Illicit Financial Flows: A Constraint on Poverty Reduction in Africa

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The amount of illicit financial flows out of Africa is staggering. According to estimates by Global Financial Integrity (GFI), these flows amounted to between USD 854 billion and $1.8 trillion over the period 1970-2008 (GFI 2010). Another study found that the cumulated amount of capital flight out of Sub-Saharan Africa over the same period is in excess of $700 billion (Ndikumana and Boyce 2011). It is ironic that out of the six countries with the highest average capital flight over the period 2000 to 2008, namely Angola, the Democratic Republic of Congo, Côte d'Ivoire, Nigeria, South Africa, and Zimbabwe, four had poverty rates above the African average in 2008. Moreover, five out of eight countries with the highest capital flight in Africa are classified as low human development countries (UNDP 2011).

Assessing the negative effect of illicit financial flows on poverty is not easy. The effect is partly through direct channels such as foregone investment in poverty-reducing programs (health, education, job creation, etc.) or indirect channels such as low investment and its resulting effect on income. This article focuses on the latter channel, the income channel, given the direct relationship between changes in income per capita and poverty reduction. We are not aware of any study that has attempted to estimate the effect of illicit financial flows from Africa and the level of poverty in the continent, with the exception of the *African Economic Outlook 2012* (AfDB et al. 2012). The discussion in this paper partly draws from the background work the author was involved in when preparing UNDP Regional Bureau for Africa's input to this document. Before analyzing the relationship between illicit financial flows and poverty in Africa, it is useful to briefly discuss the contrasting trajectories of the two variables.

Illicit financial flows and Africa's slow poverty reduction

Some analysts argue that Africans involved in illicit financial flows are motivated by portfolio considerations as they seek abroad for higher returns on their assets. Even though this justification makes sense from a theoretical standpoint, it is hard to convincingly justify Africa's illicit financial flows on the basis of the portfolio argument only. The average investor in the continent has limited capacity to access the knowledge, information, and technology required to engage in financial market operations across continents. In contrast, given the history of weak governance characterizing many African countries, a more plausible reason behind Africa's high illicit outflows is the illicit appropriation of resources in the form of theft, corruption, mismanagement of public resources, and trade mispricing. For example, ongoing investigations in France and USA into fraudulent acquisition of assets by some African political elites have revealed that they have embezzled large sums of money used to buy mansions costing hundreds of millions of dollars apiece, luxury goods such as expensive cars, jewelry, paintings, memorabilia, private jets, yachts, etc., mostly in Western countries.[1]

Illicit financial flows increase risk and uncertainty in the domestic economy, discouraging investment and its potential positive effect on poverty reduction. Moreover, in countries where corruption allows the elites to unlawfully appropriate resources and transfer them abroad, the incentive to put in place economic and social measures that reduce poverty is weakened. Illicit financial flows allow the elites to easily access foreign services such as healthcare and education, leaving the poor to fend for themselves.

Illicit financial flows from Africa have been increasing over the last years. The highest growth rates of illicit financial outflows from Sub-Saharan Africa over the last 30 years were recorded during the period from 2000 to 2008, a period of accelerated economic growth in the continent. It is noted that this increase was partly due to trade mis-invoicing during a period of increasing trade volumes. From an average of $17.8 billion per year in the 1990s, illicit financial flows shot to $50.3 billion per year on average during the period from 2000 to 2008 (GFI 2010).

It is striking that Africa suffers from high levels of poverty, defined as the number of people living on less than $1.25 per day using 2005 purchasing power parities, when so much of its resources are leaving the continent. Although sub-Saharan Africa recorded its best performance in terms of poverty reduction in the 2000s, the level of poverty was still the highest in the developing world. In 2008, the latest year for which comparable data is available, 47.5% of Africa's population were poor. This proportion is more than twice the average poverty level of all developing regions combined, which stood at 22.4% of the population. Africa's poverty ratio was more than three times the figure in the East Asia and Pacific region where poor people represented 14.3% of the population in 2008. In absolute numbers, Africa had the second highest number of poor people with 386 million against 571 million in South Asia in 2008. In terms of poverty dynamics, Africa shows a remarkable difference relative to other developing regions. Between 1999 and 2008, the rate of poverty in Africa declined by 18%, a poor performance in comparison with East Asia and Pacific as well as Latin America and Caribbean regions where the ratio of poverty declined by 60% and 45%, respectively (World Bank 2012a).[2]

Several factors help explain why Africa has not been able to reduce its level of poverty as fast as other developing regions. Among the key factors is high population growth that reduces the growth of income per capita. Between 2003 and 2008, GDP per capita in Africa increased by about 2.7% per year even though the average rate of real GDP growth was 5.9% per year (AfDB et al. 2012). Second is high inequality. While economic growth strongly affects poverty elsewhere, it has a weak effect on poverty in Africa as it disproportionately benefits the wealthy more than the poor. The third factor relates to high volatility of Africa's growth. Erratic growth rates could not sustain gains in employment and poverty reduction, partly explaining the weakness of the poverty-growth relationship. Fourthly, Africa's rate of economic growth has remained low relative to the level needed to induce a meaningful effect of growth on poverty reduction. Africa's income growth elasticity of poverty is about -1.5, the lowest in the developing world. Hence, for a given rate of poverty reduction, Africa needs much higher rates of economic growth than, say, Latin America and the Caribbean region where the elasticity is -3.1 (Fosu 2011). It has been estimated that Africa needed a growth rate of 7% per year on average

1 See for example, "France Seizes Equatorial Guinea's Family Mansion" in *The Wall Street Journal*, 3 August 2012. http://blogs.wsj.com/corruption-currents/2012/08/03/france-seizes-equatorial-guineas-family-mansion/.

2 From a poverty ratio of 51.5% of the population in 1981 to 56.5% of the population in 1990, poverty increased to 57.9% of the population in 1999 before falling to 47.4% of the population in 2008 (World Bank 2012a).

between 2000 and 2015 in order to reach the first Millennium Development Goal (MDG) of halving the 1990 level of poverty by 2015.

Africa has been unable to reach the growth rate required to meet the first Millennium Development Goal partly as a result of low investment in economic and social sectors that have direct and indirect effects on poverty reduction. From 1980 to 2009, the decadal average ratio of gross fixed capital formation over GDP in sub-Saharan Africa was 20.1%, 17.1%, and 18.5% for the three respective decades. In the East Asia and Pacific region where poverty reduction was fastest, investment rates over GDP were 33.3%, 36.2%, and 36.3% for the same decades (World Bank, 2012b). This shows that fast poverty reduction in the East Asia and Pacific region was accompanied by high investments in economic and social infrastructure. Hence, according to some estimates, for sub-Saharan Africa to reach the economic growth needed to halve the 1990 level of poverty by 2015, the region would need $72 billion to $89 billion of additional annual investments (Atisophon et al. 2011). Another estimate finds that Africa needs $40 billion annually for several years to bridge its infrastructure gap and another $40 billion each year to maintain the existing one (Gijon 2008).

Had Africa had not lost so much resources in the form of illicit financial transfers, it is likely that poverty would have been less acute. The logic is that keeping these resources in Africa would have produced higher rates of investment, allowing African countries to invest in productivity enhancing sectors such as infrastructure, creating jobs, and raising incomes, resulting in lower levels of poverty. In contrast, the leaders of the countries with high illicit financial outflows care less about poverty reduction as the people engaged in this process are primarily the country’s elites who value more their foreign assets than building domestic socioeconomic structures that would benefit the poor. Given that African elites are able to send their family members abroad for education and healthcare, they are less affected by poor domestic service delivery.[3] The majority of the population, however, has no access to foreign services. Illicit financial transfers by African elites are also a signal that African elites do not have confidence in their own economies, so they discourage investment and its potential effect on job creation and poverty reduction.

Illicit financial outflows, considered to be "dis-saving," have been found to have a strong and negative effect on the rate of investment, particularly private investment. This effect is stronger in Africa where savings and investments are strongly correlated (Nkurunziza 2010) and traditional sources of investment provide limited funding. Therefore, for Africa to win its battle against poverty, it needs to identify non-traditional sources of finance to close its large investment gap.[4] Preferably, non-debt creating sources of investment should be sought in order to avoid accumulating unsustainable levels of public external debts whose servicing absorbs important resources that could be invested in poverty-reduction programs. Reversing the flow of illicit financial transfers and finding ways to repatriate these resources could potentially generate important resources for investment and contribute to the fight against poverty.

3 In recent years, three African presidents from countries highly affected by illicit financial transfers have died in foreign countries’ clinics due to the lack of reliable health infrastructure in their own countries. In recent years, another African president has regularly traveled to Singapore and Malaysia for medical treatments.

4 Traditional sources include Official Development Assistance (ODA), Foreign Direct Investment (FDI), remittances, and domestic tax revenue. Even though many African countries have benefited from ODA, it is known to be too volatile, subject to conditionality, and tends to create dependency on external resources. For example, many donor countries have drastically reduced their ODA to Africa as a result of the economic crisis that has weakened their economies over the last four years. FDI and remittances are also volatile and too dependent on the business cycles in developed economies.

Potential effect of capital flight on poverty

Two simulations were performed to determine the potential effect of capital flight on poverty in Africa. The first was based on the incremental capital-output ratio (ICOR) approach which determines how many units of investment are needed to produce one unit of output. In other words, the simulation determines the additional units of income per capita would be generated if all flight capital had been invested in the originating country during the year it fled. The simulated effect of capital flight on poverty is derived using pre-determined income-growth elasticities of poverty.

The second simulation used capital stock instead of investment as the variable capturing capital flight. The idea is that investing capital flight in a given year has an effect on income not only during the same year but also in subsequent years. Capital stock is computed on the basis of the perpetual inventory method which derives the current stock of capital by adding current investment to the past stock of capital, net of capital depreciation. Each stock of capital generates a certain level of income, so the additional income per capita due to capital flight is determined using the ratio of capital to GDP. The effect on poverty is obtained by multiplying the income-growth elasticity of poverty and growth of GDP per capita that would result from investing flight capital. Country data on capital flight covers 33 countries over the period from 1970 to 2008, although data coverage is unequal across countries (Ndikumana and Boyce 2011).

These simulations suggest that over the period 2000 to 2008, assuming that all flight capital had been invested in Africa with at least the same productivity as actual investment, poverty would have been remarkably lower in the region than it currently is. The average rate of poverty reduction would have been 4 to 6 percentage points higher per year, on average. There are differences between oil-rich and non-resource-rich groups of countries. Using the ICOR methodology, poverty reduction would be highest in the group of non-resource-rich countries whereas the capital stock-based method returns a better performance in the case of oil-rich countries. Discussing the reasons of these differences is beyond the scope of this article.

Considering the most recent average annual rate of poverty reduction of -2.87% per year, the results of the simulation suggest that stemming capital flight would indeed have a very significant impact on poverty reduction. Adding 4 to 6 percentage points to the current rate of poverty reduction would allow most African countries to reach the MDG1 of halving poverty by 2015, a goal that only a handful of them will reach if the most recent trend in poverty reduction is maintained. The stimulation results show that stemming capital flight would have an even stronger impact on poverty in oil-rich economies, which have the highest incidence of capital flight. Oil-rich countries as a group would comfortably meet MDG1 if their illicit financial transfers had been invested domestically.

Conclusion and some policy suggestions

The analysis and the simulations presented above make it clear that if Africa is to successfully fight against its high level of poverty, it will need to mobilize more resources to invest in poverty-reducing programs. Poverty in Africa is so widespread that traditional sources of investment such as ODA, FDI, and tax revenue have shown their limit in addressing the problem. New additional sources of finance are needed. Mobilizing the resources that leave the continent in the form of illicit financial flows could provide such needed resources. If these resources had been invested with the same efficiency as current investment, they would have added 4 to 6 percentage points to the most recent estimate of the annual rate of poverty reduction in Africa. This would allow African countries as a group to reach the Millennium Development Goal of halving the 1990 level of poverty by 2015. Hence, the fight against illicit financial transfers from Africa should be considered as a fight against poverty.

Tapping illicit financial flows for poverty reduction purposes will not be possible without strong political will from African leaders. Indeed, unless they are fully on board, they may frustrate the process given that some of them are part of the problem. Provided there is political will, action will be needed on two major fronts: first, countries will have to put in place structures that prevent new resources from illicitly leaving Africa; second, given the size of accumulated resources that have left the continent over the years, it will be important to find ways of attracting them back to the region in order to use them as investment into poverty-reducing activities.

A number of measures could be taken to minimize illicit financial outflows from Africa. First, considering that a large part of such flows result from trade mispricing, import and export operations should specifically integrate shipment inspections by specialized agencies. Their role would be to check the conformity of the physical quantities of the goods traded and their value, quality and quantity on export or import documents. International agencies, such as the *Société Générale de Surveillance* (SGS), have established an international reputation in doing just this. Second, African governments should be encouraged to ensure transparency and disclose information relating to financial inflows and outflows. Breaking the secrecy surrounding financial flows to and from Africa is crucial in the fight against illicit financial flows. For example, requiring that each country publishes information on how much it receives in debt, FDI, and ODA and showing how these resources are used would go a long way in addressing the problem of illicit financial flows. Fourth, improving the general level of economic and political governance would not only lead to the adoption of policies that are more inclusive of the poor but also minimize the corrupt practices that fuel illicit financial flows.

The second front for action could center on the repatriation of the resources which are currently held abroad and not benefiting the continent. For example, if only a quarter of the stock of flight capital was repatriated to Africa, the ratio of the continent's domestic investment to GDP would increase from about 19% to 35% (Fofack and Ndikumana 2010), giving Africa investment ratios comparable to those in the regions that have been most successful at reducing poverty. African countries could use the Stolen Asset Recovery Initiative, a joint initiative of the World Bank and the UN Office on Drugs and Crime (UNODC), to make their case at the international level. Given the asymmetric interests between African countries that need these resources to fight against poverty and the countries and institutions hosting these assets which would like to keep them, this strategy will be successful only if the international community is united behind it.

Describing illicit financial flows as a cause of poverty in Africa could help, to some extent, if naming and shaming those holding these assets is deemed appropriate, as seen in some countries that have threatened to name and shame the biggest tax avoiders.[5] In addition, it is important that African countries demonstrate that these resources would be used for poverty reduction and other development purposes and not be embezzled by people in power. Finally, following the example of successful experiences in capital flight repatriation, African countries could grant time-bound amnesties to anyone willing to bring back illicit assets without any risk of prosecution. Although this measure is controversial, it has allowed countries such as Italy to repatriate tens of billion of dollars. Otherwise, countries should reserve the right to prosecute any of their citizens suspected of holding abroad assets transferred illicitly from their countries of origin.

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5 See, for example, "Taxes and the Rich: Britain May Name and Shame Biggest Tax Avoiders" at http://www.theworld.org/2012/07/tax-evasion-britain/.

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Table 1: Effect of Capital Flight on GDP per Capita and Poverty (Annual, 2000-08)

	Oil-Rich	Resource-Rich	Non-Resource-Rich	Full Sample
Actual GDP per capita (a)	1101	993	399	604
Income-growth elasticity of poverty (b)	-1.35	-1.37	-1.4	-1.37
Simulations with ICOR methodology				
GDP per capita (c)	1156	1018	423	621
Annual % growth of GDP per capita (d)	5.00	2.52	6.02	2.81
Effect on poverty [(b) * (d)]	-6.74	-3.45	-8.42	-3.86
Simulations with capital stock				
GDP per capita (e)	2174	1518	582	858
Annual % growth of GDP per capita (f)	8.88	5.45	4.83	4.49
Effect on poverty [(b) * (f)]	-11.98	-7.46	-6.76	-6.15

Source: AfDB et al. (2012).