ILLICIT FINANCIAL FLOWS AND THE EXTRACTIVE SECTOR IN AFRICA

Illicit Financial Flows and the Extractive Sector in Africa

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1. Introduction and Background

The literature on underdevelopment in Africa has mainly focused on issues such as weak governance, corruption, and ill advised development policies. The issue of illicit financial flows has not received a lot of attention in academic literature. However, recent research is showing that illicit financial flow is also a key factor to underdevelopment in Africa. According to various studies, in the period between 1970 and 2008, an estimated $854 billion to $1.8 trillion has left Africa through illicit financial flows. This amount greatly surpasses money earned through Aid and Foreign Direct Invest (Kar & Cartwright-Smith, 2010). Evidently, illicit financial flows play a large role in perpetuating Africa's economic dependence on donor countries. In addition, illicit financial flow weakens governments by reducing tax revenues and scarce foreign exchange resources, which also contributes to the stifling of growth and socio-economic development. Furthermore, it has an adverse effect on pro-poor policies as the beneficiaries of illicit financial flows become wealthier; they tend to gain more control of the polity which further exacerbates the unequal distribution of power (ECA, 2013). Thus, illicit financial flows need to be given serious considerations when trying to understand underdevelopment in Africa.

In a period were Africa is scrambling for greater resources to finance development, addressing issues related to illicit financial flows might provide additional sources of income for development. Predatory multinational corporations in alliance with corrupt officials operating in Africa are highly culpable for these outflows. According to Baker and Kodi (2010), multi-national corporations operating in Africa account for 60 per cent of total illicit flows, making international trade the most common way illicit money is moved out of Africa. The three most common channels of illicit flows in multinational firms are: fraudulent transactions, product mispricing, and the distortion of transfer price. Through these channels, multinational corporations are able to maximize their profit by evading the weak enforcement and regulation mechanisms in developing countries. Therefore, the state of governance in Africa is also a major driver of illicit financial flows. The weaknesses in the regulatory mechanisms and the lack of transparency and supervision of cross border flows related to multi-national activities are all contributing factors to the widespread nature of illicit financial flows. Of recent, there have been efforts to improve international laws and regulations to combat illicit financial flows (Billon, 2011). However, many African countries may lack the political will or the capacity to implement measures to combat illicit financial flows.

The aim of this research paper is to assess the extent to which illicit financial flows are facilitated by African states and multi-national corporations. Specifically, the paper looks at the role of governments officials and companies in the extractive sector in Africa. There is much evidence that suggest that the extractive sector in Africa is associated with high levels of illicit financial flows. Furthermore, the paper looks at the international measures aimed at tackling illicit financial flows. Multi-national corporations account for a significant share of illicit financial flows. Therefore, understanding and assessing the role of multinational corporations is important to gain insights into illicit financial flows in Africa.

2. Defining Illicit Financial Flow

The term illicit financial flow is often misconstrued with three other concepts: informal flows; capital flight; and money laundering. It is important to note that not all informal flows are illicit. In particular, legitimate remittance through an underground banking system is often seen as illicit. However, such systems are used due to difficulties of the sender to open a bank account or due to the fact that the recipient may not also hold a bank account (McCusker, 2005). In literature, the term illicit financial flows is also often used interchangeably with the term capital flight. However, by definition, and in practice, illicit financial flows and capital flight are two different ideas. More specifically, illicit financial flows include practices that are more than what is considered as capital flight. For example, payments of unrecorded imports are considered illicit financial flows, but not capital flight because the money is spent on goods that are imported to the country (Ndikumna, 2014). Capital flight is generally understood as the movement of funds from the country of origin to protect or secure a better return in response to an unfavourable event such as an economic crash (Reed and Fontana, 2011). Capital flight can be legal or illegal. Legal forms of capital flight will be recorded on the books of the entity transferring the capital. Returns on the investment are likely to go back to the origin country. On the other hand, illegal capital flights tend to be proceeds of illegal activity and therefore tend to be unrecorded.

As regards money laundering, this is a practice that disguises the source of criminally derived proceeds in order to make them appear legal (Reed and Fontana, 2011). Money laundering is a specific legal concept, which includes only the proceeds of a set of predicated criminal offences that are often related to narcotics, which are defined by the laws of a given country. As such, funds originating from other forms of criminal activity may not be considered money laundering, even if these activities are illicit. Furthermore, the range of offences that are considered money laundering varies across countries and does not always include corruption and tax evasion (Reed and Fontana, 2011).

While the subject of illicit financial flows is marred by the lack of terminological clarity, for the purpose of this paper, illicit financial flows are defined as money that is illegally earned, transferred, or utilized (Kar & Cartwright-Smith, 2010). Specifically in the extractive sector, illicit financial flows includes cross-border transfers of the proceeds of tax evasions, corruption, and illegal resource exploitation. In the context of this paper, illicit financial flows are essentially practices and crimes aimed at transferring financial capital out of the origin country in breach of national or international law. The activities can range from individuals working in the extractive sector and transferring funds into private accounts abroad without paying taxes, to highly complex schemes carried out by extractive companies transferring capital out of the origin country.

3. Scope and Methodology of Estimating Illicit Financial Flows

Estimates of the level of illicit financial flows in Africa vary according to the methodologies used and this variation is also due to the lack of precise data. According to Kar and Catwright-Smith (2010), in a study that examines the 39-year period from 1970 to 2008, Africa has lost an estimated amount of $854 billion to illicit financial flows. This loss averages to $22 billion a year. This trend has been increasing over time, especially in the last decade. They estimated that the annual average flow increased to $50 billion between 2000 and 2008 which is much greater than $9 billion average from

1970-1999 (Kar and Cartwright-Smith, 2010). These estimates suggest that not only are the cumulative funds lost to IFF enough to wipe out Africa's total external debt ($250 billion), they can also provide sufficient funds ($600 billion) for poverty alleviation and economic growth.

According to Kar and Catwright-Smith (2010), the overwhelming bulk of IFF over the period of 1970-2008 was from Sub-Saharan African countries. West and Central Africa was by far the most dominant driver of illicit financial flows in sub-Saharan Africa, followed by Southern Africa, the Great Lakes, and the Horn of Africa, respectively (see Table 1). However, it is important to note that the proportion of illicit flows form West and Central Africa States may have been overstated due to the fact that other regions in Africa may have poor data, thereby understating the contribution of those regions to IFF (Karr and Catwright-Smith, 2010). Countries in those regions tend to suffer from an incomplete balance of payments and bilateral trade data because, historically, they are prone to conflict and instability. Therefore, the distribution of illicit financial flows in Kar and Cartwright-Smith's study, from 1970 to 2008, may be due to margins of error associated with data deficiencies.

Table 1. Africa: Illicit Financial Flows, 1970-2008
(in millions of U.S. Dollars)

Group	Total IFFs				
	1970s	1980s	1990s	2000-2008	1970-2008
Africa	**57,291**	**203,859**	**155,740**	**437,171**	**854,061**
North Africa	19,161	72,020	59,813	78,742	229,737
Sub-Saharan	38,130	131,839	95,927	358,429	624,324
Horn of Africa	2,354	14,131	5,108	15,603	37,197
Great Lakes	6,925	16,079	4,978	10,285	38,267
Southern	5,894	20,581	31,447	116,828	174,751
West and Central	22,956	81,047	54,394	215,712	374,109
Fuel-exporters	20,105	67,685	48,157	218,970	354,917
Nonfuel-exporters	7,867	26,517	22,375	23,342	80,102
Group	**Average IFFs**				
	1970s	1980s	1990s	2000-2008	1970-2008
Africa	**7,299**	**21,678**	**17,813**	**50,328**	**29,021**
North Africa	3,097	7,754	6,316	9,166	6,866
Sub-Saharan	4,202	13,924	11,497	41,162	22,156
Horn of Africa	249	1,421	715	1,949	1,183
Great Lakes	745	1,778	580	1,286	1,142
Southern	811	2,412	4,659	13,388	9,635
West and Central	2,397	8,313	5,544	24,538	10,196
Fuel-exporters	2,239	6,922	5,105	24,806	9,878
Nonfuel-exporters	1,017	2,729	2,433	2,787	2,502
Group	**Rates of Change (real 2008 CPI deflated)**				
	1975-1979	1980s	1990s	2000-2008	1970-2008
Africa	**18.9**	**-2.1**	**-4.8**	**24.6**	**12.1**
North Africa	14.0	-11.5	0.5	6.0	6.5
Sub-Saharan	n.a.	1.3	-7.0	30.1	15.1
Horn of Africa	n.a.	7.3	-15.5	33.5	20.0
Great Lakes	13.2	-12.7	-17.7	35.0	13.5
Southern	n.a.	13.5	7.3	21.5	16.7
West and Central	21.5	0.0	-11.4	36.0	14.5
Fuel-exporters	n.a.	2.2	-15.6	42.6	21.8
Nonfuel-exporters	n.a.	11.3	-1.6	11.0	13.6

Source: Kar, D., & Cartwright-Smith, D. (2010). Illicit Financial Flows from Africa: Hidden Resource for Development. Global Financial Integrity.

The methodologies adopted in the Kar and Catwright-Smith study are based on the World Bank residual model and the trade misinvoicing model. the residual model compares a country's source of funds with its recorded use of funds. More specifically, the model looks at the countries inflows of capital, including the increase in net external debt of the public sector and the net inflow of foreign direct investment. The logic behind the model is that whenever a country's source of funds exceeds its recorded use of funds, the outstanding funds that are unaccounted for are illicit capital flows. The World Bank residual method is presented by the formula below.

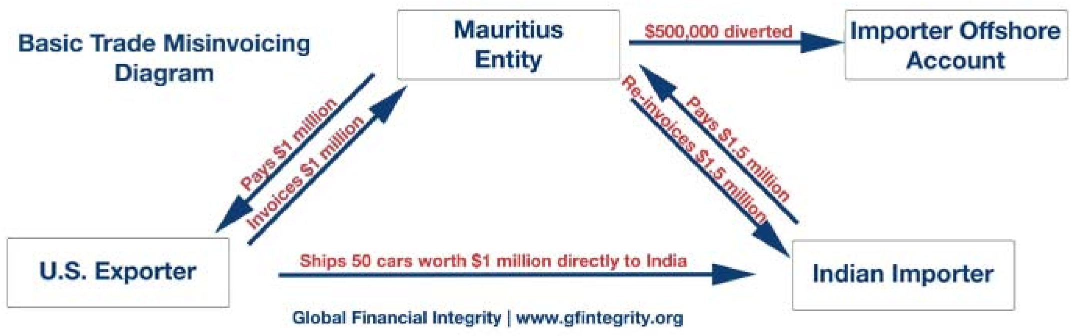
World Bank Residual Method. The unrecorded flows occur when the sources of funds exceed the recorded use of funds:

$$\begin{array}{ccc} & \leftarrow \textit{Source of funds} \rightarrow & \leftarrow \textit{Use of funds} \rightarrow \\ K = & \left[\Delta \textit{External Debt} + \textit{FDI}(net)\right] - & \left[\textit{CA Deficit} + \Delta \textit{Reserves}\right] \end{array}$$

***World Bank Residual*= (Increase in foreign debt + increase in FDI) - (financing of the current account deficit + additions to the county's reserves)**

(Kar and Cartwright-Smith, 2010)

The trade misinvoicing model is focused on overpricing imports and the under pricing of exports on customs documents which can be used to illegally transfer money abroad. The model estimates trade misinvoicing by comparing what the global market reports as having imported from the country to what the developing country has claimed to have exported. In addition, the country's import values are compared to what the global market has exported to the country (Kar and Cartwright-Smith, 2010). The model adjusts for insurance and freight in the calculation and the resulting discrepancies in trade data, between the global market and the country, indicate misinvoicing. This method is limited because it only captures the illicit transfer of funds abroad through custom re-invoicing and cannot capture misprices that are conducted on the same customs invoice (Kar and Cartwright-Smith, 2010). A simple example of trade misinvoicing model is presented in the diagram below.



(Global Financial Integrity, 2010)

Estimates through the trade misinvoicing model can be based on the Gross Excluding Reversal (GER) method or the traditional "Net" method. In the latter, gross capital outflows are reduced by gross capital inflows to reach a net position, which is then added to the World Bank residual model estimates. On the other hand, with the GER method, only estimates of exports that are under-invoiced and imports that are over invoiced (outward flows) are included in the illicit flow analysis, while inward illicit flows are ignored (Kar and Cartwright-Smith, 2010). The rationale behind the GER method is that illicit inflows that are captured by these models are also unrecorded; hence, the government cannot use them for productive purposes. Therefore, it does not offset against what a country loses through illicit outflows. Furthermore, net illicit inflows are not plausible in countries with a history of political instability, governance issues, and wasteful economic policies. Lastly, if there was genuine reversal of illicit capital then there would be an appreciation of real effective exchange in developing countries, not a depreciation of domestic currencies overtime against other currencies, like the US dollar that exist today (Kar and Cartwright-Smith, 2010).

In their research on IFF in sub-Saharan Africa, Ndikumana and Boyce (2008) have more conservative estimates in comparison to the work of Kar and Cartwright-Smith. Using a sample of 40 countries, their estimates indicate that from the period of 1970 to 2004 real capital flight (in 2004 US Dollar) for sub-Saharan Africa amounted to $420 billion (see Table 2). While this amount is lower than what Kar and Cartwright estimated, it is sufficient enough to wipe out Africa's external debt and provide additional funds for poverty alleviation and economic growth. In addition, their research estimates that for every dollar borrowed from abroad, 62 per cent was lost, due to IFF between 1970 and 2004 (Ndikumana and Boyce (2008). This estimate suggests that external borrowing is linked to increases in IFF in Africa, as borrowed funds are sneaked away into foreign firms. The linkages of external borrowing to IFF further support the view that Africa is a net creditor to the rest of the world.

Table 1: Total capital flight (million 2004 dollars and % of GDP), stock of accumulated capital flight (million dollars and % of debt stock) over 1970-2004 period

name	real KF	stock of KF in 2004	net foreign assets in 2004	total KF/GDP (%)	stock of KF/Debt (%)
Angola	42178.8	50950.6	41430.0	215.6	535.2
Benin	-3989.7	-7663.9	-9580.3	-98.6	-399.9
Botswana	1127.9	-1086.9	-1610.9	12.6	-207.4
Burkina Faso	3076.9	4670.6	2934.6	73.6	269.0
Burundi	2073.6	2566.6	1181.2	312.2	185.3
Cameroon	18378.9	27287.7	17791.8	116.5	287.4
Cape Verde	2190.9	2707.1	2190.1	231.1	523.6
Central African Republic	1943.8	2774.1	1696.4	148.7	257.4
Chad	1337.7	2345.6	644.3	31.1	137.9
Comoros	-176.3	-168.7	-474.5	-47.8	-55.2
Congo, Dem. Rep.	19572.5	36737.6	24896.7	295.1	310.3
Congo, Rep.	14950.4	17474.8	11645.4	344.3	299.8
Cote d'Ivoire	34349.4	54000.6	42261.2	222.0	460.0
Ethiopia	17031.5	22526.0	15951.9	175.0	342.6
Gabon	8580.8	11997.6	7847.9	118.7	289.1
Ghana	8503.7	11208.4	4173.3	98.7	159.3
Guinea	551.2	1048.9	-2489.6	14.6	29.6
Kenya	2665.4	6369.3	-456.9	16.6	93.3
Lesotho	407.4	893.4	129.8	29.8	117.0
Madagascar	7430.9	9570.8	6108.5	170.3	276.4
Malawi	2527.8	3825.4	407.5	132.9	111.9
Mali	-372.0	-425.4	-3741.8	-7.6	-12.8
Mauritania	2319.1	4006.0	1709.2	151.2	174.4
Mauritius	-962.8	650.1	-1643.8	-16.0	28.3
Mozambique	10677.7	14273.4	9622.9	180.6	306.9
Niger	-5975.7	-8732.6	-10682.6	-195.7	-447.8
Nigeria	165696.7	240781.0	204891.3	230.0	670.9
Rwanda	3366.8	5889.5	4233.8	183.5	355.7
Sao Tome and Principe	723.3	1059.1	696.9	1265.9	292.4
Senegal	-8885.0	-13077.3	-17015.7	-114.3	-332.0
Seychelles	2700.9	2986.3	2371.5	384.1	485.7
Sierra Leone	4607.7	7005.4	5282.6	424.7	406.6
South Africa	18266.0	17492.3	7552.7	8.5	176.0
Sudan	9218.7	16325.0	-3006.7	43.0	84.4
Swaziland	1263.9	1342.6	872.5	50.2	285.6
Tanzania	5185.2	9963.4	2163.9	45.8	127.7
Togo	-3481.6	-4064.6	-5876.9	-168.9	-224.3
Uganda	4982.0	6853.7	2031.4	73.0	142.1
Zambia	9769.5	19814.3	12535.5	180.2	272.2
Zimbabwe	16162.0	24556.0	19758.5	344.2	511.9
Sample total	419975.7	606733.7	398433.6	81.8	291.3

Notes: for Burkina Faso, last year where KF is available is 2003; so totals, stocks, and ratios refer to 2003

Sources: Ndikumana and Boyce 2003; series updated (1997 to 2004) and sample expanded using information from: IMF, *International Financial Statistics*; IMF, *Balance of Payments Statistics*; IMF, *Direction of Trade Statistics;* IMF, various country online information in "Selected issues and statistical appendix"; World Bank, *Global Development Finance;* World Bank, *World Development Indicators*.

The methodology used by Ndikumana and Boyce (2008) in their research is the Trade Misinvoicing Model with the traditional Net Method. This is probably the reason why their estimates of IFF were relatively low in comparison to that of Kar and Cartwright-Smith. The Net Method takes into consideration gross capital inflows basically the inflow of illicit capital into Africa. In the process of calculating the estimates of IFF, gross capital outflows are reduced by gross capital inflows to derive a net position. Then, the net position, which can be negative, is then added to the World Bank Residual model estimates. Therefore, the difference in methodologies may be the main reason behind the difference in the estimates of IFF in Africa in the two studies.

It is important to note that there are limitations to the World Bank Residual model and the Trade Mis-invoicing Model (Net or GER methods) in their estimation of IFF in Africa. These models cannot capture all forms of illicit outflows, as they rely on official data to make estimations. There are illicit outflows that cannot be captured because they evade custom authorities and their recording systems (Kar & Cartwright-Smith, 2010). Therefore, these models most likely understate the actual volume of illicit flows from Africa. Furthermore, these models cannot capture IFF generated through fake invoices that are aimed at hiding mispriced trade transactions. For example, buyers and sellers collude to ensure that there is no recorded difference between export and import values (Kar and Cartwright-Smith, 2010). These types of activities are nearly impossible to estimate. In addition to the technical issues, Africa also suffers from data deficiencies. There is no reliable data on external debt, foreign direct investment, and direction of Trade Statistics for most African countries going back to 1970. These limitations also have an impact on estimations, as most missing data is set to zero in model estimates for that specific year. Thus, the difficulties in estimation suggest that IFF in Africa may be higher than what is predicted by most models. This led Kar & Cartwright-Smith (2010) to suggest that IFF could be as high as 1.8 trillion if fake invoices and data deficiencies are taken into consideration.

4. Extractive Sector and Illicit Financial Flows

In both the Kar & Cartwright-Smith (2010) and Ndikuma and Boyce (2008) research on IFF, resource rich countries in Africa contributed to the bulk of outflows in Africa. According to Kar and Catwright-Smith (2010), Nigeria, Sudan, Angola, and the republic of Congo are responsible for substantial outflows in Africa between 1970 and 2008. While, Ndikuma and Boyce’s (2008) research suggest that there are strong linkages between natural resource endowments and outflows in Africa. These studies are further supported by Baker and Kodi (2010), who assert that fuel exporting countries accounted for nearly half of the IFF from Africa between 1970 and 1980. This is most likely due to the poor performance of resource rich countries in revenue collection. In Sub-Saharan Africa, high share of fuel in total exports is associated with revenue loss to the State. Another study by Ndikumana and Boyce (2011) claims that for each extra US dollar in oil export, an estimate of 11 to 26 cents also leaves the country in the form of IFF. These findings are further supported by Williams (2010) who asserts that high natural resource dependency increases the level of corruption while reducing transparency.

The proneness of the extractive sector to illicit financial flows suggests that there are major malpractices in the administration and regulation of companies in this sector. Since the extractive sector accounts for the majority of foreign earning and fiscal revenue in resource-rich countries, the control over the sector is an important source of economic and political power (Gillies, 2010). Therefore, in most resource-rich countries, a significant portion of the extractive sector tends to be in the control of the executive office and their cronies. They tend to exhibit a high level of discretionary political control over the sector. This gives the executives and their cronies significant access to revenue gains from the sector allowing them to achieve relative autonomy from the population and external donors (Gillies, 2010). As such, access to discretionary funds helps reduce transparency and accountability in the extractive sector.

According to Billon (2011), public and personal interest tend to be blurred in the extractive sector. Government officials tend to have a vested interest in State companies, especially in the oil and gas sectors. In many cases, State companies are forced to serve the personal interest of their political patrons. This often leads to senior management receiving excessive compensation packages (Billon, 2011). Furthermore, the complex technical and financial processes of extractive sectors means that companies tend to do most of the accounting for tax payments, especially in developing countries. Therefore, companies have significant leeway in the accounting process leaving room for manipulation, especially in countries where auditing capacity is limited or corrupt (Gillies, 2010). The high degree of integration and the number of channels in which resource rich countries are linked into the global economy makes them susceptible to IFF. Their participation in the global economy is mainly through natural resource exports and the import of foods and manufactured products. These channels provide a lucrative opportunity for trade mis-invoicing (Billon, 2011).

The malpractice that exists in the regulation and administration of extractive sectors suggests that the main source of IFF in Africa is due to corruption, tax evasion, and illegal exploitation. These three sources of IFF are not mutually exclusive; there are often linkages between these activities. For example, an extractive company might pay a bribe to a government official to illegally exploit a resource, and ship the product without export duties.

4.1 Extractive Sector and Corruption

Corruption is often defined as the abuse of public authority for personal interest at the expense of the broader community. Corruption in the extractive sector often comes in the form of bribes or facilitation payments paid by companies, money embezzled from tax collection, and budgetary allocation. The main beneficiaries of these activities tend to be corrupt government officials and extractive companies who gain an undue advantage (Reed & Fontana, 2011). There is strong evidence highlighting that corruption is intimately linked to the extractive sector. According to Leite and Weidman (1999), larger exports of fuels and ores are associated with worse corruption scores, while agricultural and food exports are related to better scores . Using a simple growth model, their research determined that capital intensive natural resources, such as fuel and ores, tend to induce a higher level of corruption (Leite and Weidman, 1999). The most likely reason is that these industries create better opportunities for rent-seeking behaviour and patronage due to large revenues.

However, it is important to note that the presence of extractive industries alone does not inherently lead to corruption. The factor that drives corruption is the impact of the extractive sector on economic and political conditions in resource rich countries. For example, the discovery of oil reserves in Sao Tome and Principe increased the value of political power for politicians. Therefore, politicians spent more resources on increasing their chances of getting elected through corrupt practises such as buying votes (Vicente, 2010).

According to Tsegaye Lemma, corruption is the prevalence of monopoly and discretion without accountability, integrity, and transparency. The extractive sector creates avenues for monopoly and discretion, which have a negative impact on accountability, integrity and transparency. According to Transparency International (2010), of the top 10 most corrupt political leaders, three are from Nigeria, Indonesia, and Democratic Republic of Congo--àall extractive sector dependent countries. This further supports Lemma's definition of corruption, as the extractive sector in these countries opens opportunities for government officials to seek illicit wealth and it also opens opportunities for private sector companies to influence politics. Thus, weakening governance (accountability, integrity, and transparency) in these countries would lead to increased corruption. The lack of accountability, integrity, and transparency combined with increased monopoly and discretions allows for both extractive companies and governments to engage in activities that lead to IFF.

4.2 Extractive Sector and Illegal Resource Exploitation

There are broad ranges of practices in the extractive sector that lead to illegal exploitation and contribute to IFF. These practices include: operating outside the confines of licensed areas, extracting resources from outside a concession (or beyond contractual limits), extracting extensive quantities of resources under an exploration license that only authorises sampling (Billon, 2011). Theft is a common practice in the extractive industries. In South Africa, approximately 30 tons of gold was suspected of being stolen on a yearly basis in the mid-1990s. This led to the subsequent loss of 13 per cent of potential revenues in the gold mining sector (Gastrow, 2011). In addition, the underreporting of the volume or quality of the resource produced is a common practice by companies, especially in cases where measurement involves technical expertise and equipment (Billon, 2011). Companies are able to capitalize on the fact that resource rich countries often lack the technical expertise to properly regulate their actions. In the oil sector, the accurate reading of volume of extraction for tax reporting is a major issue, especially in countries like Nigeria. This is largely due to the lack of production metering devices to provide accurate measures of volume of production. The weakness in measuring processes has led to substantial losses to production theft in Nigeria (McPherson and MacSearraigh, 2007).

The failure to respect environmental and social regulations is another aspect of illegal resource exploitation. For example, extractive companies can disregard policies on wastewater disposal or on the exposure of workers to harmful chemicals. Some companies are unwilling to adhere to environmental and social regulations because it is perceived to increase the cost of production (Billon, 2011). This creates opportunities for corruption through compliance avoidance, or facilitation payments to officials, or the lowering of environmental standards. For example, non-compliant companies can illegally increase profits by declaring false compliance expenses in their tax reports (Billon, 2011). Thus, the strong desire to maximize profits creates an incentive for extractive companies to engage in practices that fuel IFF. These acts can also lead to negative externalities for the rest of the society, in addition to losses for a country in IFF.

4.3 Extractive Sector and Tax Evasion/Avoidance

The largest contribution to IFF from the extractive sector is tax malpractices- from trade mispricing or over invoicing, excessive tax exemptions, and the misreporting of export volumes by extractive companies and operation cost inflation. According to Kar and Cartwright-Smith (2010), 60 to 65 per cent of IFF is essentially due to tax evasion by companies with international operations. In understanding IFF, it is important to make a clear distinction between tax evasion and tax avoidance. Tax evasion is generally understood as the violation of tax laws, while tax avoidance is a practice that individuals or firms undertake to reduce their tax in a way that is not strictly illegal but runs counter to the spirit and purpose of tax law (Fuest and Riedel, 2009). In terms of extractive companies, the most notorious form of tax avoidance is transfer pricing by firms that operate in more than one country. In these cases, subsidiaries of an extractive firm will overcharge or undercharge each other so that profits are highest in those subsidiaries operating in countries with the lowest corporate tax rates. These actions have become more severe with the proliferation of tax havens that have zero to minimal tax rates. Thus, extractive companies can vastly reduce their tax obligations by shifting their profits to a paper company registered in a tax haven (Chang, 2007). In this case both resource rich countries and home countries of extractive companies lose possible earnings from taxation. Transfer pricing is made easier due to current International Accounting Standards (IAS), which do not require multinationals to produce earnings broken down by the country. According to Christian Aid (2008) , an estimated 160 billion dollars is lost by developing countries each year to transfer mispricing and falsified invoicing.

Tax avoidance can shift to tax evasion if the practice involves corrupt practices such as the payment by companies to public officials to secure better terms. For example, extractive companies can pay public officials to receive low tax rates via specific contractual arrangements or broad fiscal reforms (Billon, 2010). There are various illegal streams through which extractive companies try to attain attractive investment conditions. These practices include the direct bribing of corrupt elites, offering of lucrative service contracts, and signature bonuses. In a recent case in the Democratic Republic of Congo, an estimated $23.7 million was suspected of being embezzled from a $100 million signature bonus for a copper mining contract (Billon, 2011). Thus, tax evasion and avoidance in the extractive sector not only leads to significant tax revenue loss for resource rich countries, but also contributes to IFF.

5. Impact of Illicit Financial Flows on Socio-Economic Development in Resource-Rich Countries

IFF is an issue of great concern for Africa because a significant amount of financial resources, which could have been potentially used to finance socio-economic development, is lost through this process. IFF drain resources and tax revenues, stifle growth and socio-economic development, and weaken governance, which further prolongs the cycle of underdevelopment. The draining of resources lowers a country's exchange reserves and this limits its ability to import, while the investment capabilities of governments are diminished by the loss of tax revenues. In addition, the loss of tax revenues and resource drainage can lead to higher levels of inflation through money-financed government budget deficits, and further depreciate the values of domestic assets (ECA, 2013). All of these factors significantly hinder socio-economic development in the continent. The lower levels of investment due to IFF hamper poverty alleviation programs and economic development efforts. For example, estimates show that if Africa could repatriate stolen funds, the capital stock could potentially expand by 66 per cent. Africa's gross domestic product (GDP) per capita would have been 16 per cent higher without the losses to IFF (Ndikumana and Boyce, 2008).

IFF also contributes to greater inequality in developing countries due to their impact on the distribution of wealth and power. The elites that benefit from IFF get wealthier, further widening the gap between the rich and the poor. The economic power usually translates into political power, which has adverse implications for pro-poor policies. In addition, citizens face higher taxes and austerity measures in order to finance external debt obligations. The poor are also disproportionately affected by the tax burden, due to their lack of political power. Furthermore, the ability of States to provide social services is greatly diminished by IFF. The revenues lost to IFF could have been spent on education, health, and the agriculture sector to improve schooling, provide health care, and bolster food security and employment. Thus, the ability of African countries to reduce poverty and boost economic growth is greatly hindered by IFF. In addition, its impact on income distribution, in the long term, may impact economic and political stability of African countries.

IFF further entrenches Africa's economic dependence on more advanced regions, as substantial losses to IFF forces countries to borrow to finance socio-economic development. This has led to Africa having a high cumulative external debt at $279 billion, as of 2008 (ECA, Economic Report on Africa, 2009). In addition, the conditionalities attached to official donor assistance (ODA) and other forms of aid have made it extremely difficult for African countries to shape their own development policies. These conditionalities are often not in the best interest of African countries and often further contribute to underdevelopment. For example, the World Bank and the IMF conditionalities have been widely accused of leading to reduction of government spending on social services and increasing tax rates and interest rates. Thus, these conditionalities have been widely associated with the decline of quality of life in developing countries especially the poor (Ferraro & Rosser, 1994). However, Africa cannot simply end its dependence on more advanced regions as they lack alternative sources of funding for development. Stemming IFF could provide much needed resources to reduce this dependency.

The illegal exploitation of resources is also a major driver of conflicts in resource-rich countries. The proceeds from activities related to IFF often funded violent competition for power and control by rebel groups, terrorist, criminals and corrupt government officials. This has been the case in many resource rich countries, including Nigeria, Democratic Republic of Congo, Angola, Sierra Leone, and Liberia. In Angola, the National Union for the Total Independence of Angola (UNITA), a rebel group, fought a decade long war from 1992 to 2001 with the Government. The rebel group was able to sustain itself through the use of proceeds gained illicitly from diamond revenues. The Revolutionary United Front (RUF), a rebel group in Sierra Leone was able to sustain a decade long war with the government of Sierra Leone using diamond revenues (Safer world, 2014). In the DRC, a civil war which is estimated to have claimed roughly 4 million lives was largely sustained by revenues from the extractive sector, particularly coltan, diamonds, and gold. These resources allowed various groups from the military to rebel groups to sustain the war effort (Safer World, 2014). In Nigeria, the oil belt of the Niger Delta is constantly embroiled in various forms of conflict involving the Nigerian Armed Forces, ethnic and youth militias, and other militant groups. These groups mainly struggle for the control of oil resources in the region. According to McPherson and MacSearraigh (2007), between 30,000 and 40,000 barrels a day are lost to thefts. These losses equate to considerable fortunes for thieves as the price of a barrel can range from $65 to $75. The armed militant groups have a strong incentive to keep the oil rich region in turmoil, as the illicit funds earned through conflicts can be used for weapons and recruiting essentials, leading to a cycle of violence. As long as militant groups in African countries are able to earn income illicitly by selling commodities from extractive countries, the political stability of African countries will continue to be undermined.

According to the United Nations' Millennium Development Goals (MDGs), $529 billion will be needed to cover MDG costs by 2015. There is a high likelihood that most African countries will not meet the MDGs by 2015. In addition, there is also a strong likelihood that official donor assistance (ODA) commitment will not be enough to cover the costs that are necessary to support the MDGs (Kar and Cartwright-Smith, 2010). This suggests that most countries will most likely fall way short of the MDGs targets. Therefore, in order for Africa to even have a chance at meeting the MDGs, the mobilization of domestic resources is necessary. Thus, the issue of illicit financial flows must be a priority for African countries not only to meet the MDGs, but to prevent further decline of access to basic public services in the midst of devastating poverty. Furthermore, addressing illicit financial flows will greatly improve the political stability of many African countries, especially countries with a history of resource-led conflict.

6. Combating Illicit Financial Flows in Africa's Extractive Sector: The Role of International Initiatives

Since the late eighties, there have been numerous international initiatives aimed at tackling illicit financial flows in the extractive sector. These initiatives include the Extractive Industries Transparency Initiatives (EITI), section 1504 of the US Dodd-Frank Act, Financial Action Task Force, and Natural Resource Charter. These individual efforts aim to combat IFF by addressing tax evasion, strengthening anti- money laundering measures, strengthening national and international policies related to IFF, and establishing legal and institutional frameworks aimed at tracking, freezing, and recovering illegal assets. This chapter discusses some of the key international initiatives, focusing particularly on those that target the extractive sector. They include those that African governments have directly subscribed to, and those that foreign companies that do business with them have subscribed to either voluntarily, or compelled by law.

6.1 Extractive Industries Transparency Initiative

The Extractive Industry Transparency Initiative (EITI) is a culmination of the work of many civil society organizations' continued advocacy on increasing transparency and accountability in the extractive sector, which provides the opportunity to develop an initiative built on the notion of equal transparency on the part of governments and extractive companies. This foresight led to the launch of the EITI in 2003 to improve transparency and accountability through the full publication and audit of company payments and Government revenues from oil, gas and mining (EITI, 2009). The voluntary based initiatives requires both private and public companies to publish their payments to governments and for governments to also publish what they receive from companies. Finally, an audit of both government and company reports is done to identify any discrepancies between the two. EITI also requires the active participation of civil society in the design, monitoring and evaluation of the audits (EITI, 2009).

EITI is relevant to the extractive sector in Africa, as resource rich countries face a great difficulty in managing their resource wealth to foster economic development. In addition, the extractive sector in most African countries is highly prone to illicit financial flows due to malpractices in the sector. The aim of EITI is to provide a means for a prudent and transparent governance of resources in the extractive sector. The EITI through its monitoring and reconciling of company payments and government's revenues aims to improve the tax collection process, reduce corruption, and increase investment in resource rich countries (EITI, 2011). Thus, there are strong incentives for resource-rich countries to commit to the EITI framework. Since its launch in 2003, the initiative has grown rapidly. Forty-eight countries have made the voluntary commitment to more openness, and are publishing the reports of their respective extractive industries. As regards African countries, currently sixteen are EITI compliant, and three are EITI candidate countries (EITI, 2014). However, the number of EITI compliant African countries is modest compared to the number of resource rich countries on the continent.

While EITI is credited for directing the attention of the international community towards issues in the extractive sector, the Initiative faces criticism regarding its inability to reduce corruption in the sector (Keblusek, 2010). The key criticism leveled against the EITI is its narrow mandate focused on company government financial flows, its assumption about the role of civil society, its assumption that transparency can lead to accountability, and the voluntary nature of EITI.

6.1.1. Narrow mandate of EITI

Revenue Watch and other civil society organisations have argued that EITI's purely focus on the extractive sector is too narrow to create the level of transparency necessary to reduce corruption in developing countries. They assert that ignoring the social and environmental cost of extractive activities undermine the EITI process, as well as its exclusion of other non-extractive industries (Billon, 2011). Another issue for concern is that EITI does not address what governments do with oil-related revenue. However, an attempt to broaden the scope of the EITI could have its drawbacks, as it might extend the initiative beyond its optimal capacity. Furthermore an attempt to broaden the scope of the initiative may face resistance from EITI participants and may dissuade others from joining EITI (Billon, 2011).

6.1.2. EITI and Accountability

A key assumption of EITI is that by exposing audit information to public scrutiny, civil society will be able to hold governments accountable and impact public policy. However, in reality, the ability of these audits to mobilize the public may be overstated. For instance, the audit report tends to use highly sophisticated language and analysis making it inaccessible to the average citizenry in a developing country, thus, making it unlikely for these audits to mobilize the citizenry in a broad and meaningful way (Keblusek, 2010). Furthermore, the ability of the media to translate the essential elements of the audit is often limited, because journalists often lack the understanding needed to analyze the findings. Another issue is that civil society groups, who choose to participate in EITI process, may not be the best representatives of the broader society. Capacity issues limit the ability of civil society and broader society to hold governments accountable through the EITI process (Keblusek, 2010). The Nigerian experience with EITI presented in Box 1 below highlights the difficulty of transparency leading to accountability.

Box 1 : Case Study on the implementation of EITI recommendations in Nigeria

Nigeria joined the EITI in 2004 spearheaded by then president Olusegun Obasanjo. The Nigerian government made it a requirement for all oil and companies to publish company payments, and Governments to publish revenues. Consequently, a working group was established comprising 28 members from the Nigeria government, corporations (both domestic and multinational), civil society, media, private sector, and the legislative branch. The objective of the working group was to complete an independent audit of the oil and gas industries. The group conducted three audits: a financial audit, a physical audit and a process audit (Keblusek, 2010). The financial audit mapped the financial flows in the oil and gas sector reconciling payments and revenue and identified systematic issues in the government financial system that impacted transparency and accountability. The physical audit, tracked the actual movement of oil and gas from extraction through refinement/export. Lastly, the process audit, focused on the process affecting the financial factors throughout the extractive sector. The audits were able to find a significant amount of irregularities and systemic blocks to transparency in Nigeria (Keblusek, 2010). For example, there was a serious lack of information sharing between government entities making it difficult to reconcile payments. The physical audit found many irregularities in the way oil was accounted for, which led to misleading assessment of the amount oil volume extracted. As regards the gas sector, there was total lack of regulation. The process audit determined that the licensing process for oil and gas was ambiguous and arbitrary with no transparency in the binding process among many other issues(Keblusek, 2010).

After concluding the audit report, a set of recommendations were made to address the irregularities that affected transparency and accountability in the extractive sector. However, there seemed to be no political will to carry through with the specific recommendations to address the systematic irregularities. Even the passing of the Nigerian EITI Act, which codified the provision of EITI into Nigerian Law in 2007 did not compel the implementation of the recommendations. Furthermore, since the release of the audit report, progress has significantly slowed on the implementation of EITI requirements (Keblusek, 2010). The EITI greatly underestimates the difficulty of making reforms to a system that rewards an entrenched group of elites so massively.

However, the World Bank is taking steps to address capacity issues related to holding government accountable. The Bank provides grant funding to civil society groups to enhance their capacity to hold governments accountable (World Bank, 2005). In addition, Non-Governmental Organizations (NGOs) such as Publish What You Pay (PWYP) and Revenue Watch and Transparency International have been working on training activists to increase their capacity to analyze audit reports. Furthermore, the Revenue Watch Institute has funded the preparation of two guidebooks for both civil society and journalists in an effort to help various stakeholders understand and report on issues in the extractive sector (Goldwyn, 2008). Similar efforts have been made by other international funders to build civil society capacity in the various EITI countries (Keblusek, 2010).

6.1.3. Voluntary nature of EITI

The voluntary nature of EITI poses a significant challenge to the enforcement capability of the process. Critics seriously doubt the ability of EITI to bring about a meaningful reduction in corruption and embezzlement in the extractive sector (Harman & Williams, 2013). Since the EITI is voluntary, member countries or companies can simply choose to stop adhering to its regulations if they felt that the process does not fit their interests. The ability to backtrack from EITI obligations makes the process a “safe alternative” to mandatory regulation for governments and large oil, gas, and mining companies. For critics, the voluntary nature of EITI provides too much leeway for governments and companies, making it difficult to hold them accountable through the Initiative. Some critics argue that it is precisely the systematic leniency that has made the EITI so attractive to companies and governments (Harman & Williams, 2013). They believe that the systematic leniency resulting from the voluntary nature of EITI is to blame for its “slow and piecemeal” adaptation in many countries (MSI Evaluation Report, 2013). This prompted for NGOs such as PWYP and Oxfam to argue that EITI must be matched with legal requirements (Financial Times, 2014). However, adding a legal requirement may make it difficult to get governments and companies to commit to the Initiative. Thus, the EITI faces a dilemma between creating a validation process that meaningfully reduces corruption and one that is attractive to both governments and companies.

Despite the shortcomings, the EITI represents a step towards greater transparency and accountability in the extractive sector. The Initiative is by no means a magic bullet to address all the issues in the sector but it is leading to incremental gains in terms of transparency and accountability. It has led to the growing awareness of the importance of transparency and accountability in the extractive sector and has catalyzed reforms in many resource rich countries. Although progress has been 'slow and piecemeal", the Initiative is still an important step to addressing some of the issues in the extractive sector.

6.2 Section 1504 of the US Dodd-Frank Act and the EU Accounting and Transparency Directive

In July 2010, the United States passed the Dodd-Frank Act as the response to the 2008/2009 financial crisis to bring more regulation to the financial industry. Section 1504 of the Act deals exclusively with oil, gas, and mining companies and requires these companies to fully disclose their payments to foreign governments annually, including those in Africa. In addition, companies should file an annual report publicly disclosing payment to foreign governments with the Securities and Exchange Commission (SEC) which is the principle government agency responsible for regulating the U.S. financial sector (Veit and Easton, 2013). In 2014, the SEC voted to implement Section 1504, the act is now in effect. The reporting process entails that companies report any payment whether single or a series of payments that equals or exceeds a threshold of $100,000 in a fiscal year. Companies are required to report the type and total amount of payments and provide information regarding those payments in an interactive data format. The Act will impact over 1, 100 companies that are publicity listed on the US securities exchange, and are headquartered in the United States (Veit and Easton, 2013). The Dodd-Frank Act, unlike the EITI, is a mandatory regime, thus making it a requirement for all companies listed in the United States to disclose payments or face legal action. The advantage of having an enforcement mechanism is that oil, gas, and mining companies will no longer drag their feet when it comes to the disclosure of payments. Thus, unlike the EITI, implementation of the requirements of the act will not be a “slow and piecemeal” process. This has made the Dodd-Frank Act very unpopular with many companies listed in the United States.

The American Petroleum Institute together with other industry lobby groups try to challenge the Dodd-Frank Act and it’s implementing rules in court. The industry lobby groups are hoping to pressure the SEC to devise weak rules that would allow for company exemption and keep the information companies disclosed to the SEC a secret. They argue that other extractive companies not listed in the US will gain a competitive advantage from the disclosure of revenue payment data. Therefore, they believe that the disclosure of payment will harm the competitiveness of U.S. companies globally (Gallagher, 2012). Additionally, they argue that the Act will impose significant costs on resource extraction issuers, and subsequently, shareholders. They claim that implementing the Act will lead to undue cost and an administrative burden to extractive companies (Gallagher, 2012).. The SEC itself estimates that the initial compliance to section 1504 of the Dodd Frank Act will cost companies around a US 1 billion. Furthermore, the annual cost of disclosure is estimated at between $200 to 400 million for the entire extractive industry (Mathews, 2012).

However, the experience of extractive companies such as Statoil and Newmount shows that disclosure does not mean loss of competitiveness. These two companies were able to maintain competitiveness despite being two of the very few companies that disclosed payment prior to the enactment of the Dodd-Frank Act. The Act is also advantageous to extractive companies because it will aid in risk management and strengthen market efficiency (Ushie, 2013). It is in the best interest of extractive companies to demonstrate to shareholders and possible investors that they are trustworthy and do not pose a financial risk. Increased transparency will allow shareholders and possible investors to make informed decisions in regards to companies operating in the extractive industry. Therefore, the criticism of Section 1504 of the Dodd-Frank Act by industry lobby groups is considered unfounded.

Another criticism of Section 1504 of the Dodd-Frank Act questions its ability to fight corruption in the extractive sector. According to Firger (2010), the Act does not directly target corruption in the extractive sector; it just provides information which can be used to determine if acts of corruption have taken place. However, this requires for stakeholders to be well informed and provided with the right incentives and the required capacity to effectively utilize the disclosed information (Firger, 2010). In many resource rich countries, including those in Africa, the capacity to use the disclosed information is limited, thus the ability of civil society and broader society to hold governments and companies accountable through the process will also be limited. Furthermore, critics argue that the SEC lacks the capacity to police extractive companies on the accuracy of reported payments to foreign Governments (Firger, 2010). Therefore, extractive companies could possibly manipulate the information they provide to the SEC, thereby hiding any signs of illegal activity. This is a cause for concern because if extractive companies manipulated information they provide to SEC, it will severely limit the ability to hold them accountable. However, the Dodd-Frank Act is still at an early stage of implementation, thus providing the opportunity for the SEC to learn lessons and put in place mechanisms to ensure that the information reported is accurate.

Globally, there has been a push towards more transparency and accountability in extractive sectors. In 2010, the Hong Kong Stock Exchange adopted disclosure requirements for extractive companies, including payments to Governments. The enactment of the Dodd-Frank Act has sparked the European Union (EU) to develop a similar legislation. In June 2013, the European parliament voted overwhelmingly in favour of adopting the Accounting and Transparency Directive. The Directive compels oil, gas and mining companies to disclose payments to governments and release information on their earnings in each country (Nunes, 2013). This Accounting and Transparency Directive brings the EU in line with the disclosure rules adopted in the United States. EU member states were given until July 2015, to transpose the Directive into national laws. Companies in the extractive sector are expected to publish their first reports by 2016/2017 depending on how quick member states transpose the directive into national laws.

The EU is also in the midst of encouraging other countries to adhere to international efforts to establish transparency and accountability in the extractive sector (Nunes, 2013). The Tokyo Stock Exchange for example, was reportedly considering similar reforms to the EU (Ushie, 2013). In Canada, due to the growing pressure to adopt a similar legislation to Section 1504 of the Dodd-Frank Act, the Canadian government, in December 2014, passed a new legislation requiring the disclosure of payments by Canadian extractive companies to domestic and foreign Governments (PWYP, 2014). The Canadian government is aiming to align Canadian policy with the standards of other

G-8 counties with the hope of reducing corruption in the extractive sector (Snarch, 2013). The Extractive Sector Transparency Measures Act has yet to come into force but it is expected that the Governor in Council will set a date no later than April 1 2015 (PWYP, 2014). While regulations are yet to be in place, the Act marks a significant step in improving transparency and accountability in Canadian extractive companies.

Thus Section 1504 of the Dodd-Frank Act has sparked a global movement for mandatory disclosure of payments by extractive companies to foreign governments. While many of these disclosure regimes set up in the EU, Canada, and Honk Kong are still in their infancy, they hold extraordinary potential in improving accountability and transparency in the extractive sector (Ushie, 2013). These mandatory regimes could have serious implications for resource rich countries and the fight against illicit financial flows from their respective extractive sectors. However, in order for the mandatory requirement to effectively combat illicit financial flow, stakeholders should be well informed and provided with the right incentive and capacity to utilize the disclosed information.

6.3 Financial Action Task Force

A key means through which illicit financial flows often leave resource rich countries is the financial system. Illicit funds are laundered through the financial system to disguise their origin. As a result money laundering has been high on the international agenda for over two decades. This has led to the development of many conventions which were ultimately incorporated into the recommendations for the Financial Action Task Force (FATF). The FATF was established by the G-7 in 1989, and is considered the most comprehensive instrument for tackling money laundering to date (OECD, 2014). The objective of the FATF is to set standards and promote the effective implementation of legal, regulatory, and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system (Midgley et al, 2014). The FATF responsibilities were initially based on a set of 40 recommendations issued in 1990; however the list has been revised twice in 1993 and 2003 to take into account the changing global environment. The aim of these recommendations is to set out a basic, universally applicable framework for tackling illicit financial flows covering the criminal justice system, financial sector, specific non-financial businesses and professions, and creating a mechanism for international cooperation (IMF, 2012). The global war on terror led to the addition of nine more recommendations to the initial 40, aimed at tackling the financing of terrorism.

The FATF is a thirty-six member intergovernmental organization that consists of thirty-tree countries and two regional associations. However its reach is much broader than its thirty-six members. The FATF recommendations have been endorsed by more than 180 jurisdictions, the World Bank and the International Monetary Fund (IMF), (Terry, 2010). The Task Force primarily conducts its work through its plenary group, four working groups and its Secretariat which is based in Paris, France.

A key criticism of the FATF is that it does not have any legal authority with respect to its members. Similar to many other intergovernmental organizations, the FATF policies and recommendations are soft law rather than hard laws. Thus, its enforcement mechanism is limited to its ability to expel members who do not comply with its policies and recommendations (Terry, 2010). In order to determine how well members are complying to its policies and recommendations the FATF conducts a mutual evaluation of each member to assess their compliance with the recommendations. The evaluation is then used to prepare a list of non-cooperative countries and territories (Terry, 2010). This has prompted legal reforms in many of these countries and jurisdictions. Therefore, although FATF edicts and recommendations are soft laws, through its evaluations procedures it can help foster legal reforms in its 180 jurisdictions. That said, note that no country has yet been found to be in full compliance with the entire set of complex recommendations. The OECD countries for example, on average, have a low compliance rate with the central FATF recommendation (OECD, 2014).

While compliance has improved since the third revision of FATF recommendations was established in 2003, the improvement is not even across the board (OECD, 2014). The low compliance by OECD countries is troubling because they represent the core members of FATF. If compliance is low in OECD countries there is a high likelihood that this may also be low in other FATF jurisdictions. The Global Witness study of over 600 pages of evaluations of FATF jurisdictions highlight a general lack of compliance to the FATF recommendations globally (Midgley et al, 2014). The low level of compliance prompted the organization to advocate for more effective accountability mechanisms. Global Witness recommended that country reporting should focus on clear and accurate information on the strength of implementations of laws, and should provide a list of follow-up actions (Midgley et al, 2014).

FATF has been widely receptive to the recommendations of Global witness, and has since agreed to rate countries both for the strength of their anti-money laundering (AML) and combating the financing of terrorism (CFT) legal frameworks and also their actual implementation of recommendations (Midgley et al, 2014). In 2013, the fourth round of evaluation of its 180 jurisdictions focused much more intensively on assessing how effectively countries have implemented the recommendation standards that have been set.

The 2003 FATF Recommendations required that countries put in place the necessary (AML) / (CFT) legal framework, introduce measures to prevent, detect, prosecute and sanction AML related crimes, and promote better international co-operation to deal with financial crimes (OECD, 2014). The full implementation of these recommendations would have significant impact on tackling illicit financial flows in the extractive sector. However, despite the almost global endorsement of the FATF recommendations, compliance and actual implementation of standards have been limited. The G20 leaders have expressed their commitment to the FATF standards, especially with regard to the identification of beneficial owners and to the automatic exchange of information for tax purposes (OECD, 2014). The backing of the G20 could represent a significant catalyst in increasing compliance to FATF recommendations in addition to the full implementation of these standards. It is important to note that like many other international initiatives aimed at tackling illicit financial flows, the FTAF is not a silver bullet solution to the problem. However, it can contribute significantly in the fight against illicit financial flows.

6.4 Natural Resource Charter

The exploitation of natural resources in most African countries has failed to deliver socio-economic development dividends. Instead of helping to foster economic development, a significant amount of wealth generated through natural resource exploitation is lost through illicit financial flows. Such outflows have greatly limited the ability of resource-rich countries to capitalize on their resource endowment to promote socio-economic development. In order for African countries to meet their long-term needs for socio-economic development, it is imperative to curb the prevailing loss due to this phenomenon. The Natural Resource Charter is an initiative spearhead by Paul Collier and focuses on creating international standards in the area of natural resource governance. The Charter provides policy options, practical advice for governments, societies and the international community on how best to manage resource wealth (Collier, 2007).

The Charter provides 12 voluntary "Precepts" which are meant to inform and guide natural resource management for resource-rich developing countries. The key ideas expressed in these "precepts" are that resource development should take place under open and accountable management, supported by strong fiscal regimes, in order to maximize benefits for citizen while reducing social and environmental impacts (Billon, 2011). In addition, the charter stresses that contracts in the extractive sector should be awarded competitively and that all relevant actors should operate transparently. Finally, governments should invest resource revenues domestically to foster economic diversification and promote economic growth (Billon, 2011).

The Charter is relevant to illicit financial flows with several of the precepts targeting issues that lead to outflows. Precept 2 of the charter focuses on accountability and transparency, suggesting that there should be transparency along the entire decision chain of the extractive sector, and active civil society capable of holding governments and companies to account, and finally strong commitment to enforcing penalties (NRC, 2015). Precept 4 on taxation, highlights the importance of competent tax administration with stringent tax avoidance rules, the importance of auditing, access to verifiable variables such as world prices, enforcement mechanisms and due diligence on investors. Finally, Precept 12, on the role of international actors, highlights the importance of establishing international standards to curtail illicit financial transactions, and transfer-pricing abuse, use of tax havens, and other tax avoidance and evasion techniques (NRC, 2015).

The Natural Resource Charter is led and backed by some high-profile personalities in the field of natural resource governance and also supported by many international organization such as the World Bank, the United Kingdom Department for International Development (DfID), and the Norwegian Government (Flohr et al, 2013). The aim of the Charter is to become a basis of formal intergovernmental or private-public agreements in the extractive sector. Its developers suggest that working through its framework, government, companies and civil society in resource-rich countries will be able to engage more actively with the challenges in the extractive sector (Flohr et al, 2013).

A key criticism of the Natural Resource Charter is that it ignores the fundamental issues on political economy surrounding resource extraction. Singh & Bourgouin (2013) argue that the Charter does not address key political economy issues that shape resource governance. It neglects the macroeconomic and ideological trends, the organization of social interests, social divisions, and informal politics, and pre-existing conditions that influence the management of natural resources (Singh & Bourgouin, 2013). They argue that the Charter cannot lead to institutional changes while failing to address the social processes that shape power relationships in resource rich countries. In their view, the lack of context in the Natural Resource Charter means that it does not provide a realistic understanding of the conditions for reform in the extractive sector. For example, the charter operates under the assumption that governments in resource rich countries are interested in tackling problems of corruption, neglecting the pre-existing social interests that may constrain their willingness to address corruption (Singh & Bourgouin, 2013).

Singh & Bourgouin (2013) argue that the narrow perspective through which the Charter's measures are conceived makes it unlikely that they will succeed, because it is not clear under what conditions weak institutions might undertake necessary reforms. This is because improving the institutional environment in the extractive sector is constrained by structural conditions such as political and vested interest, social cohesion, and history (Singh & Bourgouin, 2013). Therefore, reform is unlikely to take hold without addressing the pre-existing conditions that structure governance in the extractive sector.

In their view, reform in the extractive sector should be context driven, rather that the best practice approach advocated in the Natural Resource Charter. They warn that governance strategies that work well in countries with mature institutions may not necessarily lead to similar results in resource-rich developing countries. The pre-existing conditions that structure governance in the extractive sector may limit the capacity of governance strategies to deliver similar results. Therefore, critics assert that for governance strategies to deliver more efficient and equitable institutions, there needs to be an internally driven shift in balance of political forces that influence good governance in the extractive sector (Singh & Bourgouin, 2013).

In 2012, the Natural Resource Charter shifted from the phase of standard setting to implementation in the form of country assessments. The assessments was based on the twelve voluntary precepts which Governments can use as a comprehensive performance management framework for the extractive sector (Flohr et al, 2013). A pilot project was conducted in Nigeria in 2012, to create a benchmark report on the performance of petroleum governance in the country across all twelve Natural Resource Charter precepts. The assessment was conducted by a panel of Nigerian experts including former government officials, extractive professionals, and civil society representatives (Flohr et al., 2013). The result of the assessment suggests that the petroleum industry was not delivering sufficient contribution in terms of social and economic benefits for the country. Furthermore, a large proportion of the wealth generated through extraction has either been lost before it gets to government treasuries, or funds consumption only (NNRC, 2012).

After analyzing the findings, a set of recommendations were made to address the irregularities that affected governance in the extractive sector. However, there seemed to be no political will to carry through with the specific recommendations to address the systematic irregularities (NNRC, 2014). Since 2012, there has been no progress with regards to the Petroleum Industry Bill (PIB), which seeks to comprehensively reform the entire governance and regulatory framework of the oil and gas industry in Nigeria. As a result, Nigeria's 2014 Benchmark report found that the situation in the country did not change dramatically since the 2012 Benchmark Report (NNRC, 2014).

The experience of Nigeria with the Natural Resource Charter highlights how the pre-existing conditions that structure governance in the extractive sector, may limit the capacity of governance strategies to deliver comprehensive reforms. The PIB bill stalled despite its potential to ensure that the petroleum industry contributes to socio-economic development of the country. The Nigerian pilot project demonstrates that addressing the pre-existing conditions that structure governance in the extractive sector is critical in ensuring a successful implementation of the Natural Resource Charter. There is growing interest in the Natural Resource Charter in Africa; many countries including Liberia, Uganda, Ethiopia, Mali, and Niger have expressed interest in conducting benchmark report (Flohr et al, 2013). Given Nigeria's experience with the Natural Resource Charter, a successful implementation of reforms in these countries may require tackling the political forces that influence governance in the extractive sector.

7. Discussion & Recommendations

The initiatives discussed above are among a body of instruments at the international level aimed at tackling illicit financial flows. However the success of such instruments can only be measured on how effectively they are implemented in practice. In Africa, significant challenges are being experienced in terms of their actual implementation due to the lack of political will. Therefore, it will be extremely difficult for these initiatives to spark reforms in systems that reward disproportionately an entrenched group of elites and other stakeholders. The following sections will highlight some reflections and recommendations on tackling illicit financial flows.

7.1 Political Will and Program Implementation

The extractive sector is deeply entrenched in patronage politics that shape the overall political environment in resource-rich countries. The allocation of revenues and windfall profits from the extractive sector is a key aspect of patronage politics in resource-rich countries (Cobham, 2014). As such, the executive offices in resource rich countries tend to exhibit a high-level of discretionary political control over the sector. Longevity in office in resource-rich countries is highly correlated with the ability of the executive to distribute rents to political cronies, elites and other supporters.

Therefore, African policy makers have vested interest in maintaining the status-quo to guarantee their place in office. In addition, the executive offices' access to revenue gains from the extractive sector also allows them to achieve relative autonomy from the population which contributes to longevity in office (Cobham, 2014). The types of reforms proposed by many of these initiatives will limit the capacity of the rent-seeking patronage system to function effectively. Any reforms to the governance of the extractive sector that may increase transparency and accountability will be resisted. The patronage system has a vested interest in financial opacity in the extractive sector, to facilitate the misuse of revenues and windfall profit from the sector (Herkenrath, 2014). In this regard, any reforms in the extractive that is a threat to the patronage system will not generate political will necessary for actual implementation.

The political and financial incentives tied to maintaining the status-quo, make the adoption of anti-illicit financial flow measures very unlikely in Africa. The ability of resource-rich countries to adopt these measures to a large extent depends on their relative autonomy from powerful interest groups with vested interests to maintain the status-quo. However, in many resource-rich countries, these interest groups tend to have strong influence in the politics which can have adverse effects on reforms. Nigeria's EITI for example was spearheaded by then president Olussegun Obasanjo. However, his political will to push forward with reforms in the extractive sector eventually subsided due to his desire for a third term in office. As a consequence, the president could no longer afford to alienate elites who had a vested interest in maintaining the status-quo (Keblusek, 2014). In order to push for a third term, Obasanjo needed the backing of the elites and significant amount of money to facilitate his bid for office. The actual implementation of EITI reforms was in direct conflict with both those objectives because it would limit the capacity of the rent-seeking patronage system to function smoothly (Keblusek, 2014).

The allocation of revenues and windfall profits from the extractive sector is a key aspect of patronage politics in Nigeria. Therefore, in order retain the integrity of the patronage system the EITI reform team was eventually disbanded (Keblusek, 2014). The experience of Obasanjo with EITI highlights the dilemma that policy makers face when it comes to pushing reforms in resource-rich countries. Any attempts by policy makers to push for reforms in a sector that rewards an entrenched group of elites, can lead to the eventual loss of political capital. This is a threat to any policy maker's longevity in office as these entrenched groups of elites tend to have a strong influence in the political process. As a result, policy makers are less inclined to have the political will to follow through with reforms because it might jeopardize their political capital.

Therefore, a key issue these instruments must address is the political will of policy makers to implement desired reforms in the extractive sector. However, the initiatives cannot guarantee that, as most of them simply offer a governance framework that resource-rich countries may either choose to adopt or not. In order for these frameworks to be adopted in resource-rich countries there needs to be an internally driven shift in the balance of political forces that influence governance in the extractive sector. Policy makers need to have relative autonomy from powerful interest groups in order for reforms to take place. However, this may require a more open, inclusive, accountable political system. Resource rich-countries in Africa are characterized by high degrees of socioeconomic inequality and little or no effective institutionalized popular control of the actions of political elites (Kar and Cartwright-Smith, 2010). The unequal distribution of power, in resource rich countries means that the rest of the population lack the capacity to significantly affect the political behaviour of public actors. As a result, there is nothing compelling policy makers to conduct reforms if they do not fit their personal interest. The power to shape and control important decisions on public policy is largely in the hand of the elites. This often leads to the abuse of public authority for personal interest at the expense of the broader community. Therefore, in many of these resource-rich countries there is a great need to empower the broader community to enable them to have influence on public policy decision.

The broader society has a vested interest in reforms in the extractive sector because they are the ones excluded from the rents and benefits from the sector. The wealth generated from the extractive sector does not trickle down to the rest of society, rather it is monopolized by the political elite. In addition, little of the wealth generated from the sector is used to implement developmental or transformative policies which can have positive implication for the rest of society. The ultimate objective of the group of instruments aimed at tackling illicit financial flows is to ensure that the extractive sector helps to foster economic development and poverty alleviation. Therefore, the broader community in resource rich countries are the ones that would benefit the most from the implementation of the initiatives. As such, the initiatives should seek to build support in broader society who stands to gain the most from the reforms. This can be done by for example, empowering the broader society through awareness creation and capacity building so that people can exert pressure on policy makers to implement reforms.

7.2 Empowerment and Accountability

In literature, empowerment is used in many ways and in a wide range of contexts dealing with the social and political theory of power. Empowerment is generally defined as enhancing the opportunities of groups or individuals that are socially, politically, or economical excluded and transforming the power relations that lead to such exclusion (O'Neill et al, 2007). In the context of this paper, empowerment means enhancing the capacity of the broader community in resource-rich countries to influence the policy-making process and also their ability to participate in decision-making in the extractive sector to ensure that governance policies reflect their needs and interest. Empowering the broader community in resource-rich countries requires a change in the political environment that allows for broader participation. Increasing political participation can include a range of approaches, such as strengthening democratic citizenship, promoting engagement between the state and civil society, and civil society activism.

While access to information is an important pre-condition for citizens' ability to hold decision makers to account, empowerment is critical to enhance people's abilities to engage with decision makers and push for reforms. The empowerment of the broader society in resource-rich countries may force policy makers to make decisions that run against the interest of entrenched elites, therefore, increasing the likelihood for the international initiative aimed at reforming governance in the extractive sector to be implemented.

7.3 Strengthening Democratic Citizenship

In many resource-rich countries in Africa, the political system has transitioned to a democracy but authoritarian practices and institutions persist. Many of these countries are considered "hybrid regime" as they have made a formal transition to democracy and hold elections at regular intervals, but are unable thus far to strengthen their democratic structures (Rakner et al, 2007). As such, in many of these countries, political participation in the decision-making process is limited to entrenched elites. Therefore, there is a great need to strengthen democratic citizenship to ensure inclusiveness of political participation and deepen citizen engagement in decision-making processes. Improving state accountability and responsiveness requires for active citizens who understand how to voice their interests, act collectively and hold public officials accountable (NDI, 2015). This requires people to understand the basis of politics, government, and citizenship in a democratic country. This understanding is necessary in order to influence the policy making process and to have a more active role in the decision-making process. Therefore, in resource rich-countries there is a great need for citizen participation programs to help empower citizens that are outside the political process. These citizen programs could include support for civic and voter education, issue organizing and advocacy, budget oversight and government monitoring (NDI, 2015). Through these programs the broader community in resource-rich countries can learn techniques needed to initiate action to help them become more active in the political process. The National Democratic Institute (NDI), for more than 20 years, has conducted programs to empower citizens and civic groups to establish strong civic culture and achieve an appropriate balance of power between citizens and government. The international initiative aimed at tackling illicit financial flows may consider partnering with NDI. This type of partnership can help the initiatives to build awareness in broader community about illicit financial flows and deepen citizen engagement in the decision making process, and to push for reforms in the extractive sector. Research has shown that even in countries where formal mechanisms for accountability are weak, citizens can engage with the state through collecti veaction to create policy reform (Citizenship DRC, 2011).

7.4 Promoting Engagement Between the State and Civil Society

It is generally regarded that the presence of active, informed and coordinated civil society organizations (CSOs), can play an important role in empowering marginalized groups. CSOs play a key role in collecting, analyzing and using information to bridge information gaps. They also act as checks and balances, and provide opportunities for people to engage in collective action and social mobilization (Tandon, 2003). However, the role of CSOs in empowering marginalized groups depends significantly on the political context and the space provided by the state for citizen engagement. In some countries, civil society actors can freely engage citizen, while in others the relationship between civil society actors is more fragile with power holders less reluctant to engage with civil society actors (Bebbington, 2009). Most resource rich-countries in Africa fall under the latter category. In Angola for example, Sarah Wykes a British campaigner for Global Witness was detained by government for educating local CSOs about oil revenue transparency (PWYP International, 2008). Therefore, there is a great need to promote engagement between the State and CSOs to ensure that there is political space for civil society actors to operate. The international community can play an important role in improving State and CSO engagement through the use of diplomatic pressure to lobby for changes in the political environment, and by so doing, facilitate CSO operations. The presence of active CSOs can play an important role in putting pressure on resource-rich governments to adopt reforms in the extractive sector.

Social mobilization by CSOs can play a critical role in enhancing the capacity of marginalized groups to influence the policy-making process, and their ability to participate in decision-making. In Africa, mass movements were present and played a crucial role in pushing for reforms in several countries. In francophone African countries for example, the struggle to reform national political and economic systems would not have succeeded without the support of civil society activism (Mbaku, 1997). Depending on the strength of the movement, Civil society activism has the potential to exert significant political pressure on governments. This can allow activists to gain access to the political system and obtain access to the political agenda. Furthermore, activism can force authorities to adopt new policies or implement certain policies (Giugni, 2004). Therefore, activism can serve as an effective strategy to ensure reforms in the extractive sector. However, social movements rarely bring about policy changes by themselves. In order to be successful movements need the support of the public and political allies (Giugni, 2004). The international community can also help by providing financial and technical support to instigate or propagate civic activism for policy reform in the extractive sector. Furthermore, they can be strong political allies to reforms in the extractive sector through diplomatic pressure on governments in resource-rich countries. Therefore, increasing the likelihood that the international initiative aimed at reforming governance in the extractive sector will be implemented.

7.5 Extractive Companies

While governments in resource rich-countries should be primary targets in the fight against illicit financial flows in the extractive sector, significant attention should be given to extractive companies. According to Kar and Cartwright-Smith (2010), 60 to 65 per cent of illicit financial flows is essentially due to tax evasion by companies with international operations. It is important to note that the unwillingness by governments in resource-rich countries to adopt measures aimed at tackling illicit financial flow is partly to blame for the opportunities provided to extractive companies to evade taxes with impunity and maximize net profits through bribery (Cobham, 2014). In many resource-rich countries tax agencies have a low overall capacity, especially in dealing with complex issues such as transfer prices. Furthermore, policing services have limited investigatory powers, court systems are vulnerable to corruption, and public audit offices are weak or non-existent (Reuter, 2012). However, despite the enabling role played by governments to illicit practices by extractive companies, a concerted effort needs to be taken to ensure that extractive companies do not take advantage of weak institutions in Africa.

8. Conclusion

Illicit financial flows in the extractive sector are a major challenge to socio-economic development in resource-rich countries in Africa. While the estimates vary regarding the volume of money lost through illicit financial flows, the capital loss greatly surpasses money earned through ODA or FDI on the continent. Therefore, stemming illicit financial flows from Africa can help curb donor dependence while simultaneously providing financial capital necessary for meaningful and sustainable socio-economic development. This paper analyzed the role of African countries and multinational-corporations in illicit financial flows in the extractive sector. It also examined the international initiatives aimed at tackling illicit financial flows in the extractive sector. A review of the causal factors of illicit financial flows indicates that tackling illicit financial flows in the extractive sector will be a complex and extremely challenging undertaking. It will require not only the political will of African leaders, but also the support of the international community. In Africa, empowering citizen to influence the policy-making process and participate in decision-making will be critical to ensuring that reforms to tackle illicit financial flows are adopted and implemented. Internationally, there should be enhanced dialogue and negotiations with international financial institutions, multi-lateral institutions, and other stakeholders to limit the avenues for illicit financial flows. Additionally, home-countries for multinational corporations need to implement earnest measures to ensure that corporations do not take advantage of weak institutions in Africa. While, this paper emphasizes that the international community has an important role to play in tackling illicit financial flows, any measures aimed at tackling outflows will not succeed in the absence of political will in resource-rich countries. As long as the extractive sector continues to be shrouded in secrecy and financial opacity, Africa will continue to lose significant amounts of financial resources that could be used to finance its socio-economic development programs. Furthermore, multi-national companies will continue to benefit from weak institutions to maximize profits at the expense of host countries.

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