Capital Flight from Africa: What is to be Done?

Statement to the Joint Meeting of the United Nations General Assembly
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Mr Chairmen, distinguished fellow Panelists, Excellencies, Ladies and Gentlemen;

Thank you for inviting me to present this statement. I am old enough to remember when the subject of illicit financial flow was not discussed in polite company. The topic was relegated to the shadows of official discourse. It is gratifying to see this important issue moving squarely onto the agenda of the international community.

I will focus my remarks this morning specifically on capital flight from Africa and on policy responses to this challenge.

Capital flight and illicit financial flows

The terms 'capital flight' and 'illicit financial flows' sometimes are used interchangeably, but they are distinct concepts. Capital flight is usually defined as unrecorded capital outflows and measured as the missing residual in the balance of payments, after corrections for underreported external borrowing and trade misinvoicing. All capital flight is illicit, but not all illicit financial flows are capital flight. Capital flight is illicit by virtue of illegal acquisition, illegal transfer, illegal holding abroad, or some combination of the three.

Illicitly acquired capital is money obtained through embezzlement, bribes, extortion, tax evasion, or criminal activities. Wealth acquired by these means is often transferred abroad clandestinely in an effort to evade legal scrutiny as to its origins.

Illicitly transferred funds are outflows not reported to government authorities. Mechanisms include smuggling of bank notes, clandestine wire transfers, and falsification of trade invoices.

Illicitly held funds are assets whose earnings are not declared as income to national authorities of the owner's country. The concealment of foreign holdings may be motivated by the desire to evade prosecution for illicit acquisition of the funds, or by taxation evasion, or both.

The broader universe of illicit financial flows includes not only capital flight but also payments for smuggled imports, transactions connected with illicit trade in narcotics and other contraband, outflows of illicitly acquired funds that were domestically laundered before flowing overseas through recorded channels, and transfer pricing by the corporate sector. These, too, are illicit, but they are not the same as capital flight.

Capital flight and external debt

Countries often experience external borrowing and capital flight simultaneously. At first glance this may seem anomalous. Why would we observe large capital flows in both directions at once? External borrowing implies that both lenders and borrowers expect attractive investment returns. Yet capital outflows appear to signal higher returns elsewhere. In practice, the two phenomena may not only co-exist but also be causally linked. External borrowing can lead to capital flight, and capital flight can lead to external borrowing. Understanding these linkages is important for the formulation of appropriate policy responses.

In *debt-fueled capital flight*, external borrowing finances private wealth accumulation outside the borrowing country. On the borrower side, the government contracts loans in the name of the public. Officials and other politically connected individuals then siphon part or all of the money into their own pockets – via kickbacks, padded procurements contracts and diversion of funds – and stash part or all of the proceeds abroad for safekeeping. On the lender side, loan officers are rewarded for simply 'moving the money,' creating myopic incentives to turn a blind eye to these risks.

In *flight-fueled external borrowing,* flight capital finances external loans. A private individual illicitly parks funds abroad and then 'borrows' them back. A key motive for such round tripping is concealment of the origins of the funds. The borrower reaps further illicit gains if, as often happens, liability for repaying the loan ultimately passes to the government by virtue of public guarantees in the event of default. Such transactions are attractive to bankers because they generate fees and commissions on both sides.

Econometric analysis indicates that for each new dollar of external borrowing by African countries, as much as 60 cents exits Africa as capital flight in the same year (Ndikumana et al. 2015). The tight year-to-year correlation between external borrowing and capital flight suggests that debt management is important in addressing the problem of capital flight. Of course, not all flight capital originates in external borrowing. Statistical analysis shows that natural resource extraction, for example, is also strongly correlated with capital flight.

Stolen asset recovery

Let me now turn to policy responses, starting with efforts to recover and repatriate stolen assets. Some success has been scored on this front. For example, $700 million held in Swiss bank accounts by Nigeria's former military ruler Sani Abacha and his family has been recovered and repatriated. To be sure, the amounts recovered are modest compared to the total magnitude of capital flight, but they are not inconsequential. An added benefit of such recoveries is their demonstration effect, which may help to deter future capital flight.

Over the past two decades the international community has begun building institutional infrastructure to assist in stolen asset recovery. The United Nations Convention against Corruption includes articles on asset recovery and mutual legal assistance. The Stolen Asset Recovery Initiative, launched in 2007 by the United Nations Office on Drugs and Crime and the World Bank, provides technical assistance in tracing stolen wealth, asset seizure and confiscation, and enlisting international cooperation. Many countries have established Financial Intelligence Units to investigate transactions related to criminal activity, and anti-money laundering legislation requires banks and other financial institutions to file reports on suspicious transactions.

A key feature of this emerging international architecture is that when investigators identify substantial foreign holdings of politically exposed persons and others suspected of criminal activity, asset holders can be required to prove that the wealth was acquired legitimately (Brun et al. 2011). Pending the outcome of the legal proceedings, the assets can be restrained or seized.

Selective debt repudiation

Debts that fuel capital flight can be considered 'odious' under international law. Selective repudiation of odious debt – which is distinct from across-the-board default – can prevent the diversion of scarce public resources into debt service payments on loans from which the public derived no benefit. Repudiation of odious debts also would change the incentive structure for creditors, encouraging due diligence and helping to improve the quality of future lending.

Odious debts are liabilities contracted by governments without the consent of the people, from which the people did not benefit, in circumstances where creditors knew or should have known these conditions to hold (King 2015). They include funds stolen by corrupt individuals and money used to maintain the power of authoritarian regimes. Determining which loans served *bona fide* development purposes and which are odious is a challenging task. Systematic audits can help to establish which debts are legitimate and which offer objective grounds for repudiation. Where there is evidence of systematic misuse of borrowed funds, the burden of proof can be placed upon creditors to demonstrate that their loans were used for legitimate purposes, much as the burden of proof can be placed upon politically exposed persons to prove the legitimacy of foreign assets held in their names.

In this arena there is scope for innovations in international governance. An impartial body for arbitration of odious debt disputes is sorely needed. A United Nations commission chaired by Nobel laureate Joseph Stiglitz called in 2009 for the creation of an international bankruptcy court that could consider, 'where appropriate, partial debt cancellation' (United Nations 2009, paras. 47-48). The IMF (2013, para. 57) has noted that such a body could be charged with adjudicating claims of odious debts. The creation of such a forum could do much to curb debt-fueled capital flight and flight-fueled external borrowing.

Regulatory reforms in international banking

Further efforts are also needed to increase transparency in international banking. Most flight capital is domiciled in what are commonly referred to as offshore financial centres. The most important of these are not tropical islands, but rather New York, London and other international banking centres (Shaxson 2011). Improved transparency requires strengthening the enforcement of existing banking regulations and closing loopholes arising from the inadequate harmonization of banking regulations across countries.

An important piece in efforts to improve financial transparency is cross-country exchange of information on investment income, including interest, dividends and capital gains. This necessitates information on beneficial ownership so that the recipients cannot conceal their identities behind shell companies and trusts. Banks and other financial institutions, including brokers and insurance companies, should be required to report this information to their governments, who can then share the information with the governments of income recipients.

Recent years have seen some progress on this front. In 2009, the exchange of information upon request became the international standard, monitored by the Global Forum on Exchange of Information and Transparency for Tax Purposes. This gave tax authorities access to information on offshore investment income, although it put the onus on them to identify specific individuals or firms in order to request this information. In 2013, the G20 Finance Ministers and Central Bank Governors endorsed the automatic exchange of information—rather than exchange upon request—as the new international standard (OECD 2013). Bilateral agreements are now laying the foundation for multilateral cooperation to implement this policy.

Conclusion

Capital flight occurs for a variety of reasons. Two important motives are the desire to conceal funds that have been illicitly acquired and the desire to evade taxation. Individuals who engage in capital flight are aided and abetted in illicit transfers of funds by officers in banks and other financial institutions who are in a position to profit from these transactions as long as they are not detected and subjected to penalties. Foreign borrowing and extractive resource revenues are important correlates of capital flight, suggesting that these are significant sources for the illicit acquisition of private wealth.

Growing recognition of these problems is spurring international efforts to mitigate the consequences of past capital flight and to reduce its recurrence in future years. These include efforts to recover stolen assets, relieve external debt burdens, and promote transparency and due diligence in international banking. The creation of an impartial body to adjudicate cases of odious debts would further strengthen this international architecture. If well designed and implemented, these initiatives will help to curtail malfeasance, improve incentive structures, and contribute to a more efficient and equitable international financial architecture.

Thank you.

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