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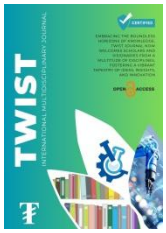

The Impact of Illicit Financial Outflows on SA's Economic Growth

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Abstract
Background: The Sustainable Development Goals 16.4 and 17.1 call for reducing illicit financial flows (IFFs) and domestic resource mobilisation. IFFs constitute resource leakage, and drain resources intended to propel economic growth inevitably reducing the South Africa (SA) government's ability to address socioeconomic challenges. Consequently, infringing on SA citizens' social and economic rights as entrenched in the constitution.
Aim: This paper aimed to ascertaining the impact of IFFs on SA economic growth and to assist the SA government in crafting strategies to curb IFFs.
Materials and Methods: Sequential exploratory mixed method research was used to enable triangulation of research outcomes. Partner Country Method, Multi-regression econometric model was employed to identify trade value gaps, to establish a correlation between IFFs and economic growth and semi-structured interviews were conducted.
Findings: IFFs from SA export and import sectors were estimated to be R4.9 trillion between 2000 and 2020. The official GDP was 436.7 billion rands less than the recalculated GDP, the difference is attributed to IFFs.
Recommendations: SA should adopt the following strategies to curb IFFs: global trade information exchange, minimum tax regime, Sixth Method, active citizenry, localise beneficiation of minerals, whistle-blower comprehensive program, invest in IFFs focused research, and political will in implementing IFFs legislations.
Future research: Role of multinational corporates as beneficiaries and paddlers of IFFs should be investigated against their ethical obligation vis-à-vis profit maximisation.

Keywords
Economic growth, Illicit financial outflows, Resource mobilisation, SA, Socio-economic challenges, Trade value gaps

INTRODUCTION

The World Bank (2016) has indicated that since 1997, the performance of the SA economy has been inconsistent, with moderate growth in 2007 and poor growth from 2012 to 2020. International Monetary Fund found that SA economic growth has, over the last decade, continued to deteriorate, and so have revenue (IMF, 2020).

The African Union recognised the havoc created by IFFs on Africa's development and named 2018 as the year of combating the continued existence of IFFs in the African continent, under the theme 'winning the fight against financial crimes' (African Union Commission, 2019). The impact of IFFs on economic development in Less Developed Countries (LDC) is not self-evident and its impact on African economies is devastating (GFI, 2019; IMF, 2020; Ndikumana and Boyce 2018).

SA has not been spared the challenges of IFFs, however, the actual impact of IFFs on SA's economic growth remains unclear. In February 2023, SA was grey listed by the Financial Action Task Force (Kempen, 2023). Therefore,

the urgency in tackling IFFs has never been more important and the status quo is untenable. Organisation for Economic Co-operation and Development (OECD) alluded that "The most immediate impact of IFFs is a reduction of domestic expenditure and investment from both public and private sectors in LDC" (OECD, 2018:11). United Nations Conference on Trade and Development (UNCTAD) estimated that governments, globally, are losing an average of US $1.6 trillion to US $2.2 trillion annually from IFFs (UNCTAD, 2020). United Nations Economic Commission for Africa (UNECA) projected that the African continent is losing more than US $50 billion every year to IFFs (UNECA, 2015). GFI (2019) estimates that the SA Revenue Service loses about US $7.4 billion annually as a result of trade misinvoicing and revenue leakage through IFFs. IFFs have been significant and detrimental to Africa's development.

In September 2015, world leaders at the United Nations adopted 17 Sustainable Development (SDG). These goals set out an agenda for sustainable development for all nations that embrace economic growth, social inclusion and environmental protection. The set target date for attaining these goals is 2030 (United Nations, 2020). The 2030 agenda for sustainable development specifically highlights, in goals 16.4 and 17.1 of the SDG, the significant reduction of IFFs by 2030, calls for the recovery and return of stolen assets through IFFs (UNCTAD, 2020).

PROBLEM STATEMENT

SA has been plagued with stagnant economic growth, elevated levels of unemployment, poverty and inequality and at the same time losing millions of dollars through IFFs. Therefore, IFFs deny SA much-needed resources to invest in productivity-enhancing sectors that will in turn create employment and increase incomes, which would result in lowering levels of poverty and inequality. IFFs have been a problem globally for decades and yet there is little research that examines the implications of IFFs on economic development, specifically in the context of SA.

Additionally, majority of academic research on SA to date focuses on capital flight (Nkurunziza, 2012; World Bank, 2016; Aboobaker, Naidoo & Ndikumana, 2022). In the SA context, there is a dearth of knowledge on the economic impact of IFFs. Many studies do not establish the link between the impact of IFFs and economic challenges, as it is assumed that the link is self-evident (Barasa, 2018; Gumede & Fadiran, 2018; Badwan & Atta, 2019; Ndikumana & Boyce, 2022). As a result, there is a need to explicitly conceptualise the relationship between IFFs and economic growth.

OBJETIVES OF THE STUDY

To investigate the effect of IFFs on SA's economic growth and how IFFs are carried out in SA in terms of sources, channels, drivers, facilitators, emitters and beneficiaries.

RESEARCH SIGNIFICANCE

The SA National Development Commission (NPC) developed National Development Plan 2030 (NDP) calls for a reduction of poverty, inequality, levels of unemployment and aims to achieve rapid economic growth by 2030 (NPC, 2012). To achieve these NDP objectives it is vital that SA revenue is maximised and channelled to activities that will grow the economy, create employment, alleviate poverty and reduce inequality levels. Therefore, revenue leakages in the form of IFFs are detrimental to achieving the NDP 2030 goals. This study seeks to provide recommendations which, through various mechanisms, can be used to curtail the magnitude of IFFs and its impact. Curbing IFFs will assist the country in making more resources available to invest in social priorities such as health care, education, employment creation, crime reduction, gender-based violence, land reform, energy challenges and investing in infrastructure.

RATIONALE OF THE STUDY

This paper's novelty is that it does not only delve into quantifying the value lost through IFFs, but it ascertains the impact of IFFs on SA's economic growth and how IFFs manifest in SA. It also focuses on the sectors that contribute about 18% to the Gross Domestic Product (GDP) StatsSA, (2021), which are the import and export sectors. It further tries to understand factors that make IFFs thrive in the form of sources, channels, drivers, facilitators, emitters and beneficiaries of IFFs. Therefore, this paper is different from previous work done on the subject of IFFs, especially within the SA context. Existing literature on IFFs predominantly focuses on the quantification of IFFs and conceptualises the correlation between capital flight and socio-economic challenges from the African continent as a whole or from LDC. Many academic studies largely focus on what causes IFFs, measuring the value of IFFs in monetary terms and aggregates and generalise the impact of IFFs on socio-economic challenges in either LDC economies or Sub-Saharan Africa (Kar, 2013; Ajayi & Ndikumana, 2014; Kar & Spanjers, 2015; World Bank, 2016; Ndikumana & Boyce, 2018; GFI, 2019; IMF, 2020). Gumede and Fadiran (2018) focused on the impact of IFFs on SA's mining sector.

LITERATURE REVIEW

Study's IFFs conceptual framework

Figure 1 summarises the expected relationship between the variables of interest and their causal effect. Basically, it is expected that the prevalence of IFFs leads to erosion of resources meant to propel economic growth through infrastructural investment. When the economy is not growing leads to deterioration of income levels, worsening of poverty levels, unemployment and inequality. This further results in rule of law being undermined, low investment appetite from investors, undermining of governance structures, and further erosion of revenue base and reliance to external funding in the form of foreign external funding, foreign aid and foreign debt.

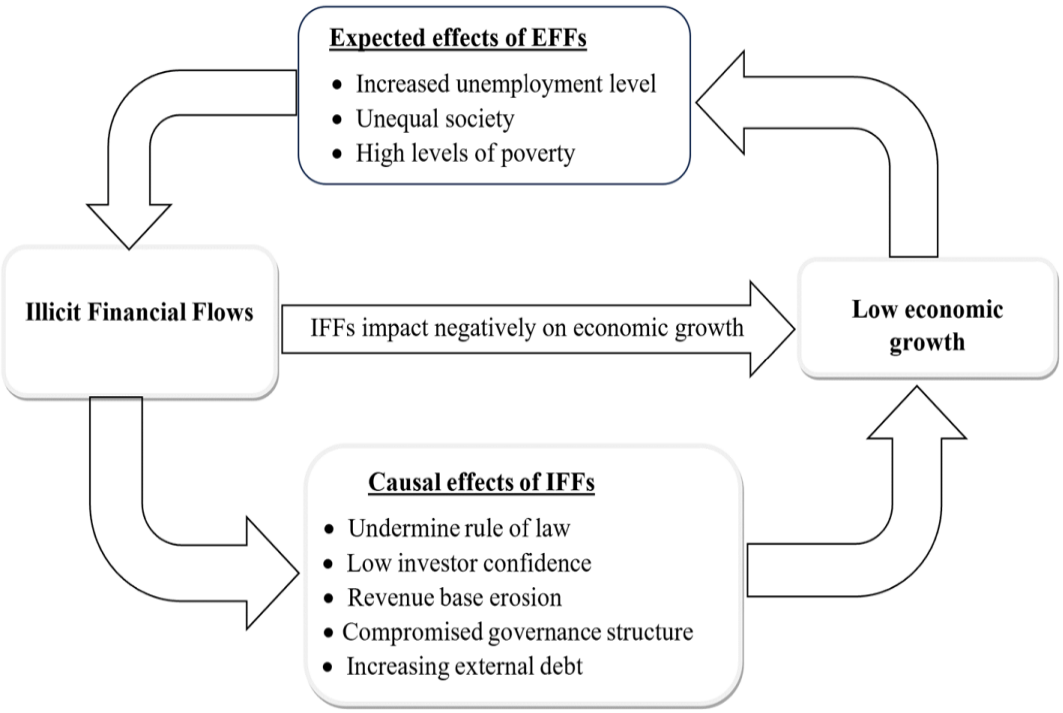

Fig. 1 Conceptual framework
Source: Author's representation

IFFs and capital flight

Studies on financial outflows from SA have been biased towards capital flight rather than IFFs (Rustomjee, 1991; Smit & Mocke, 1991; Fedderke & Liu, 2002; Barasa, 2018; Sagire & Muriu, 2021). There is a difference between IFFs and capital flight; capital flight might be both legal and illegal whereas IFFs are all illegal (World Bank, 2016). Capital flight is the migration of financial assets due to political instability, economic volatility, currency devaluation or weak financial exchange rates and high rates of inflation (Cuddington, 1986; IMF, 2020). The World Bank (2016) defines the concept of IFFs as the cross-border movement of assets related to illegal activity, or money that is illegally earned, transferred and used across borders. It can therefore be deduced that the main difference between IFFs and capital flights is that IFFs are illegal whilst capital flight might be either legal or illegal. UNCTAD (2021) classifies IFFs into two categories, namely: i) taxation illicit outflows which are carried through profit shifting, transfer mispricing, debt shifting and assets and intellectual property shifting and ii) commercial financial flows which are carried out through transfer of wealth and trade misinvoicing. This paper is concerned with commercial financial flows from trade misinvoicing.

IFFs and economic development

IFFs by their nature are hidden and carried out in secrecy, therefore, assessing their impact on LDC is complex (Cobham, 2014). The World Bank (2018) found that the effects of IFFs are not only monetary but multidimensional as they undermine economic growth, social and political stability and governance in LDC. While these countries experience IFFs in different forms, the consequences for economic growth are significantly similar. IFFs erode a country's revenue base, leading to poor domestic investment and high debt costs which affects economic growth (Gumede & Fadiran, 2018). Kar and Spanjers (2015) confirm that there is a negative relationship between IFFs and economic growth; as the economy stagnates, IFFs decrease and as the economy grows, so do IFFs. Ajayi and Ndikumana (2014) and Gumede and Fadiran (2018) confirmed that IFFs are negatively impacting economic development in communities. These studies unanimously conclude that IFFs deny LDC essential revenue which is meant to propel economic growth and fund public services. Bisseker (2018) observed that the African economy could have experienced a growth of up to 30% over the current growth in the absence of IFFs. In a recent study, UNCTAD (2020) found that Africa loses approximately US$88.6 billion annually through IFFs. Therefore, if Africa could prevent IFFs outflows, continental economic growth could fulfil its potential resulting in self-sufficiency and achieving the SDGs of reducing IFFs, ending dependency on external funding and propel domestic resource mobilisation.

Quantification of IFFs

The World Bank (2016) concluded that due to IFFs being hidden and veiled in secrecy, arriving at a precise value figure is impossible. To quantify the value of revenue leakages through IFFs, a number of statistical models have been established. These models differ conceptually as some focus on the proceeds of the illegal economy market, while others focus on commercial crimes to reduce tax obligations (Fontana & Hearson, 2012). There are various methods to measure the value of IFFs and each method has strengths and shortcomings. These include balance of payment method, World

Bank residual method, IMF – Direction of trade statistics, UNCTAD and GFI method. However, this paper opted for the latest and currently acceptable measurement method, which was developed by UNCTAD, piloted in 2021/22 in 12 countries on the African continent. This method is discussed in the methodology section.

Economic theories

Various economic growth theories, i.e. classical theory, neo-classical theory and modern theory, outline different ways in which economic activity can have an influence on economic growth. One of the factors influencing economic growth is capital formation; capital accumulation is the key driver of economic growth, capital is required to invest in infrastructure projects, resulting in employment creation and an increase in consumer expenditure (Nweke et al., 2017). Economists Walt Rostow and Joseph Schumpeter found that economic growth is dependent on the accumulation of capital (Piętak, 2014). Koopman and Wacker (2023) found that capital accumulation represents, on average, 9% of the increase in economic growth and that capital accumulation is an important factor for the sustainability of economic growth. IFFs hinder capital accumulation and by implication IFFs hinder economic growth. Therefore, intensive resource mobilisation through plugging the revenue leakage in the form of IFFs will result in capital being available to propel economic growth.

RESEARCH METHODOLOGY

This study has used sequential, exploratory, mixed method research. Mixed method research entails the use of several techniques and/or data sources to obtain a thorough picture of a research phenomenon (Johnson & Onwuegbuzie, 2004; Maxwell, 2016; Creswell & Clark, 2018; Dawadi et al., 2021). The complexity of this research phenomenon further justified the use of this method. This study was guided by pragmatism. Pragmatic position in a study allowed research to be conducted in a pluralistic manner by gathering both qualitative and quantitative data and includes data triangulation to best answer the research questions. There are three reasons why philosophical paradigm was chosen for this research. First, the nature of this study is problem centred. Second, pragmatic philosophy is designed to be a broad paradigm. Last, pragmatic philosophy provides the researcher with the freedom to employ any methods and techniques that can adequately achieve the study's objectives and is within the limits of employing actionable knowledge. This choice of research philosophy is supported by Morgan (2014) as the pragmatic philosophy applies to mixed method studies in that the research draws freely from quantitative and qualitative data sets.

Two sets of quantitative secondary data were collected from the United Nations Commodity Trade Statistics Database (UN Comtrade) and from Statistics SA (StatsSA) from 2000 to 2020. Qualitative data was collected from 18 participants through semi-structured online interviews, chosen through a non-probability, purposive sampling strategy. This type of sampling entails the researcher using their judgement to select the most appropriate participants to best achieve the research objectives and answer research questions (Kumar, 2014). Data analysis consists of two methods, method one: UNCTAD, (2021) Partner Country Method (PCM+) trade misinvoicing method was used to identify trade value gaps in SA's import and export sectors. Method two: GDP regression econometric model. These two methods are discussed in detail. PCM+ identify trade value gaps as follows:

$$\text{InwardIFFs}_{c,r,p,t} = \textit{Overinvoiced } EX_{c,r,p,t} + \textit{Underinvoiced } IM_{c,r,p,t} \quad (1)$$

$$\text{OutwardIFFs}_{c,r,p,t} = \textit{Underinvoiced } EX_{c,r,p,t} + \textit{Overinvoiced } IM_{c,r,p,t} \quad (2)$$

where:

InwardIFFs = IFFs enter a country (Overinvoiced exports and/or Underinvoiced imports)
OutwardIFFs = IFFs leave a country (Underinvoiced exports and/or Overinvoiced imports)
OverinvoicedEX = $EX_r > IM_p$
UnderinvoicedIM = $IM_r < EX_p$
UnderinvoicedEX = $EX_r < IM_p$
OverinvoicedIM = $IM_r > EX_p$
EX = export
IM = import
c = commodity
r = reporting country
p = partner country
t = year

Data analysis method two: Second quantitative data related to SA key economic indicators was collected from StatsSA. The data was used to ascertain the impact of IFFs on SA's economic growth. Data was analysed using multiple regression models formulae. The study used standard GDP formula and factored in the value of IFFs as calculated from formulae 1 and 2. Therefore, the remodelled GDP formula is as follows:

$$\begin{aligned} \textit{RecalGDP(imp-exp)} = {} & \textit{a(0)} + \textit{a(1)*InterestRate} + \textit{a(2)*InflationRate} + \textit{a(3)*GDP\_d} \\ & + \textit{a(4)*IFF(imp-exp)} + \textit{a(5)*P a(6)*G} + \textit{a(7)*I} + \textit{a(8)*Ex\_Im} \\ & + \textit{a(9)*GDP\_statsco} + \textit{a(10)*Invetory\_chang} + e \end{aligned} \quad (4)$$

where:

RecalGDP(imp-exp)	= GDP formula after factoring in IFFs from import and export sectors of SA economy, adjusted for inflation rate and interest rates.
a	= Weight 0,1,2,3,…,10
InterestRate	= Average SA interest rate from 2000 to 2020
InflationRate	= Average SA inflation rate from 2000 to 2020
GDP_d	= GDP deflator, converting nominal GDP to real GDP
IFF (imp-exp)	= IFFs from import and export sectors of the SA economy from 2000 to 2020
P	= SA goods and services expenditure from 2000 to 2020
G	= SA government expenditure from 2000 to 2020
I	= SA capital formation from 2000 to 2020
Ex-Im	= SA exports less imports from 2000 to 2020
GDP_statsco	= GDP Statistical correction
Invetory_chang	= Change in Inventories from 2000 to 2020
e	= Error term

RESULTS AND DISCUSSION

Value of IFFs

PCM+ identified value of net inward and outward trade value gaps to be R4.9 trillion lost by SA's import and export sectors. This represents revenue leakages from the SA economy from 2000 to 2020. To put the R4.9 trillion into perspective, if the R4.9 trillion is extrapolated to the rest of the SA economy, it translates to R27.1 trillion lost by the SA economy over a 21-year period.

Impact of IFFs on economic growth

The multiple regression model was used to ascertain the impact of IFFs on SA's economic growth by contrasting the official GDP as published by StatsSA and the remodelled GDP. The main difference between these two GDPs is that the official reported GDP does not consider the impact of IFFs in the form of revenue leakages. Multiple regression results of IFFs' impact on SA's economic growth are presented in Table 1.

Table 1 Paired t-statistic for official GDP and recalculated GDP

	N	Mean	Standard Deviation	SE Mean
CurrGDP	21	0.0223	0.0269	0.0059
RecalcGDP	21	0.0294	0.0287	0.0063
Difference	μ (CurrGDP) - μ (RecalcGDP)			
Estimate for difference:	-0,00707			
95% upper bound for difference:	0.00739			
T-Test of difference = (vs <):				
T-Value	0,82			
P-Value	0.018			
DF	39			

***Source*:** Author's representation

Difference between the mean of current (official) GDP and recalculated GDP, signifies the impact of IFFs towards SA GDP. Low P-value of 0.018 implies statistically significant; the decision is to conclude there is statistical evidence that IFFs negatively impact on SA economic growth. Furthermore, based on t-statistic of 0.82 leads to safely conclusion that the difference between the official GDP and recalculated GDP is statistically significant at 10% significant level.

Figure 2 denotes the difference between official GDP and remodelled GDP. This means that SA average GDP from 2000 to 2020 was 0.7% lower than it should be and the difference is attributed to the prevalence of IFFs.

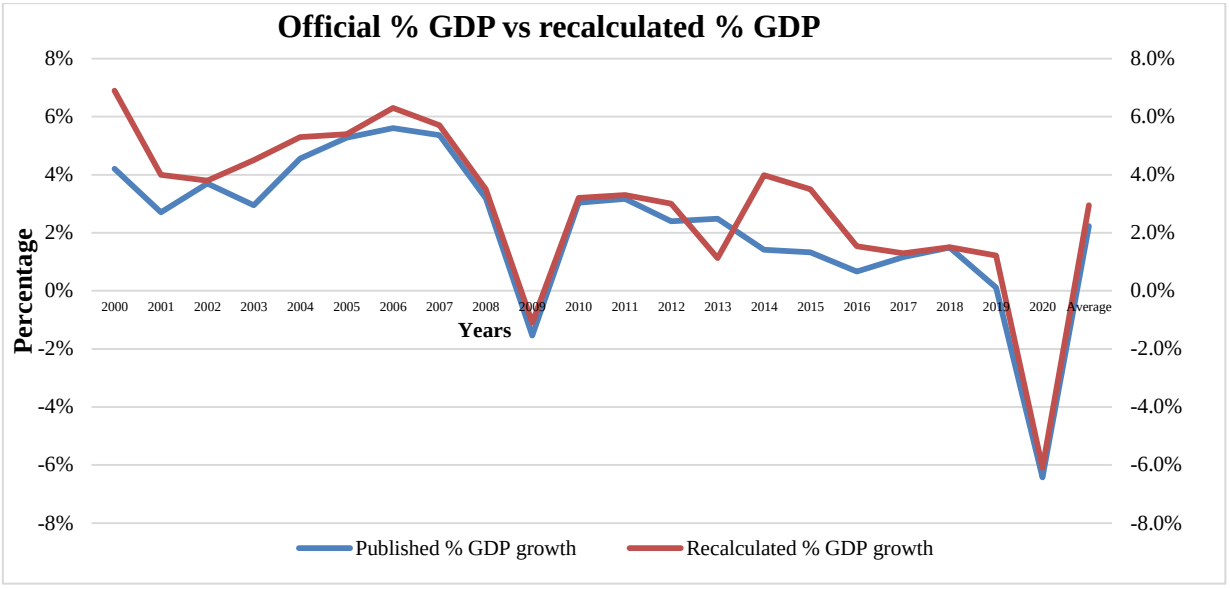

Fig. 2 Percentage difference between reported GDP and recalculated GDP
Source: Author's representation

The official GDP percentage growth, as published by StatsSA, is lower than the recalculated GDP percentage growth after considering the calculated IFFs. The average official GDP as published by StatsSA is 2.2% over 21 years. The recalculated GDP growth percentage after considering the trade value gaps is 2.9%. This means, if SA did not have revenue leakages in the form of IFFs, the GDP average growth between 2000 and 2020 would have been 2.9% instead of 2.2%. The difference is 0.7%, which might look insignificant but in terms of rand value, this equates to R437.6 billion. Ndikumana and Boyce (2018) found that the 39 countries studied from 2000 to 2015 may have been able to achieve, on average, 3% more economic growth had there been a concerted effort to stop all IFFs. The study found it necessary to understand the underlying factors that allow IFFs to thrive in SA. Therefore, the study further sought to identify the sources, channels, drivers, facilitators, emitters and beneficiaries of IFFs.

The facilitators of IFFs

Various types of professionals were mentioned by study participants as being considered the main facilitators of IFFs. These included professionals from law firms, accounting firms and financial institutions. Including politically-exposed individuals, developed countries and estate agents. In return, these facilitators benefit through exorbitant professional fees.

Drivers and sources of IFFs

It is difficult to capture all possible drivers of IFFs as these crimes are evolving and are hidden crimes, committed in secrecy. However, the participants highlighted main sources as weak governance environment, high net worth individuals, criminals and corruption activities. The study found that the major source of IFFs involves trade-related activities, which are predominantly used by Multi Nation Corporations (MNC). MNC employ various strategies to maximise profits, such as exploiting gaps and mismatches between countries' tax systems, misinvoicing, manipulation of transfer pricing strategies, base erosion and profit shifting, tax avoidance, aggressive tax planning and using low-tax jurisdiction countries as headquarters (Picciotto et al., 2021). Ndikumana and Boyce (2018) supported the study's findings by highlighting the role played by MNC in advancing IFFs from LDCs by concluding that 63% of IFFs from LDCs are generated by MNC through trade-related activities. OECD (2018) not only cited MNC as drivers of IFFs but estimated that US$240 billion is lost annually on IFFs caused by MNC, which is about 4% to 10% of the global corporate income tax.

The beneficiaries of IFFs

The participants highlighted main benefactors of IFFs as MNC, developed countries, low tax jurisdiction and political exposed individuals. Rivié (2020) also found that Anglo American, De Beers, Glencore, BHP, Rio Tinto and Umicore, among others, operating from LDC rich in natural resources, are predominant beneficiaries of IFFs. Kar and Cartwright-Smith (2010) refer to policymakers, high net worth individuals, MNC and politicians as key beneficiaries and drivers of IFFs who, together, form a working triad of political class that generates IFFs.

Emitters of IFFs in Africa

The participants highlighted main top emitters of IFFs as SA, Zambia, Nigeria, Botswana, Angola and Congo. Ky (2020), found that the top five African countries that emit IFFs are SA, Nigeria, Botswana, Angola and the Democratic Republic of Congo. The common denominator, amongst these countries is that all are rich in natural resources. Despite the prevalence of IFFs in various economic sectors, IFFs are concentrated in the natural resources and extractive sectors

(Mevel et al., 2013; Kar & Spanjers, 2015; Njie, 2015; Gumede & Fadiran, 2018; Alstadsæter et al., 2019; Gorenstein & Ortiz, 2018. UNECA (2015) also found that IFFs thrive in natural resource-driven economies. Therefore, resource-rich countries provide fertile ground for IFFs to thrive. This is the case in the SA economy where the mining sector contributes 18% of the country's GDP (StatsSA, 2021).

RECOMMENDATIONS

To curb IFFs and its negative impact on SA's economic growth, this study proposes several recommendations including

Recommendation	Discussion
Automatic exchange of information	SA and its trade partners, wherein all its trading partners compelled to publicly disclose trade information on a country-by-country basis. Publicly disclosed information should include trade information, transfer pricing agreements with subsidiaries and MNC shareholding structure.
Global minimum corporate taxation	The SA government must immediately implement the global minimum corporate tax. Even if the MNCs managed to avoid taxation through misinvoicing and transfer pricing strategies. SA government will at least be able to recoup some taxation through global minimum corporate taxation.
Customs personnel capacity	The SA government must significantly enhance customs enforcement by equipping and training officers to better detect intentional misrepresenting and falsifying of trade transactions.
Sixth Method	The Sixth Method is another mechanism that can be used to prevent the manipulation of import and export documentation resulting in IFFs in the form of misinvoicing. The Sixth Method considers quoted export/import prices at the time of shipment, regardless of volume, geography and other price-influencing factors, and it requires that the market price of traded commodities be used on the date the goods are shipped, regardless of means of transport.
Local beneficiation	SA government can curb IFFs by local beneficiation of its natural resources into finished goods rather than export raw materials. Local processing of natural precious metals into finished goods will result in employment for South African citizens, will prevent revenue leakages in the form of IFFs and create additional revenue streams
Public participation	The success of SA fight against IFFs relies on the successful engagement of non-governmental organisations, investigative journalists, the private and public sectors and ordinary SA citizens in general. These stakeholders are the ultimate recipients of the impact of IFFs and could help in exposing financial criminal activities thereby assisting the government and state organs in winning the war against IFFs.
Whistle-blower and witness protection programme	SA needs to foster a culture where it is more acceptable to report criminal activity and other abnormal behaviour than to commit it. Therefore, whistle-blowers, and an effective witness protection programme, are crucial for successful public participation projects, especially concerning the sensitive topic of IFFs. Weak and ineffective whistle-blower and witness protection programmes will foster reluctance in sharing sensitive and confidential information.

FUTURE RESEARCH

MNC have been cited as the main beneficiaries and peddlers of IFFs, with the aim of profit maximisation. The main objective of business is shareholder value maximisation. This objective should no longer be the case in the 21st century and the roles and objectives of business must be to bring about the notion of shared value for all stakeholders including employees, shareholders, communities and government to make SA a better state. MNC cannot be allowed to chase profits at all costs. Future research should investigate the conduct of MNC operating in LDCs by evaluating the ethical obligations vis-à-vis profit maximation.

LIMITATIONS OF THE STUDY

The study has two limitations. The accuracy of import and export trade data obtained from UN Comtrade might have been incomplete as some countries do not consistently provide their commercial statistics to UN Comtrade. SA law enforcement institutions tasked with fighting IFFs declined to take part in this study, including the National Prosecution Authority, the Directorate for Priority Crime Investigation and the Special Investigative Unit. The reasons cited by these organisations were confidentiality and sensitivity pertaining to ongoing financial crimes investigations. In recognition of these limitations, the study endeavoured to be objective in finding answers.

CONCLUSION

This study has found that SA loses about R4.9 trillion in import and export sectors from IFFs and that IFFs negatively impact and stagnates SA's economic growth. This resulting in infringement of SA citizens' social and economic rights as

entrenched in the SA Constitution. IFFs alone are not responsible for SA's economic stagnation and eradicating IFFs may not translate to super economic growth. However, IFFs contribute to SA's economic decline.

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DECLARATION OF CONFLICT
The researchers declare that they have no known any interests or relationships that could have influenced this study.

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