



**SUBMISSION TO THE COMMITTEE ON
PLANNING AND BUDGETING**
**TITLE: EFFECTS OF ILLICIT FINANCIAL FLOWS ON THE BUDGET
AND ITS SUSTAINABILITY IN ZAMBIA**

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DEFINING ILLICIT FINANCIAL FLOWS

Illicit Financial Flows (IFFs) are illegal movements of money, wealth or capital from one country to another. Global Financial Integrity classifies this movement as an illicit flow when funds are illegally earned, transferred, and/or utilized across an international border. Illegal means could be corruption, transactions involving contraband goods, criminal activities and efforts aimed at sheltering wealth from tax administrations.

- IFFs are a challenge that continues to plague the development of many countries on the African continent
- IFFs are defined as involving the transfer of financial resources earned through illegal activities such as
- The Report on High Level Panel on Illicit Financial Flows defines IFFs as money that is illegally earned, transferred or utilized, originating from three main sources, namely: commercial tax evasion; criminal activities; and theft by corrupt government officials . IFFs can occur through deliberate criminal behaviour or through complex avoidance schemes.

Abusive transfer pricing – through Multinational Enterprises (MNEs) employing multiple and often complex structures to shift profits from normal rate tax jurisdictions to low or no tax jurisdictions. This is a major source of IFFs in Africa, even though not all forms of abusive transfer pricing resulting in IFFs rely on manipulating the price of the transaction.

Mis-invoicing - this is often found in intra-group transactions for goods and services and involves the deliberate fabrication of the value of such goods or services. It is often a subset of abusive transfer pricing methods but exist independently of the transfer pricing framework

Unequal contracts - which present themselves as opaque (or secret) contracts relating to resource extraction. There are some contracts that lack transparency, emanating from bribes that are paid to circumvent existing legal provisions for the payment of royalties and taxes. In addition, there is information asymmetry between MNEs and African Countries which often have less information about the quality and quantity of mineral deposits for which they sign contracts.

Excessive interest payments base erosion: where MNEs employ excessive leveraging. These companies often tend to borrow from their low taxed affiliates, rather than raising capital through shares, because accrued interest on debt is deductible against tax liability and dividends are usually not tax deductible.

- While illicit inflows to developing countries also exist, the net effect of outflows and inflows shows developing regions are at the negative end of the pole, being the environments for greater extraction and exploitation.
- Global estimates are phony in their measures, especially those that try to quantify in monetary terms. However, this much is clear: illicit financial flows line the pockets of greedy politicians and bureaucrats, and finance violence, corruption, and other abuses. These crimes not only undermine local and national economies, but also destroy the environment, and jeopardize the health and wellbeing of the public

SITUATIONAL ANALYSIS OF TAX EVASION IN ZAMBIA

- IFFs contribute to an estimated loss of around USD 50 billion annually in Africa. Due to the illicit nature of IFFs, it is not possible to obtain accurate figures – therefore the loss to African countries may even be far greater. Illicit financial flows all thrive in a climate of secrecy, inadequate legal frameworks, lax regulation, poor enforcement, and weak inter-agency co-operation.
- In Zambia one of the biggest sources of illicit leakages from the mining sector of Zambia is through transfer mispricing. According to the United Nations Economic Commission for Africa, Zambia loses 10% of its gross domestic product annually, due to corporate tax avoidance practices and accounts for 65% of all African trade misinvoicing in Copper.
- The estimates by Boyce and Ndikumana (2001) show that Zambia lost about US\$10.6 billion (354 percent GDP) between 1970 and 1991 to capital flight. About 50 percent (US\$4.82) of this loss is explained by trade mis-invoicing.
- Between 2001 to 2010, Gascoigne (2012) estimates USD 8,8 billion to have been illegally flowing out of the Zambian economy.
- The recent findings by the Financial Intelligence Centre (FIC) are a source of concern to all stakeholders. In July, 2017, FIC reported that multinational mining companies were getting away with an estimated \$3billion annually through tax evasion and illicit financial flows.
- Tax evasion – defined as an illegal practice where a person, organization or corporation intentionally and wilfully avoids paying their tax obligations – is a serious concern to all governments and Tax administrations world over.
- There is consensus among practitioners that tax evasion is part of the greater problem of financial crimes that affect countries around the world. Criminals operate across international boundaries, constantly trying to find new ways to break the law, and hide their illicit profits.
- Despite various tax reforms to boost the declining tax revenue to GDP ratio in Zambia, tax revenue collection has to a large extent been unsatisfactory, recording average tax revenue-to-GDP of 17% in the last five years which is largely below its peers in the sub-Saharan Africa region.
- Growing global integration has resulted in increased tax avoidance among transnational corporations and it is LDCs who often bear a disproportionate cost of this, given that a much higher percentage of their capital stock is owned by foreign companies.
- Particularly, such innovations have increased the potential risk concerns regarding offshore tax evasion, where funds are being deposited and sheltered from the home Tax authorities, having potential connections with illicit financial flows, money laundering and terrorist financing

COMMON TAX EVASION PRACTICES IN ZAMBIA

The Commonwealth Association of Tax Administrators'(CATA) Practical Guide (2005) identified many causes of tax evasion but those applicable to the African situation include the following:

- i. Complexity of Law/System
- ii. High Rate of Taxes:
- iii. Attitudes and perceptions towards the tax system, tax administration and government:
- iv. The fairness of the tax system encompasses: Horizontal and vertical equity; as well as transparency and visibility
- v. Perception of procedural justice stems from tax administrators and how staffs treat taxpayers.
- vi. Limited resources and capacity of administration:
- vii. Cash Economy
- viii. Low literacy and education:
- ix. Commercial compulsions: Where a producer or importer hides his transactions, he forces the wholesaler to do the same. The retailers down the line have no choice but to keep those transactions hidden too. In order to keep his expenses low, the consumer is also interested in keeping the transaction hidden. In such a culture, it becomes impossible for anyone to keep his records straight. Even the honest are forced to swim with the flowing currents

Some notable practices of tax evasion in Zambia include:

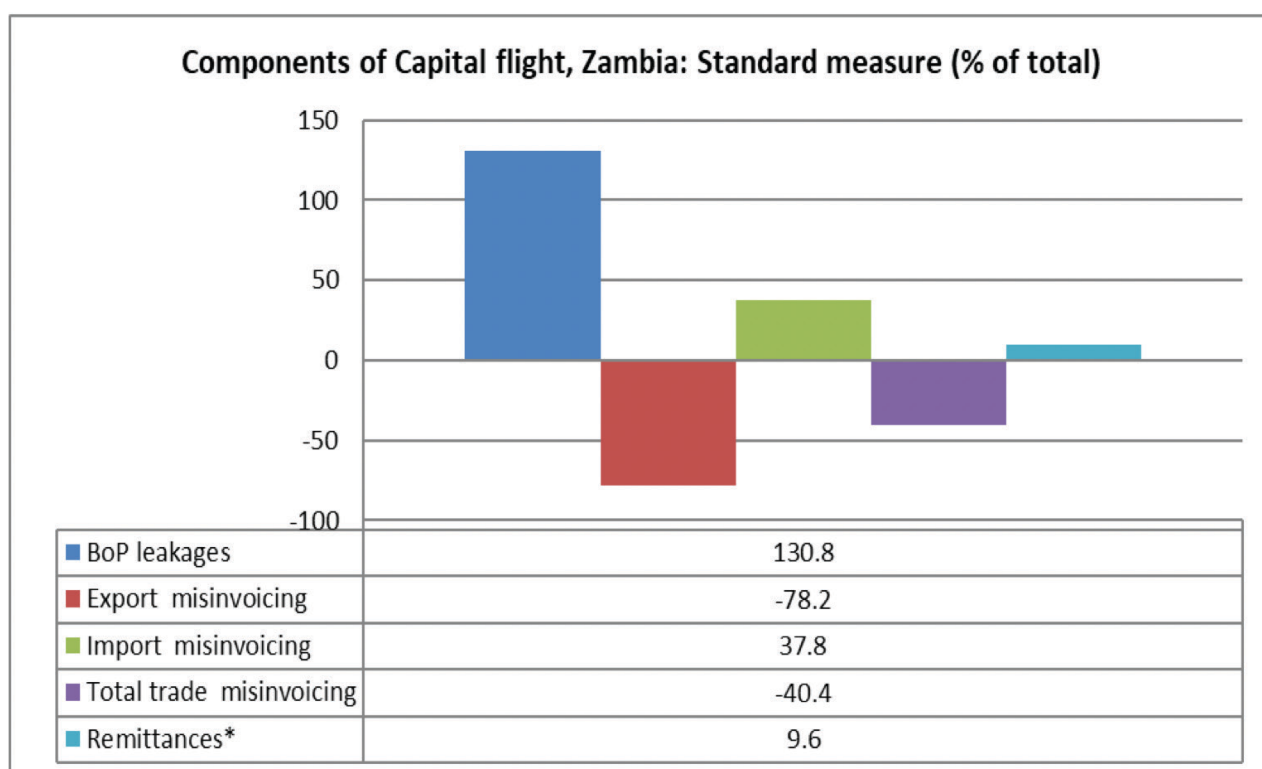
- Inflation of cost elements – procurement
- Over pricing of loans and overcharged interests
- Not using fiscal devices or cash registers
- Large cash transactions
- Transfer pricing through the use of avenues such as management and consultancy fees etc.
- Profit shifting through existing “tax loopholes” e.g due to differentiated income tax rates, some organisations opt to declare losses in specific sectors and declare profits in those that have lower taxes i.e. manufacturing and agriculture
- Use of Tax havens

CAUSES OF ILLICIT FINANCIAL FLOWS IN ZAMBIA

- The main conduit or sources of illicit financial flows in Zambia are:
- Abusive transfer pricing – Through employing multiple and often complex structures to shift profits from normal rate tax jurisdictions to low or no tax jurisdictions. This is a major source of IFFs in Zambia. According to the United Nations Commission on

Africa, Zambia loses 10% of its gross domestic product annually, due to corporate tax avoidance practices. The Centre for Trade and Policy Development (CTPD) claims that Zambia accounts for 65% of Africa's illicit financial flows, of which 80% is through copper.

- Mis-invoicing - this is often found in intra-group transactions for goods and services and involves the deliberate fabrication of the value of such goods or services. It is often a sub-set of abusive transfer pricing methods but exist independently of the transfer pricing framework
- Unequal contracts - which present themselves as opaque (or secret) contracts relating to resource extraction. There are some contracts that lack transparency, emanating from bribes that are paid to circumvent existing legal provisions for the payment of royalties and taxes. In addition, there is information asymmetry between MNEs and African Countries which often have less information about the quality and quantity of mineral deposits for which they sign contracts.
- Others include Balance of Payment Leakages and remittances among others.



Source: United Nations Development Program (2014)

Around USD 8,8 billion is estimated to have been illegally flowing out of the Zambian economy in the period 2001 to 2010. **The causes of capital flights or IFFs in Zambia and many other African nations may be grouped into the following categories:**

The economic structure

- Just like many other developing nations, Zambia is prone to capital flights because of its economic composition. This includes natural resource abundance (and a dependence on natural resources) combined with trade openness in the context of relaxed approach to enforce regulation.

- Indeed, evidence from Sub-Saharan African countries shows that countries that are rich in oil and minerals figure prominently at the top of the list in terms of capital flight (Ndikumana and Boyce 2012; Boyce and Ndikumana 2012; UNDP 2011).
- Endowment in natural resources presents opportunities for embezzlement, theft, and trade mis-invoicing given the large volumes of transactions involved in exploration, exploitation and export of these resources.
- *It is important to note, however, that it is not the endowment in natural resources per se that makes a country prone to capital flight, but rather poor regulation and the lack of capacity to manage these resources*
- In turn, secrecy jurisdictions around the world provide a safe haven for the proceeds of embezzlement of natural resources.

Macroeconomic environment and macroeconomic policy

- The macroeconomic environment and the macroeconomic policy choices of the Government affect the investment climate and therefore the choices by individual investors between domestic and foreign assets.
- Strong economic performance reflects positive returns to domestic investment, and may serve as a deterrent to capital flight.
- High and variable inflation in contrast raises investment risk, which may encourage capital flight. High fiscal deficits and high tax rates also discourage domestic investment and could stimulate capital flight

Risk and returns to private investment

- Factors that normally affect the returns to private investment would also influence the decision to invest domestically vs. abroad and hence capital flight.
- These factors include inter alia: the real interest rate differential between a country and the rest of the world; the real exchange rate; the quality of infrastructure, human capital, and other features of the domestic economy that affect trade and production costs; as well as the business environment in general

Political and Governance Factors

- The political and governance environment of a country influences capital flight.
- An unstable political environment raises the risk of losses of private wealth through expropriation or destruction of assets by violence.
- Poor governance in turn facilitates theft, embezzlement of national resources, trade mis invoicing, and smuggling of goods and capital across borders, all of which can induce illicit financial flows.

LEGAL AND POLICY FRAMEWORK GOVERNING ILLICIT FINANCIAL FLOWS

Anti-Money Laundering and Financing of Terrorism (AML/CFT) legal framework promote financial integrity by making it difficult to conceal illegal activities.

AML/CFT LEGAL FRAMEWORK

The AML/ CFT framework is made up of the following institutions:

Anti-Money Laundering Authority (AMLA)

This is the AML/CFT Policy making body established under Section 3 of the Prohibition and Prevention of Money Laundering Act, No. 14 of 2001, amended Act, No. 44 of 2010. The mandate of AMLA is to provide general or specific policy directives and to advise Government on measures required to prevent and detect money laundering in the Republic of Zambia. AMLA is chaired by the Attorney General, and other members include; the Governor-Bank of Zambia, the Commissioner General of the Zambia Revenue Authority (ZRA), the Inspector General of Police, the Commissioner-Drug Enforcement Commission (DEC), the Director General-Anti Corruption Commission (ACC)

Task Force of Senior Officials on AML/CFT matters

Cabinet Office set up the National Task Force of Senior Officials on AML/CFT. The overall mandate of the National Task Force of Senior Officials is to coordinate AML/CFT matters among key stakeholders with a view to improving the effectiveness of existing policies to combat money laundering, financing of terrorism and other serious offences.

The Financial Intelligence Centre ('the Centre')

The Financial Intelligence Centre was established to be the sole designated agency responsible for the receipt, requesting, analysing and disseminating of the disclosure of suspicious transaction reports to Law Enforcement Agencies (LEAs) and other foreign designated authorities pursuant to the Financial Intelligence Centre Act No 46 of 2010 ("The FIC Act" or "the Act").

Law Enforcement Agency (LEAs)

Some of the law enforcement agencies are; Zambia Police Force, Zambia Security Intelligence Service, Immigration Department, Drug Enforcement Commission, Anti-Money Laundering Investigations Unit, Anti-Corruption Commission and Zambia Revenue Authority.

Supervisory Authorities

Some of the supervisory authorities are; Governor of the Bank of Zambia, Zambia Development Agency, Law Association of Zambia and Zambia Institute of Chartered Accountants.

Reporting Entities

Reporting entities are institutions regulated by Supervisory Authorities and are required to make a suspicious transaction reports concerning Money Laundering, Terrorist Financing and any other serious offences to the Financial Intelligence Centre. Commercial Banks and Non-Bank Financial Institutions are some of the examples.

National Prosecution Authority

It is the principal authority for all prosecutions in the country as it houses the Office of the Director of Public Prosecutions (DPP).

Judiciary

The Judiciary is considered to be a relevant stakeholder on AML/CFT related issues as it provides efficacy to the process by being an impartial arbiter in proceedings.

Others Relevant Government Agencies

The Office of the Auditor General, Ministry of Home Affairs, Ministry of Mines, Ministry of Defence, Zambia Air Force, and Registrar of Societies among others are considered very critical for the provision of intelligence Information on Money Laundering, Terrorist Financing and other serious offences.

CHALLENGES IN ABATING ILLICIT FINANCIAL FLOWS

Compromised national and regional capacities

- The inability to combat IFFs is seriously impeded by deficiencies in capacities to track, stop and repatriate illicit financial outflows.
- For instance, despite having extensive institutional framework to combat various dimensions of IFFs, the outcome has not been encouraging either due to political interference, poor coordination among agencies and lack of resources.
- The 2021 Financial centre trend report cited that the main drivers of IFF and related vices remains weak institutional arrangements in the value chain for oversight institutions.

Corruption and abuse of entrusted power

- Corruption is a crosscutting and integral part of IFFs because of its facilitating role.
- Corruption in the form of abuse of entrusted power for private benefit in both the public and private sectors remains an issue of continuing concern.
- The financial intelligent Centre trends report 2021 records a series of Suspected Corruption, abuse of entrusted and Money Laundering. During the reporting period FIC analysed 211 Suspicious Transactions Reports (STRs) out of which 44 intelligence reports were disseminated to Law Enforcement Agencies (LEAs).
- The value of disseminated intelligence reports was ZMW3.56 billion compared to ZMW3.14 billion in 2020 representing a 13% increase.
- The majority of intelligence reports disseminated were on suspected money laundering, corruption and tax evasion.

New and innovative means of generating illicit financial flows are emerging

- In addition to the difficulties that exist in measuring the contribution to IFFs of traditional services, the digital economy and intangibles, these now contribute to the problem in novel and abstruse ways.
- The digital revolution has enabled speedier transfers of money, often at the click of a button, while e-commerce and online gambling make it harder to “follow the money.
- While consultancy fees, payment of royalties and charges for the use of intellectual property are not in themselves new, there is increased resort to such activities because of the opportunity they afford for increased opacity.

Dependence on natural resources extraction

- Zambia depend to a large extent on the extraction of natural resources for her exports and tax revenues.
- However, this sector is very prone to the generation of illicit financial outflows by such means as transfer mispricing, secret and poorly negotiated contracts, overly generous tax incentives and under invoicing.

Political Interference

- The range of issues related to IFFs makes this a technically complex subject.
- However, consensus can be reached that success in addressing IFFs is ultimately a political issue.
- Issues involving abusive transfer pricing, trade mis-invoicing, tax evasion, aggressive tax avoidance, double taxation, tax incentives, unfair contracts, financial secrecy, money laundering, smuggling, trafficking and abuse of entrusted power and their interrelationships confer a very technical character to the study of IFFs.
- However, the nature of actors, the cross-border character of the phenomenon and the effect of IFFs on state and society attest to the political importance of the topic. Similarly, the solutions to IFFs that are the subject of ongoing work in various global forums attest to this political significance.

BEST PRACTICES IN CURBING ILLICIT FINANCIAL FLOWS

India

- India has adopted and supported a few transparency reforms to curb illicit financial flows. In June 2015, the country signed up the standard of Automatic Exchange of Financial Account Information between jurisdictions (OECD and G20) to allow exchange of financial account information automatically at regular intervals with the holder's home country. This allows India to have access to their overseas citizens financial account information. In addition, India introduced a provision for creating a registry of true human owner in 2016, requiring all companies to report their significant beneficial owners. The country in 2016 also announced the adoption of Country-by-Country Reporting (CbCR) of multi-national corporations to ensure big corporations operating in India report their operational and tax data to Indian authorities. India has been vocal as well in its support for the establishment of a global, democratic, intergovernmental tax body under the auspices of the UN, maintaining that it would be crucial for the effective implementation of the 2030 agenda.

United Kingdom

- In tackling illicit financial flows in the United Kingdom, the Metropolitan Police, the City of London Police, the Crown Prosecution Service and the Serious Organized Crime Agency were brought together in a Proceeds of Corruption Unit. The objective was to provide a coherent law enforcement platform, to tackle cases involving money laundering in the UK resulting from corruption of officials in developing countries, bribery involving UK-based companies or nationals with an international element, and cross-border bribery where there is a link to the UK. The result of this work has seen 30 people and companies convicted and nearly £800 million of assets from developing countries confiscated or returned. A former state governor in Nigeria was convicted in

2012 by a London court for embezzling at least £50 millions of government funds

RECOMMENDATIONS

- i. Zambia Revenue Authority has to treat wide and persistent trade gaps for a commodity group as a red flag for further investigation by detailing the many factors including those outside of illicit behavior that can contribute to a trade or price gap. ZRA may also engage the private sector where possible, to obtain new transaction level data to break down macro gaps.
- ii. The Government has to invest in data collection infrastructure by building capacity of personnel at port, customs and tax authorities to better collect and analyze trade data. The Government should also formulate a deliberate policy that requires or expedite progress on tax reporting.
- iii. The Government should also strengthen domestic regulatory frameworks by weighing the costs and benefits of investing in the expertise and facilities to detect, investigate and prosecute perpetrators of reported illicit financial flows.
- iv. The Government has to intensify the fight against corruption and money-laundering by devoting more resources to the recovery of stolen assets.
- v. The Government should be advocating for improvements in regional cooperation on illicit financial flows and tax by building regional knowledge networks to enhance national capacities to tackle illicit financial flows and agreeing on continental regulations on new technologies, such as digital payment platforms, block chain and crypto currencies. Improving the exchange of tax information between countries is critical to ensure no lost taxation occurs through double non-taxation.
- vi. The Government through Zambia Revenue Authority should engage with international taxation reform to help facilitate for reviewing tax treaties that aid to increase taxing rights and making tax competition consistent with protocols of the African Continental Free Trade Area.
- vii. Domestic legal framework must permit Suspicious Transactions Reports (STR) to be used at the tax administration level not only for identifying tax crimes but also for civil purposes, in connection with tax compliance.

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