁸⁹

3.3.3. IFF undermines the maximization of government revenues through tax evasion practices, including transfer mis-pricing and mis-invoicing. African governments have been particularly vulnerable to this, in part because of *"inadequate institutional capacity to*

83 ActionAid, 2013 How Tax Havens Plunder The Poor, http://www.actionaid.ie/sites/files/actionaid/how_tax_havens_plunder_the_poor_1.pdf

84 ActionAid, 2012 Collateral Damage: How government plans to water down UK anti tax haven rules could cost developing countries – and the UK- billions: http://www.actionaid.org.uk/sites/default/files/doc_lib/collateral_damage.pdf

85 ActionAid, Calling time: why SABMiller should stop tax dodging in Africa, November 2010: <http://bit.ly/o3PWGJ>

86 Ndikumana L and Boyce JK (2008) New estimates of capital flight from sub-Saharan African countries: Linkages with external borrowing and policy options, Working paper series number 166, Political Economy Research Institute, University of Massachusetts Amherst

87 Kar, D, and Cartwright-Smith, D (2010) Illicit financial flows from Africa: Hidden Resource for Development, Global Financial Integrity

88 Tax Justice Network (2014), Transfer Pricing in Africa: Contextual Issues. A Policy Briefing Paper, at page 6.

89 Tax Justice Network (2014), Addressing Transfer Pricing Issues in Africa. A Policy Synthesis Paper, at page 4.

ensure tax compliance” according to ATAF.⁹⁰ In turn, this significantly reduces the contribution of mineral resource revenues to national development.

3.3.4. IFF is also likely to increase inequalities of income in Africa. Individuals who engage in IFF are generally members of economic and political elites, who take advantage of their privileged positions to acquire and channel funds abroad. Both the acquisition and the transfer of funds often involve legally questionable practices like the falsification of trade documents (trade mis-invoicing) as well as the embezzlement of export revenues and kickbacks on public and private sector contracts. The shortages of revenue and foreign exchange resulting from this affect the less wealthy members of society hardest.

3.3.5. As long as IFF continues to flow out of poor African countries at a rapid pace, efforts to reduce poverty and boost economic growth will be undermined as income distribution becomes ever more skewed. In the DRC, the resources lost through fraud, and tax evasion have contributed to the exacerbation of poverty, violations of fundamental human rights, relocation of local residents in the mining sites without compensation, pollution of rivers and bad working conditions for employees and their families. In South Africa poverty is counted as one of the country’s triple threats, the other two being unemployment and inequality.

Transparency and Freedom of Information

3.3.6. There is a critical need for information on IFF losses, which depends on both a legislative framework, which allows for access to such information, as well as political will. Governments worldwide, as custodian of the resources of their countries, are vulnerable to corrupt practices and other forms of mis-administration. Throughout the world, there is thus a demand for more open and accountable governments. The key method being used to achieve this is through transparency and increased access to information.

3.3.7. Access to information is regarded as the ability of the citizen to obtain information in the possession of the State. Unhindered access to information, apart from being regarded as an essential ingredient in democratic governance, is also regarded as a fundamental human right. (Byrne, 1999). When Freedom of Information (FOI) is absent, citizens cannot effectively access information about basic services, fully participate in the social and economic development of their countries or hold their governments accountable for public spending, which can in turn adversely affect their rights to health, employment and education, and to fight corruption. Poor access to information disproportionately affects women, children and the poor and marginalized, who are often adversely affected by a lack of vital information with respect to their legal, political and economic rights. It further negatively affects economic growth and development, where inadequate mechanisms for sharing information are often attributed to slow progress.

3.3.8. Prior to 2011, the number of countries with FOI legislation on the African continent stood at five, representing just 9% of the entire continent; this number has increased to 13, representing 24% of all countries in Africa. Currently, South Africa, Angola, Zimbabwe, Uganda, Sierra Leone, Côte D’Ivoire, Nigeria, Niger, Ethiopia, Rwanda, Tunisia, Guinea and Liberia have all adopted FOI laws.

3.3.9. A 2013 study carried out by the African Platform on Access to Information examined the state of access to information in 14 countries in Africa. It found that, in addition to

90 ATAF (African Tax Administration Forum). 2010. African Tax Administration Forum e-Newsletter, no. 1. <http://www.oecd.org/dataoecd/42/51/45879507.pdf>.

existing legislation, 65% of the countries surveyed had more specific sectoral laws that supported the right of access to information. The study found that in countries where no specific FOI right existed – including Senegal, Tanzania, Zambia, Kenya and the DRC – sectoral laws often provided an alternative mechanism by which citizens could access information. In the DRC, for example, laws such as the mining code have been used to ensure greater access to, and disclosure of information. Mining communities have used the act to seek information on mining revenues and the amounts they are entitled to, as well as how licenses are allocated. Other examples of such laws include whistleblower protection, data protection, public procurement, fiscal responsibility and extractive industry transparency initiative acts.

3.3.10. Meanwhile, more countries are continuing to devote attention in passing FOI laws of their own. This has been made easier by the adoption, in April 2013, by of a new ‘model law’ on access to information by the African Commission on Human and Peoples’ Rights. This ‘model law’, which has also been endorsed by the African Union, appears to have accelerated efforts to define access to information laws in many countries such as Malawi, Mozambique, Ghana, Kenya, Tanzania, and Namibia. The ‘model law’ has also contributed to the standards for the SADC disclosure protocols, which may in turn lead to it becoming a model for all SADC countries.

3.3.11. However, laws across Africa differ in their definition of this right. In some states, such as South Africa, the right empowers the public to access information from private bodies that perform a public function or are funded by the public. The inclusion of private bodies within FOI law constitutes recognition that public functions carried out by private bodies, such as the provision of electricity or water, are connected to the functions of government and are directly paid for by taxpayers. A number of other countries, including Nigeria, Zimbabwe, Uganda and Ethiopia, do not extend their application of the law to the same extent.

Box 8: Access of Information on Mining in Selected African countries

In the DRC, the 2002 Mining Code clearly establishes procedures to obtain licenses. However, State-owned Companies still hold many of the most lucrative titles and have signed numerous joint-venture contracts under opaque circumstances, undermining the competitive provisions of the Mining Code. There is no equivalent of a Freedom of Information Act. In addition it remains unclear as to which royalties actually flow into the National Treasury.

In Tanzania, the failure to publish mining contracts and a lack of data on the state-owned mining company contributes to a weak governance regime. Little information is available on the mineral licensing process before licenses are granted. Once mining rights are awarded, information is available only in a complex digital format for a fee, and environmental impact assessments often not submitted before a license is granted are released only upon request. In addition, Parliament does not regularly review mining earnings.

South Africa’s access to information law is regarded as the ‘gold standard’. However, the government does not publish mining contracts or environmental impact assessments, and the Mineral Resources Department regularly overlooks requests for information, violating the provisions of the Promotion of Access to Information Act.

In Zambia, there is no freedom of information law, and the and Mineral Development Act of 2008 prohibits the Mines and Natural Resources Ministry from disclosing industry information without companies’ consent, although Zambia is said to be EITI compliant since 2012. Mining production data is provided by the operating companies. However companies are required to disclose beneficial ownership information, and government officials must report their financial interests in the sectors, which they oversee.

Source: primary country data and analysis by the ECA.

3.4 Conclusion

3.4.1. It is intuitively evident that IFF have a severe impact on Africa's DRM efforts. It cannot be emphasized enough that these illicit outflows deprive the continent of productive investment, significantly reduce tax revenues, worsen income gaps, undermine trade and drain hard-currency reserves. The flow of illicit money from developing countries transfers the wealth out of the countries where 80% of the world's population lives into countries where 20% live.⁹¹ It has also been estimated that due to only two forms of IFF ('transfer pricing' and 'false invoicing' by multinational companies), developing countries are losing USD 160 billion per year in tax revenue. This is more than one-and-a-half times the combined aid budgets of the entire rich world, which is around USD 100 billion. Taking into account additional sums from aggressive tax avoidance and other forms of trade abuse, the total loss of tax revenue is several times that amount.⁹²

3.4.2. IFF also hurts competition in the free market. The companies that act according to law, and honour their social responsibility through paying taxes, are disadvantaged compared to those that profit from IFF. Big MNC often have more resources than Small and Medium-sized Enterprises (SMEs) to hire lawyers and professionals that could help them to pursue IFF without getting caught. This in turn threatens the survival of SMEs at the national level, as well as multinationals that report their financial transactions and pay the right amount of tax.⁹³

3.4.3. In the light of the foregoing, combating IFF should remain one of the foremost priorities for African Governments. There is an extensive literature which highlights the multiple benefits that result in combating IFF. Froburg (2012) examines these benefits and this study-report the ones that are the most relevant for African countries. First, combating IFF effectively would raise revenues for development in the countries of origin. Secondly, enforcement mechanisms to combat IFF would seriously deter the incentive to move profits outside the country of origin. Thirdly, it would make governments far less accountable to development partners and more accountable to their taxpayers. Lastly, combating IFF would lead to fairer market competition, which would benefit local SMEs as well as MNCs.

91 Froburg 2012. "Bringing back the Billions" Global Studies, at page 12.

92 Froburg 2012. "Bringing back the Billions" Global Studies, at page 12.

93 Froburg 2012. "Bringing back the Billions" Global Studies, at page 13.

4. Existing policies and regulations in mineral-rich Africa

In the following chapter we will review IFF in the mineral sector. Based on the primary data, Section 4.1 analyses the current practices to combat IFF in the mineral sector. Section 4.2 discusses the current regulatory and fiscal frameworks to mobilize DRM within the mineral sector. In addition, this section analyzes the threats and opportunities using the 4 country case studies, while reflecting on how other mineral rich countries may consider the same issues, but within their own context. Finally, Section 4.3 sets out the gaps in mineral taxation design and management.

4.1 Current regulatory frameworks to combat IFF

4.1.1. According to the findings in the four mineral rich countries, it appears that there are no mineral-sector specific policies or practices to combat IFFs. Indeed, secondary data from Africa also indicates the same. Existing policies and practices to combat IFF in the mineral sector are anchored in broader financial regulatory frameworks, which generally cut across all sectors. These include restrictions on financial flows, foreign exchange or currency controls (see Box 9) as well as policies on anti-money laundering and counter terrorism activities. In these countries, currency controls are the most reliable alternative for controlling the illicit outflow of financial resources.

Box 9: Monitoring Capital Transfers in South Africa

In South Africa, all capital transfers require the approval of the National Treasury. The Regulation states, "*No person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose ...enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic*".^a

A Financial Surveillance Department was established within the South African Reserve Bank to implement exchange control policies and regulations. This department is tasked with analyzing and disseminating information on cross-border financial flows; appointing Authorized Dealers in the issuance of foreign currency and ensuring compliance by Authorized Dealers with anti-money laundering control measures as stipulated under the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001).¹ The exchange control regulations are thus used to ensure the timely repatriation as well as prevent the loss of foreign currency resources through the transfer abroad of financial capital assets held in South Africa.

Moreover, there are other regulations to control capital movements in and out of the Southern African Customs Union, which established a revenue sharing formula among the 5 Member countries.

Source: primary country data; and ^a Exchange Control Regulation 10(1)(c)

4.1.2. Countries have also put in place policies and/or practices to curb mis-invoicing and under invoicing of imports and exports (see Box 10). It is noteworthy to point out that Zambia's best practice, which avoids setting too high threshold for transfer pricing and instead uses a broad definition, based on the international standard. In addition, the Zambian practice also avoids the transaction value approach, which is easy to manipulate and instead refers to reference price, which is the price on recognized markets. Findings by report of the HLP on IFFs show that mis-invoicing of goods and services is a major conduit for illicit financial outflows in Africa purposefully carried out for tax evasion, aggressive tax avoidance and illegal export of foreign exchange.⁹⁴

⁹⁴ ECA-AUC, 2015... p.24, see also GFI, 2010, Illicit Financial Flows from Africa-Hidden Resources for Development.

Box 10: Examples on curbing mis-invoicing or under-invoicing in South Africa and Zambia

In order to curb the mis-invoicing and under invoicing of goods (including minerals) in South Africa, in 2011, the Financial Surveillance Department issued a directive for the implementation of an updated balance of payments (BoP) data for reporting trade-related import and export transactions to the Reserve Bank. The Directives also require the commercial banks to implement Import Verification System (IVS) for verifying the import clearance documentation issued by the Department of Customs and Excise of the South African Revenue Services (SARS). This has enabled the Reserve Bank to electronically verify import payments transactions. The country has also criminalized the mis-invoicing of goods.

In Zambia, The Bank of Zambia developed a monitoring mechanism for BoP of trade inflows and outflows. Specifically, the monitoring tool assesses the value of all imports; payments of dividends to non-residents; value of imported goods and services including management services; any amounts remitted outside the republic; loans granted to non-residents; and payments of interest and principle amount. In addition, all foreign investors are required to open and maintain a foreign dominated account with the local commercial banks and deposit the cash component of their pledged investment in the local commercial banks. Moreover, all exporters and importers are required to complete a respective proceeds monitoring form. For verification purposes, these forms are submitted to commercial banks. The law also requires all payments above USD 5,000 per transaction to be electronically remitted or received through commercial banks. There are sanctions and penalties for failure to comply with this requirement both on the part of banks, business entities as well as authorized foreign exchange dealers. In addition, the government of Zambia in collaboration with the Norwegian Government, has implemented a “mechanism to monitor shared information on the production and sale of minerals” in the country. The country has negotiated Double Taxation Treaties, to enhance the exchange of information between the two countries with an aim of curbing tax driven IFFs. The Income Tax Act has been amended to compel Financial Institutions to provide financial data to the national tax authority.

Source: primary country data

4.1.3. Global attention on money laundering and terrorism financing has led to increased awareness of criminal driven IFF practices. As a result, all countries have established institutions to combat such activities in line with international anti-money laundering standards. In 2006 the government of Tanzania enacted the Anti-money Laundering Act and signed a Multi-year Agreement with Eastern and Southern Africa Anti-money Laundering Group (ESAAMLG) in 2003.

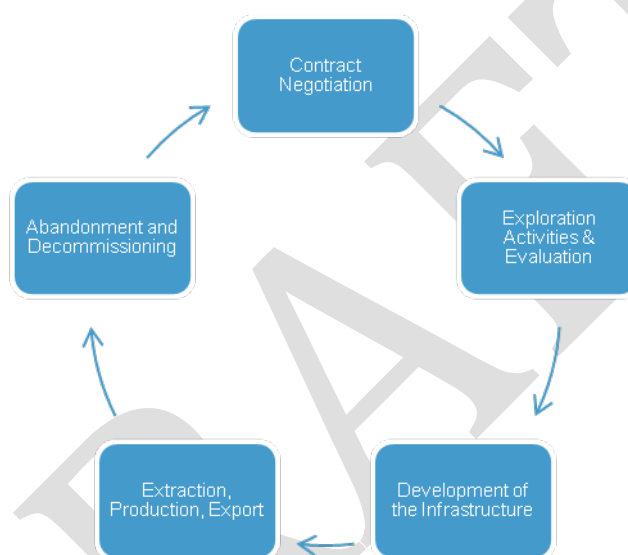
4.1.4. Although increased discourse on IFFs has contributed in raising awareness on transfer mis-pricing, these efforts remain inadequate in comparison to the gravity and magnitude of the problem. In particular, there is limited focus on mining within tax agencies in many African countries as it is placed in the same category with other sectors. The poor remuneration of customs official in DRC (around 75,000 CDF equivalent to USD 83.33) was cited as a major impediment in the implementation of anti-IFF policies.

4.1.5. In addition, some African countries have developed rules to curtail certain abusive payments, which result in tax base erosion. The tax base erosion effect has to a certain extent been controlled through the withholding tax provisions. The latter recaptures some of the potential revenue loss resulting from tax base erosion, but often countries do not set a sufficiently high threshold. For example, in Tanzania, while the standard domestic tax rate is 30%, the potential tax base erosion effect with deductible payments is significant. Hence, Tanzania’s withholding tax of 10-15% clearly does not sufficiently compensate the loss of revenue through tax base erosion practices.

4.2 Existing Fiscal Frameworks for Domestic Resource Mobilization

4.2.1. In the mining sector, fiscal models tend to reflect the unique characteristics of extraction processes of a particular resource or mineral and the key features of the particular project. Mining projects constitute different stages and taxes or government revenue can be collected in various forms at every stage depending on the existing fiscal frameworks. The lifecycle of mining projects normally begins with negotiation of the contract – granting the rights for exploration and extraction; to exploration activities; and development of the infrastructure for extraction and transportation or processing of the natural resource. The project cycle peaks at the actual extraction and transportation of the natural resource and ends with the exit of the investors – either through the sale of the project or complete extraction of the natural resource. The tax regime is a reflection of the different stages of extraction as illustrated in Figure 5.

Figure 5: Stages in mining projects



4.2.2. There are two main approaches of fiscal frameworks for Domestic Resource Mobilization (DRM) in mineral rich countries: the contract arrangement and royalty based system.⁹⁵ Most forms of fiscal instruments fall within these two broad categories. Various fiscal instruments are employed to optimize the value of net government revenues. Under the contract framework, the four country case studies use Production Sharing Agreement (PSA model). These countries also use the Royalty model, which is the most dominant framework in mining.

4.2.3. Essentially, PSAs (mainly used in the petroleum industry) are contracts between the government and the investor company, where the investor agrees to finance geological research and development of the extractive infrastructure in return for permission to extract the natural resource. The investor recovers the costs by retaining and commercializing the physical product and the profit made is shared with the government.⁹⁶ The tax regime of PSA is exclusively defined in the agreement. Zambia uses

⁹⁵ IMF. 2012, above at p.15

⁹⁶ Ibid

the PSA Model for companies in which it holds 20% share ownership while also charging royalties and a corporation tax.

4.2.4. In order to increase government profits, variances may be found in different PSAs, for instance agreements may provide that profit will increase with the daily rate of production or as the total cumulative production increases. Using a combination of these models, is critical in achieving fiscal efficiency for DRM.

Under the royalty model, on the other hand, the investor takes full control and possession of the mine field/area and is free to sell the minerals to potential customers. The investor is however obliged to pay a royalty fee to the government. A royalty is defined as a charge for the extraction of minerals, usually a percentage of gross revenue.⁹⁷ It can however be a specific charge on volume or weight of the mineral.

4.2.5. Under the two broad fiscal frameworks, countries use various tax instruments to boost government profits. These include bonus payments, which are commonly charged at discovery, contract negotiation and signature, as well as the production stages. A bonus is charged as a percentage of the expected value of the mineral resource. An exploration bonus is also paid by the investor to undertake exploration activities. In addition, governments charge other taxes such as corporate income, rent charges, employers' pay as you earn, VAT and withholding tax.

4.2.6. Similar tax instruments are applied during the development of mining infrastructure as well as import duties or levies at the commercial stage. In most countries, the extraction, production processes and export of minerals attract a hybrid of fiscal instruments but primarily royalties on gross revenues. Other taxes at this stage include profit tax, excess profit tax, withholding tax, and in some cases specific export taxes on raw ore to promote value addition within the country. In Tanzania the government fiscal regime for the mining sector consists of corporate income tax (30%),⁹⁸ Capital Gains Tax (30%), Value-Added Tax (18%), Import duty (0-25%) and Royalties for extracting the natural resources (5-15%). In South Africa the fiscal regime consists of a combination of Corporate Income Tax (28%)⁹⁹ and Royalties¹⁰⁰, depending on type of mineral.

Specific taxation regimes and practices of mineral rich countries

4.2.7. Due to governance-related challenges and volatility in commodity prices, combined with IFF practices, many African countries report collection of very minimal or no **corporation taxes** from mining companies. As a result, several countries have instituted legal reforms to address these challenges. In Zambia, under the new reforms, income from mineral processing is now taxed at 30% under corporate income tax. Prior to these new reforms, income from mineral processing in Zambia was taxed as income from mining operations where activities of the company involved both mining operations and mineral processing and were thus taxed at the variable profit tax rate of 30% to 45%. On the other hand, companies that were solely involved in mineral processing were taxed at a rate of 35% because the income was categorized as arising from manufacturing activities.

⁹⁷ IMF. 2012, above

⁹⁸ This tax may be reduced to 25% where the company is listed on stock exchange

⁹⁹ Regulated by 10th Schedule to the South African Income Tax Act, which specifically deals with the taxation of exploration and extraction activities.

¹⁰⁰ Regulated by the Mineral and Petroleum Resources Royalty Act.

4.2.8. In Africa, it appears to be common practice for investor companies to default on corporation taxes, as noted in Zambia and Tanzania. In order to address this problem, companies in Tanzania, which register losses for three consecutive years are liable to Alternative Minimum Tax (AMT) at a rate of 0.3% of turnover. Currently there is on-going work in developing a special regime for taxation of the extractive industry. The proposal includes introduction of Additional Profits Tax to boost domestic revenues.

4.2.9. **Excess profit taxes** have been a subject of arbitration and litigation in most mineral rich countries. Excess profit tax targets potential increases in profitability due to increases in global prices of minerals. The excess profit tax is an additional tax, which is payable when the investor's profits exceed a certain margin (e.g. 25%). The tax rate normally progresses with the increase in the profitability margin. The challenge with excess profit taxes is that they can have an adverse effect for investors since such measures tend to reduce possible extra profits from the increase in prices of mineral resources and may affect the development of a particular investment.¹⁰¹ Investors mitigate the excess profit tax through different practices, which impact on domestic revenues. For instance, harmful practices such as aggressive tax base erosion and profit-shifting practices are deemed to arise out of attempts to avoid excess profit tax. South Africa's Mineral and Petroleum Resources Royalty Act makes provision for the royalty rate to fluctuate with mine profitability.

4.2.10. **Royalties** are a major source of State revenues from mining activities for African countries. Often, the mining agreements waive corporation tax or lower it for a minimum of 5 to 10 years because of the initial heavy expenditure outlay. The country recovers the loss or foregone revenue through the royalties from the sales. Royalties, calculated against criteria such as gross sales and the company's net operating mining profits, are compensation to the nation for the permanent loss of non-renewable resources but, because of its sliding royalty scale, South Africa averages an annual royalty rate of about 2%, which netted the government a total of USD 57.5 million from 2010 to 2012.¹⁰²

4.2.11. However, tax holidays in countries like Tanzania have been a hindrance to the collection of royalties. Although IMF report indicated that Tanzania's gold exports increased from around USD 500 million to USD 1.5 billion in the last five years, the government's revenues have remained at USD 100 million a year mainly due to the granting of corporate income tax holidays.¹⁰³ In fact, *'none of the existing gold projects have paid substantive income tax to date'*.¹⁰⁴ In addition, companies, which are granted 10 year tax holidays sell off their holding interests to other companies in order to extend the holiday. As a result, there was almost no collection of corporate taxes from mining companies in Tanzania hence impacting on domestic resources. In Zambia, in October 2014, the Government introduced a

¹⁰¹ Ibid. "In Mongolia, prospects for a surge of investment in minerals were dampened when, in May 2006, the Government decided to impose a windfall tax on gold and copper mining revenues, just as several significant projects were being assessed for full commercial development. The resort to new windfall taxes linked to oil price levels in Algeria and China, which have been applied to existing as well as new oil projects, is prompting companies to turn to international arbitration in order to protect their contractual position and obtain compensation. Venezuela, as well as Bolivia and Ecuador, have taken the even more radical step of entirely rewriting the rules on equity participation and taxation to reduce foreign oil company interests and add to their tax bills – moves that constitute "creeping expropriation".

¹⁰² Khadija Sharife, Rough and Polished: South Africa Short-changed on Diamond Trade. 100 Reporters. May 16h2014. Available at: <http://100r.org/2014/05/rough-and-polished/> Last accessed on 17th February 2015

¹⁰³ IMF, Staff Report, 2011. Article IV Consultation and Second Review under the Policy Support Instrument, 21 April 2011, p.17

¹⁰⁴ IMF, Staff Report, 2011. Article IV Consultation and Second Review under the Policy Support Instrument, 21 April 2011, p.17

proposal to abolish corporate income tax on mining operations and replace it with a single royalty regime (see Box 11).

Box 11: The case for a single royalty regime

The new proposal for a single royalty regime in Zambia implies that mineral royalty rates will be increased from 6% to 8 % for companies with underground operations and to 20% for companies with open cast operations. However, royalties on precious and base metals will remain at norm value while other minerals will be charged on Gross value. Norm value does not represent the actual sales value as it is calculated based on the monthly average cash price of the metal as published by the London Metal Exchange (LME) or Metal Bulletin commodity exchange.

However, the regime for industrial minerals is yet to be changed, implying that the mineral royalty rate remains at 6% and the corporate tax rate on mining of industrial minerals is taxed at the variable profit tax rate. The Government of Zambia initiated the new reforms in a drive to increase the government's share of revenues from the mining operations and address tax evasion challenges. It is expected that the newly introduced "simplified regime" will avoid the complexities of determining corporate income tax.

It should be noted though that some mining companies in Zambia have both underground and open pit mines feeding into their processing plants and hence this regime may pose administrative challenges on the appropriate apportionment basis for mineral royalty purposes since the end product will be feed by materials coming from different sources (underground and open pit) that are taxed at two different rates.

Source: primary country data.

4.2.12. **Ring-fencing** is a measure adopted by many mineral rich countries to ensure that the extractive companies pay tax in a gradual and timely manner to maintain consistent revenue flows. The concept of ring-fencing requires companies involved in extractive operations to account for financial and production results of each project separately as if each project (in case the company carries on with more than 1 project) was carried out by a separate legal entity (tax-payer). This ensures that operational losses or capital expenditure (Capex) depreciation on one project does not diminish the tax revenue from another profitable project. Box 12 presents different ring-fencing regimes in mineral-rich African countries.

Box 12: Different Ring-fencing regimes in Africa

Since 2013, Tanzania has applied ring fencing to determine corporate tax liability and carried-forward tax losses for oil and gas companies. Profits are taxed on a "contract area" basis. Activities carried out by the same company in different contract areas are treated as separate operations and are taxed separately. Tax losses from one contract area are restricted to that area and cannot be offset from profits of another contract area. They can be however carried forward indefinitely. Disadvantages with ring fencing arise where the company is liable to pay tax even in cases, where it is not profitable as a whole.

In South Africa, losses incurred during the exploration phase may be offset against income generated in the post-exploration phase. There is no ring-fencing between different projects or areas. Any balance of assessed loss may be carried forward without limit and off-set also from refining and processing activities. There is however a limit that only 10% percent of any excess loss may first be offset against any other income (income that does not constitute income from extractive activities) and any balance must be carried forward to the succeeding year.

Source: primary country data & information retrieved from the Global oil and gas tax guide 2014 prepared by Ernst and Young.

4.2.13. In mining, **Value Added Tax (VAT)** may accrue in the process of exploration, development of infrastructure as well as the extraction and processing of the natural resource. VAT may also accrue in the process of decommissioning. By its nature, VAT is a consumption tax and is therefore charged where the goods and services are consumed.

Mineral resources are rarely fully processed or consumed in the country where they are extracted. In fact, in most cases where the extraction takes place in the developing country, the resources are mostly exported. VAT gradually accumulates at the level of the extraction company – often over a period of many years as goods and services are paid for in the process of negotiation, exploration and development.

4.2.14. In the extractives industry, there are some unique specificities in the application of VAT. It is generally only at the extraction stage, where turnover is subject to VAT. However, challenges arise in computing VAT on exported minerals, which warrants a refund to the host government. This explains why many of the host countries operate a special VAT regime exemption for the extractive sector to prevent such situations. Such exemptions are however not always justified, especially when a significant part of the production is intended for the domestic market.

4.2.15. In order to mobilize revenues, the tax should be designed to meet each country's specific requirements. For example, the VAT regime in Tanzania is a single rate regime, set at 18%. Tanzania exports virtually all its mineral resources. Since exports are VAT zero-rated under the VAT regime, mining firms are net-refund claimers of almost all VAT paid in the process of mining operations. In its VAT and Customs Duty regimes, Tanzania includes some tax exemptions on import of duties and relief on VAT for exploration companies. In South Africa, VAT is applied at 14%, but exports are zero-rated. This implies that since most mineral production is exported, mining companies pay no VAT on these exports, but are all entitled to a refund for all the input taxes, which they have paid. This VAT structure has been a major benefit for gold and diamond companies.¹⁰⁵

4.3 Conclusion

4.3.1. The importance of mineral revenues for DRM cannot be over-emphasized. In this regard, it is undeniable that some African mineral-rich countries have made efforts in improving their regulatory and fiscal frameworks to strengthen DRM. Notably, the use of a mix of fiscal instruments has yielded some results in improving revenue collection, but also in combating illicit financial outflows. However, there continues to be a significant amount of revenues from the mining industry, which remain largely untapped. This is partly due to the complex nature of the mining sector and apparent loopholes and compliance mechanisms in the fiscal frameworks. Countries that rely on the broader regulatory regimes in management of their mineral resources lose more revenue than countries, which have developed sector specific fiscal instruments to optimize revenues.

4.3.2. Some best practices such as anti-avoidance rules which have emerged from some country case studies can serve as lessons for other mineral rich African countries. However given the magnitude of the IFF phenomenon, it is critical for all mineral rich countries to embark on serious reforms to review and address the major conduits for IFFs.

¹⁰⁵ Chamber of Mines of South Africa, "Note on mining taxation in South Africa: A presentation by Mzolisi Diliza", 2 June 2008, www.bullion.org.za

5. Limitations in addressing IFF in mineral-rich Africa

This chapter will examine the challenges in combating IFF in mineral-rich Africa. Section 5.1 assesses the gaps in mineral taxation design and management, using the four country case studies as examples. Thereafter section 5.2 examines the institutional limitations in combating IFF within the mineral sector in Africa.

5.1 Gaps in mineral taxation design and management

5.1.1. Although countries have implemented some good practices to combat IFF, primary research has confirmed the existence of major gaps not only in the design, but also in the management or administration of tax regimes. This has resulted in significant outflows of illicit finances from the mineral sector in Africa. IFF practices have been linked to the different types of taxation regimes in the extractives.

5.1.2. Some taxation regimes in the extractives industry are more vulnerable to being abused than others. This problem is also aggravated by the lack of specific taxation regime for the mining sector in many African countries. In some cases, countries have failed to take into account the unique features of the extractives industry and continue to apply generic tax instruments in all sectors, including mining.

Limitations in mineral taxation design

5.1.3. Various factors such as market price fluctuations and political climate impact on revenues deriving from the extractives industry impact on tax designing. The two possible extremes in tax design are situations where the system effectively taxes the investor and where the tax system does not capture a reasonable portion of the economic rent or gives excessive incentives, leaving some or all of the profit generating activities untaxed.

5.1.4. The continued **abusive transfer pricing practices** is a clear signal of the critical loopholes in the tax design structure of the mining sector of many African countries. Although several African countries, including South Africa, Tanzania and Zambia (see Box 13), have transfer pricing rules, for the most part these rules are too lenient. Mining companies find means of shifting profits throughout the different stages of a mining project. At the exploration and development stage, transfer pricing techniques are used to over-inflate input prices such that profits are shifted even before they are made. In other words, by over-stating the initial costs of services and equipment, the company builds up a high depreciation base, which it can offset from future profits. The South African Revenue Service (SARS) has found that mining companies engage in transfer pricing through thin capitalization, intra-group service charges and fragmentation of the supply chain in order to extract profits through procurement companies and off-shore hedging companies.¹⁰⁶

5.1.5. Moreover, in many African countries, the possibility for mining companies to offset their taxable income against the full costs of expenditures made on inputs such as plant and machinery generally leads to perpetual declaration of tax losses and thus non-payment of corporate tax. In an attempt to address this flaw in tax design, the government of Tanzania introduced since 2008 an Alternative Minimum tax of 0.3% of turnover, payable when

¹⁰⁶ Global tax alert, 2014. South African authorities address transfer pricing and OECD'S BEPS Action plan. Available at: <http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--South-African-authorities-address-transfer-pricing-and-OECD-s-BEPS-Action-Plan> accessed on May 14 2015.

companies declare three consecutive years of tax losses. This notwithstanding, it is most likely that the revenues from the alternative minimum tax would still be lower than the losses caused by capital investment incentives.

Box 13: Transfer pricing rules in Zambia

In Zambia, the transfer pricing rules grant the Tax Commissioner General power to adjust profits from commercial or financial transactions between associates to reflect arm's length conditions. Two persons are associated if one of them participates, directly or indirectly, in the management, control or capital of the other, or if another person participates, directly or indirectly, in the management, control or capital of both of them. The sales price (i.e. arm's length price) in any transaction involving the sale of minerals by a company carrying out mining operations, directly or indirectly, to related or associated parties is the "reference price" which has a which includes: (a) monthly average London Metal Exchange (LME) cash price; or (b) monthly average Metal Bulletin (MB) cash price to the extent that the base metals or precious metal prices are not quoted on the LME.

In addition, related or associated parties, with regard to mining companies, include: (a) Parties connected directly or indirectly through shareholding, equity or partnerships; (b) Any joint venture owned or operated jointly with a related or an unrelated party; (c) Connected persons; and (d) parties connected through management and control. This approach is a preferred practice instead of setting specific transfer pricing thresholds, which may be too high.

Source: primary country data

5.1.6. Generally, high taxes discourage further investments to the mining sector. However, **failure to tax profits** is also a serious gap in the design since countries grant unnecessary incentives. The main and obvious concern with tax incentives in the extractives industry is that governments forego significant revenues, which would otherwise be used to finance national development objectives. Examples of specific incentives used in extractive industry in Africa include industry or company specific reduced rates of royalties; accelerated depreciation for the extractive infrastructure; lower percentage of governments share from Product Sharing Agreements (PSA); VAT exemptions and customs exemptions as well as tax holidays (see Box 14).

Box 14: Examples of incentives in Africa to attract investment in mining industry

South Africa established special rules to address the beneficiation of mineral resources. Section 26 of the Minerals and Petroleum Resources Development Act of 2002 provides for mineral beneficiation. Specifically, the rules provide that the Minister may initiate or prescribe incentives to promote the beneficiation of minerals in the country. If the Minister, acting on advice of the Board and after consultation with the Minister of Trade and Industry, finds that a particular mineral can be beneficiated economically, the Minister may promote such beneficiation subject to such terms and conditions as the Minister may determine. In addition, the law requires that any person, who intends to beneficiate any mineral outside the country, may only do so after written notice and in consultation with the Minister. Beneficiation is promoted by policy encouragement, regulation, and in some cases fiscal incentives.

In Tanzania, there are no explicit tax incentives in the tax laws for processing of natural resources. However, both the National Petroleum Policy and the Mineral Policy Tanzania seek to promote value addition. As a result, value addition has been introduced in the Mining Act 2010 by reducing the royalty paid for gems¹ from 5% to 1%. In the financial year 2010/11 mining companies in Tanzania receive an exemption on customs and excise equivalent to TShs 109,885,900.00. In addition, although Section 33 of Tanzania's Income Tax Act, (2004) sets the arm's length standards for transfer pricing, provisions on transfer pricing remain vague and do not cover subsidiary companies of MNCs in non-existent or low tax jurisdictions. There are thus estimated annual revenue losses of 5% of GDP equivalent to USD 1.3 billion a year from this sector.

The DRC operates an exceptional tax on companies, which is charged on the remuneration of expatriates engaged in the companies' production and exploration activities. The company is required to pay an exceptional tax on the remuneration of expatriates at the preferential rate of 10% set by the Mining Code instead of the normal rate of 25%. This tax is deductible from profits tax.

Source: primary country data

Other tax-related abusive practices by mining companies

5.1.7. Another important abusive practice undertaken by many mining companies in Africa is **debt financing**, whereby the investor finances the operational company with excessive loans instead of equity. There are also instances, where the investor uses debt financing to assure that the tax base is eroded and the profit is repatriated through interest payments. Such a practice is called "*thin capitalization*" due to the fact that the companies end up with little capital and high volume of loans. Tanzania applies a thin capitalization rule based on debt to equity ratio approach. The maximum accepted debt/equity ratio is 7 to 3. Any interest that has not qualified for deduction is disallowed permanently. In Zambia, with the exception of companies carrying out mining operations, thin capitalization is dealt with under general transfer pricing rules. For mining companies, the maximum accepted debt-to-equity ratio is 3:1. Re-characterization of interest as dividends is possible.

5.1.8. Debt financing is a tax deductible payment, where tax deduction reduces the tax base for the extractive company and the interest payment ends up in a related company located in either a low tax jurisdiction or tax haven. The loans can also take the form of more sophisticated instruments – such as profit participating loans also known as "hybrid instruments". These types of loans are debt instruments, where the interest rate is related to profitability of the company – thus effectively the profits of the company are paid out as tax deductible interest payments. Such payments would, in many countries be considered as dividends subject to exemption from corporate income tax. This leads to situations of tax deductible payments being untaxed in the recipient jurisdiction and thus the effect is very similar to a company benefiting from tax haven is achieved.

5.2 Institutional challenges in combating IFF

5.2.1. Most of the efforts to combat IFF in Africa are done within the anti-corruption umbrella. This notwithstanding, certain countries have recognized the need to establish institutions that address IFF-related practices directly by setting up Financial Intelligence Units (FIU). For instance, Zambia's FIU's primary functions are to receive, analyze, and disseminate reports on suspicious transactions. Through its director, the FIU has limited intervention powers to freeze suspected proceeds of crime while referring the case to investigators to pursue.

5.2.2. Although most mineral-rich African countries have established tax policy units, these units are generally responsible for all sectors of the economy instead of being sector-specific. In addition, there remain considerable limitations in defining tax gaps and undertaking rigorous analysis on the revenue effects of tax changes. It is also undeniable that many mineral-rich African countries suffer from low human and institutional capacity, with a shortage of tax investigators and prosecutors and ineffective supervision, particularly of the financial sector.

5.3 Conclusion

5.3.1. Revenue potential from mining is substantial, but remains untapped due to the complex nature of the sector. A lot still needs to be done in many African countries, to develop broader and stable tax regimes. Gaps in tax design and management are still a major conduit for IFFs and therefore countries should embark on serious policy reforms to address this challenge in addition to building capacity of the tax authorities.

6. Policy Recommendations

6.1.1. Although IFF is now recognized as a serious development challenge, research on this subject remains limited, contrary to the extensive research on capital flight. The concept of IFF is similar to corruption in that there is lack of clarity in its definition. Furthermore, policy recommendations on curtailing IFF are restricted by the inability to precisely determine the sources of IFF, combined with a methodological imprecision in estimating financial resources being lost due to IFF practices. IFF is also too often still perceived as yet another corrupt act and thus legal and regulatory frameworks to combat corruption are used to address IFF whereas this problem requires specific legal and regulatory refinements to address them.

6.1.2. Taxation remains the main source of generating domestic revenues for African countries, especially in mineral rich economies. However tax regimes are highly vulnerable to IFF practices. In order to intensify efforts for DRM, it is critical for policy makers to review existing taxation regimes and fiscal policies for the mining sector. Reforms in tax systems must be supported by good economic and financial governance, including in public financial management. It is in this context, that this Chapter proposes policy recommendations to mineral-rich African countries in order to combat IFF more rigorously within the mineral sector. The Chapter provides policy options and recommendations that should be considered, not only by the four country case studies, but also by other African mineral-rich countries.

6.1 General policy recommendations

6.1.3. It is critical for countries to address the economic and financial governance deficiencies urgently since poor governance will result in IFF practices and a significant loss of domestic revenues. Specifically, there is need for policy-makers to formulate policies which are anchored on best practices on transparency and accountability in mineral resources management.

6.1.4. In parallel to ensuring good governance, a clear internationally-agreed definition of IFF should be developed and adopted in countries' national legislation and/or or regional conventions. In addition, the roles of various institutions in fighting IFFs should be defined and well-coordinated at national, regional and international levels. Central banks, revenue authorities, customs agencies, ministries of finance and Parliaments have a critical role in curbing illicit financial outflows. Given that IFF is a development problem for most African countries; Governments should establish a regional platform specifically for exchange of experience and knowledge sharing.

6.1.5. Illicit financial outflows are not just an African problem, but it has a substantial international dimension, which in turn impacts on the global governance architecture. African countries should define common negotiating points, to be raised at relevant international meetings. For instance, the need for informed discourse on the problem of mis-invoicing of cross-border exports and imports within the framework of the international trade regulatory system is imperative.

6.1.6. In the medium-to-long term, it is critical for global processes to be set up for the mining sector, with clear monitoring parameters on IFF and appropriate punitive measures. Such processes cannot disfavor Africa under the pretense that IFF in the mining sector is a

‘developing country’ problematic. In addition, it is essential to strengthen international regulations, reduce banking secrecy, and improve cooperation with current continental initiatives driven by the African Union. It is also necessary to revise existing international-wide initiatives to accelerate efforts to recover money illegally transferred from the African mining sector to tax havens. Multinational corporations involved in bribery and corruption scandals should be exposed and blacklisted.

6.1.7. Bilateral treaties, which regulate foreign investments and Double Taxation Arrangements (DTA), should be carefully scrutinized. In order to address revenue losses in the minerals sector, countries should pay close attention to certain provisions of treaties which exacerbate revenue losses, which are generally the ‘stabilization clauses’. This clause implies that the range of tax incentives provided in the Agreements will still apply irrespective of changes in tax regimes. Countries should find the right balance between the need to attract investments and the objective to mobilize domestic resources for development. Agreements that provide for short term and periodical review enhance fiscal flexibility, which is necessary for resource mobilization. Ultimately the negotiation of bilateral investment treaties should be informed by countries’ overall development strategy.

6.2 Prerequisites for combating IFF in the minerals sector

Transparency and accountability

6.2.1. Combating IFF calls for deliberate policy actions on the part of government such as ensuring that transactions with investors are open to public scrutiny. This requires governments to make timely and regular disclosure of information on mining activities and revenues generated from the sector and this information should be freely accessible to the public. Governments should also consult all relevant stakeholders in negotiations for mining contracts.

6.2.2. Given that secrecy in mining negotiations opens the process to abuse, it is recommended that governments should accelerate the implementation of their commitments under various relevant Initiatives such as the Extractives Industry Transparency Initiative (EITI). The effective implementation of such initiatives requires cooperation and coordination amongst a broad range of stakeholders, including the legislature, Civil Society Organizations and the media. There is need for a mechanism, which ensures the active participation of all these stakeholders in the mining industry. All stakeholders must be represented in the negotiation of mining contracts. In some of the country case studies there is need to address the marginalization of the legislature in the minerals sector.

6.2.3. African countries should build and strengthen their institutional and technical capacities to better understand and address IFF practices. All revenue authorities should establish and build-up the capacity of their dedicated ‘transfer pricing units’. Training of human resources, specifically customs and revenue officials to detect abusive practices by MNCs is paramount in addressing IFFs in mineral rich countries. A well-resourced tax administration authority, both technically and financially, is essential to the effective implementation of the tax regime.

6.2.4. There is need to develop skills as well as collect in-country data to ensure that proper research and verifiable data exists to certify the actual magnitude of the problem:

institutions identified requiring capacity building include legislators, revenue collectors, ministries of finance and mining, as well as local government entities. Moreover, the issuing and renewal of mining licenses should be made conditional upon strict adherence to regulatory requirements including full disclosure of financial status, regular and timely filing of returns, and disclosure of ownership structures as well as payments made to the governments.

6.2.5. Mineral-rich countries should also uphold laws on freedom of the media. The role of the media as a government watchdog should be supported and strengthened by providing free and regular access to government meetings and information. Reporting of mining activities should be of all forms of print and electronic media and in major local languages for wider public coverage.

6.3 Special focus on legal and regulatory frameworks

6.2.6. Countries should develop comprehensive and detailed rules to address all dimensions of transfer pricing. This requires specific measures such as using the reference prices, irrespective of whether the transaction takes place formally between related parties or it appears to take place between independent parties. Another alternative could be establishing a rule, which allows the tax authorities to consider as related party transactions also transactions, where there is apparent reduction of tax base and shifting of profits. Training of tax and audit officials in identifying and detecting harmful and complex commercial transactions is vital to the effective implementation of transfer pricing rules.

Using a mix of instruments

6.2.7. The easy and very likely manipulation of tax base through transfer pricing is also the reason, why many countries apply **a mix of instruments rather than a single tax regime**. A tax system, which is based on a combination of instruments is less prone to abuse than a tax system based merely on one instrument. Revenue optimization can be achieved where, for example, royalties are paid for the right to acquire the ownership of the minerals and an additional tax can be levied on profits made on specific commercial activities. However, it is crucial to avoid fragmentation of the tax process. Governments should strive for uniformity of tax regimes and instruments to ease tax administration, particularly compliance.

6.2.8. Given that transfer pricing leads to manipulation of the royalty payments, it is recommended that for the tax base for royalties, mineral-rich countries should consider the market value of the mineral rather than the transaction value, since the latter can be far more easily wrongly manipulated. The market value should be taken as the actual price of the mineral at global commodity markets, which is publicly known. The challenge in using the market price is that there are significant fluctuations. In this regard, the tax system should also address what specific price should be used as reference – whether it is a spot price on the specific day that the transaction takes place or whether it is the average market price for a certain period of time (e.g. month) where the transaction takes place or other approach is used.

6.2.9. The detachment from the transaction value is also the approach that some countries adopt for income tax purposes – for example Norway (see Box 15) uses a specific approach of norm prices, while other countries use practices of listed prices - so-called “sixth method”, which is currently being analyzed by the OECD and the United Nations Economic

Box 15: Norwegian Norm Price

Norwegian Norm Price - Gross revenue from oil production and the value of lifted stocks of oil are determined on the basis of norm prices. Norm prices are decided on a daily basis by the Petroleum Price Board, a body whose members are appointed by the Norwegian Ministry of Petroleum and Energy. Norm prices are published quarterly. The Petroleum Tax Act states that the norm prices shall correspond to the prices that could have been obtained in a sale of petroleum between independent parties in a free market. When stipulating norm prices, the Petroleum Price Board takes a number of factors in consideration, including spot market prices and contract prices in the industry.

The Petroleum Price Board (Petroleumsprisrådet) is a Norwegian government agency responsible for setting norm prices for petroleum produced on the Norwegian continental shelf. The Board has currently six permanent members, including four government-appointed independent experts and one representative each from the Ministry of Finance and the Ministry of Petroleum and Energy. The Board meets quarterly.

Source: Various sources

6.2.10. It is also critical for mineral rich countries to develop **robust transfer pricing legislation**, which must be complemented by building capacities of tax administration officials to scrutinize the transfer pricing practices. For example, the threshold used to determine the concept of 'related' companies in amalgamated groups should be clearly defined. In international practice, a related party means a party, which has 10-25% equity or voting rights in the other party.

6.2.11. Furthermore, mineral rich countries should establish special procedures for **transfer pricing audits** both on the input side – purchases of goods, equipment and services from related parties and the output side – sales of mineral resources. It is recommended that assessments of tax base be detached from the value of the transaction and focus on what are the regional or global commodity/mineral prices.

6.2.12. In relation to **debt financing** challenges, one possible policy options is to introduce rules that limit the deductibility of interest based on certain criteria – such as ratio of debt to equity approach. Under the debt to equity principle, countries set the maximum permitted ratio of debt compared to equity – for example 4:1. Under the ratio system, countries are only permitted to deduct interest to the extent that the debt (loan) financing from related parties compared to equity financing, does not exceed the set ratio. Therefore where a company would finance its subsidiary with USD 8 million of loans and USD 1 million of equity, the amount of interest paid on the loans in excess of the USD 4 million of permitted debt financing would be considered as expense not deductible for tax purposes. Conversely, countries may also introduce laws which require related multinational companies to use intermediaries in the acquisition of debt. In this case the interest only flows through the local banks to the investor. This is referred to as back to back loans.

6.2.13. In order to address the problem of avoidance of special anti-avoidance rules, countries should adopt **more robust rules in order to limit interest rate deduction**. These are rules for establishing limits to deductibility of interest in terms of Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), since this is linked to the taxable revenues. Under such rules, it is less likely for any MNC or investor to repatriate all the profits without paying corporate income tax.

6.2.14. Another way to ensure limitation of deductible interest is to **limit the maximum amount of interest rate** by setting a fixed rate or using an acceptable local market rate. This means that if the maximum interest rate permissible for deduction is 10%, where intra-group loans in mining conglomerates are charged a 35% interest rate, the maximum deductible interest will be calculated using the limit of 10% and the remaining interest will be considered non-deductible and possibly also re-characterized into dividend. For low income mineral rich countries, it is recommended that the interest rate be set at a local bank rate due to problems of inflation and market volatility.

6.2.15. **Administrative measures** should be used as an alternative approach to address excessive interest deductions. Revenue authorities should be given the discretion to invoke transfer pricing rules to challenge excessive amounts of interest payment. Investigating units should be established to probe concerns related to loan financing. Excess interest can also be deducted at a future period current period as capital.

6.2.16. Given that **withholding tax** is widely used to erode the tax base, resource rich countries require measures to ensure that all payments made to certain jurisdictions such as tax havens are subjected to withholding tax. This can be achieved by creating a blacklist of such jurisdictions.

Regional Initiatives

6.2.17. The challenge of illicit financial leakages through the tax system should certainly not be seen as a national problem and must thus continue to be addressed at continental and sub-regional levels. At the sub-regional levels, there is need to harmonize fiscal policies among countries. For instance, since 2004 the SADC region has made significant progress in the harmonization of tax policies of its member States. Automatic exchange of tax information in RECs should be improved and broadened. As regards the challenge of transfer mis-pricing, RECs should develop a regional data base to provide information for comparing pricing data on goods and services to determine arm's-length transactions. In addition, countries should establish mechanisms for effective monitoring of mineral value streams considering that some member states are common transit routes for the illegal export of minerals.

Appendix 1: Methodology for primary data collection

This report has relied on both an extensive literature review as well as primary data collection, undertaken between November 2014 and April 2015. The literature review examined most of the already published research on IFF from Africa. This existing literature was used to develop a survey for the four country case studies: Zambia, Tanzania, South Africa and the Democratic Republic of Congo. These countries were selected because they are not only mineral rich, but they reflect the diverse positions of African states in relations to tax systems as well as a diversity of challenges that mirror a microcosm of African states.

The primary data collection was conducted by four national consultants in each of the selected countries, under the guidance of two lead consultants. Four different questionnaires were prepared, focusing on impartial questions relating to legislation as well as reported practices of extractive companies and the national tax authorities in the selected jurisdictions. Questionnaire 1 centred on questions relating to the legislation sources for extractive industry, anti-avoidance measures and practices, transfer pricing practices, tax treaty abuse, tax collection and related data, avoidance practices and tax administration remuneration. Questionnaire 2 centred on questions pertaining to governance and reasons for data limitations on IFF. Questionnaire 3 included additional questions on the details of tax incentives, expense deductibility, withholding taxation, policies and practices to combat IFF in oil and gas and the mining sector, specific measures on capturing DRM data in the mining sectors. Questionnaire 4 set out queries on governance, poverty alleviation including human rights as well as the ownership of mining companies and money flows, public Institutions mandated to curb IFF, the role of political leadership in curbing IFF, revenue collection management, and key recommendations.

The national consultants collected the data notably through the revenue authorities and the ministries of finance as well as national statistical offices. The raw data provided was mainly in the form of primary sources – legislation references and text of regulation and policy as well as reported practices, tax collection data. The lead experts then analyzed and processed the primary data to prepare the report and to draw observations and findings.

One key limitation has been accessing quantitative primary data in the four country case studies, since often times the data was deemed to be of a highly confidential nature. It is for this reason that the Report is unable to provide a country-specific in-depth analysis of the gaps in tax management.

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