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ADDRESSING ILLICIT FINANCIAL FLOWS AND CAPITAL FLIGHT IN THE MENA

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ILLICIT FINANCIAL FLOWS FROM THE MIDDLE EAST AND NORTH AFRICA (MENA) HAVE SIGNIFICANTLY INCREASED OVER THE PAST DECADE – BY 31 PERCENT, EQUIVALENT TO 3.5 PERCENT OF GDP

SUMMARY:

The Middle East and North Africa region accounted for on average 11.2 percent of global illicit capital outflows between 2011-2002. The MENA has long suffered from capital flight for a number of reasons – resource-based economies, corruption, weak governance, economic underdevelopment, political instability, and a less developed financial sector.
Capital flight, licit and illicit, has a deleterious effect on economic development in the MENA region, and has significantly increased over the past decade. The reasons for such a rise in illicit flows, and its impact on economies, needs to be researched and policies put forward at the national, regional and international level to curb this phenomenon.

1. INTRODUCTION:

Capital flight is the proverbial elephant in the room in policy discussions on economic integration and development. Illicit financial flows from the Middle East and North Africa (MENA) have significantly increased over the past decade – by 31 percent, equivalent to 3.5 percent of GDP - yet the issue is rarely discussed, in part due to the lack of research on the causes and consequences of capital flight at either the micro or macro level.

At the same time, the economic factors that contributed to the uprisings throughout much of the region since 2010 – the so-called "Arab Spring" - have been largely downplayed in media and academic assessments. Yet the MENA has one of the world›s highest unemployment rates and a distinct lack of economic opportunities. This stagnation coupled with the fact that half of the region›s populace is under 30 years old is a ticking-time bomb for policymakers that needs to be addressed. While the causes of such aforementioned issues are multiple, capital flight, tax evasion, and trade misinvoicing (a way to move money illicitly across borders) are major contributors.

Capital flight, licit and illicit, has a deleterious effect on economic development in the MENA region, and has significantly increased over the past decade. The reasons for such a rise in IFFs, and its impact on economies, needs to be researched and policies put forward at the national, regional and international level to curb this phenomenon.

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The MENA needs to be involved in recent international efforts, such as by the OECD, to curb illicit financial flows given its global dimensions. Reducing financial outflows is particularly important given that many of the Arab economies are reeling due to the political instability in the region. If the MENA region was able to retain even one percent of the 3.5 percent of GDP lost to illicit financial flows, this would have a positive effect on state budgets and capital available for investment.

2. THE DELETERIOUS EFFECTS OF CAPITAL FLIGHT:

Capital flight involves both the licit and illicit flows of capital out of a country. Such funds leave a country for numerous reasons including tax evasion, exchange rate depreciation, risks of capital expropriation, higher returns on investment elsewhere, diversification of savings and investment portfolios, and lack of confidence in a domestic financial sector.

IFFS DEPRIVE GOVERNMENTS OF MUCH NEEDED TAX REVENUES, WHILE ALSO CAUSING SOCIETAL AND ECONOMIC PROBLEMS THAT ARE ASSOCIATED WITH ILLEGAL ACTIVITIES.

Outflows of capital have been shown to have a negative impact on social development and economic growth, leading to greater inequality. This decrease in capital means less funds available for states to invest in public investment projects, as well as less funds available for the private sector for investment. Furthermore, the lack of domestic funds fuels the need for official development assistance and foreign direct investment (FDI). Such external capital dependency can result in governments becoming indebted to foreign creditors, an over reliance on economic aid - “aid dependency” - and subject to externally imposed political-economic decisions that may not be in the interest of citizens.

While licit capital outflows have such negative aforementioned effects, it can be considered rational in the sense that investors are looking for better financial risk-returns and are seeking to diversify portfolios. Illicit financial flows (IFFs), on the other hand, is a more pernicious issue as it involves capital that is illegally earned, transferred, or utilized, such as through corruption, money laundering, organized crime, and other illegal ventures. IFFs therefore deprive governments of much needed tax revenues, while also causing societal and economic problems that are associated with illegal activities.

3. THE SCALE OF ILLICIT CAPITAL FLIGHT AND FINANCIAL CRIME:

Capital flight, financial crime, corruption, and tax evasion have major negative impacts on countries around the world. According to recent studies, crime, corruption and tax evasion drained close to US1$ trillion from developing countries in 2011 alone. Illicit financial flows were estimated at US5.9$ trillion between 2011-2002, according to a 2013 report by Global Financial Integrity (GFI).

As the GFI report notes, "illicit financial flows are the most devastating economic issue impacting the global South." Alarmingly, such flows are increasing, up 10 percent per year over the past decade.

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Furthermore, north of US20$ trillion is estimated to be held by high net worth individuals and corporations in offshore havens worldwide, according to a report by the Tax Justice Network (TJN). The OECD›s Financial Action Task Force (FATF) meanwhile estimates US1.5$ trillion is laundered globally every year.
Most of these trillions, whether legal or illegal have passed through, or been handled by, the Western financial sector and offshore tax havens. The City of London, for instance, accounts for 11 percent of the world›s banking.

While the Western financial system benefits from such inflows of cash, so do tax havens. Tax havens, or "fiscal paradises," are typically politically stable jurisdictions that attract business to enable individuals and entities to circumvent the rules, laws and regulations of other jurisdictions. On average, the GFI found that offshore centers accounted for 43.9 percent of illicit outflows from Asia, 36 percent from the MENA, 26.8 percent from Africa, 15.8 percent from Europe, and 10.4 percent from the Western Hemisphere.

4. CAPITAL FLIGHT FROM THE MENA:

The MENA has long suffered from capital flight for a number of reasons – resource-based economies, corruption, weak governance, economic underdevelopment, political instability, and a less developed financial sector.

Capital flight has been bolstered by the globalization of finance and the ease of transferring capital, with free trade and economic de-regulation promoted internationally over the past three decades. Reining in capital flight therefore requires readjustments in global financial policies. Currently, the private interests of multinational companies and the financial sector on this issue and those of the people diverge. On a global level, the MENA accounts for 11.2 percent of

ON A GLOBAL LEVEL, THE MENA ACCOUNTS FOR 11.2 PERCENT OF TOTAL ILLICIT OUTFLOWS ON AVERAGE BETWEEN 2011-2002.

total illicit outflows on average between 2011-2002. This percentage has increased dramatically from just three percent of total outflows in 2002 to a peak of 18.5 percent in 2009, before falling to 12 percent in 2011, according to the GFI. Correspondingly, the MENA registered the fastest trend rate of growth in illicit outflows globally, at 31.5 percent. Illicit financial flows to GDP have also increased in the MENA, from one percent in 2002, to 6.8 percent in 2009 to 3.9 percent in 2011 - an average of 3.5 percent between -2002 2011.

Resource-rich countries are particularly prone to unrecorded transfers of capital. Indeed, the oil economies of Saudi Arabia, Iraq, the UAE, and Qatar are all ranked among the top 20 countries with the highest rates of non-normalized international financial flows. Lack of economic diversification and liquidity from oil revenues at the public and private levels are factors. Control of oil-based wealth among a small circle of elites is another, particularly in countries run by ruling families. Oil price fluctuations is also a potential factor given that capital outflows from the MENA haven risen in recent years as the price per barrel of oil went beyond the USD100$ mark.

5. CURRENT INITIATIVES:

At a global level, there are few official initiatives to curb IFF and capital flight. However, since the recent financial crisis, governments have begun to tackle tax evasion to reduce national debt. In July 2014, the United States introduced the Foreign Account Tax Compliance Act (FATCA), which seeks to curb tax evasion by American citizens with bank accounts overseas. In addition, the US and European Union have cracked down on Switzerland as a tax and bank secrecy haven.

In September 2014, the OECD launched a tax-sharing plan endorsed by 44 countries, including all OECD members (of which Saudi Arabia is a member) and the G20 nations. This initiative seeks to “eliminate double non-taxation or ‹hybrid mismatching› (where a company uses treaty arrangements to avoid paying tax in two jurisdictions), to establish multilateral tax agreements to streamline international tax rules (as opposed to the current system of more than 3,000 bilateral agreements), and create a standard for companies to report their activities and profits in each jurisdiction where they operate.”

Such steps, if enacted and enforced, would not only rein in tax havens in the Caribbean states of Jersey and Guernsey, but also in the US and Britain, which are the world's two largest tax havens. If successful, the OECD initiative could have positive ripple effects worldwide by bolstering transparency and by reducing tax evasion and illicit capital flight from less developed economies. While external initiatives are important, countries will have to improve national fiscal and taxation policies as well.

6. ADDRESSING CAPITAL FLIGHT IN THE MENA:

When it comes to curbing illicit and licit capital flight, the issue receives scant attention by governments, the private sector, or academia in the MENA.

MAJOR DISPARITIES IN TAXATION RATES ACROSS THE REGION CONTRIBUTE TO TAX EVASION WITHIN THE MENA

Reducing capital flight is essential as it would reduce dependency on foreign aid and FDI, which can lead to a vicious cycle of debt-repayment and further capital outflows. Retaining capital would open up funds for the development of, for instance, small and medium sized enterprises (SMEs), which are key to strong and diversified economies. With less capital outflow, more tax revenues would also be available for public infrastructure projects and services. Moreover, reducing illicit outflows would result in other socio-economic benefits, such as reducing crime, corruption, money laundering, and tax evasion.

More support and funding is needed for institutions and organizations to address the causes of capital flight by expanding economic programs currently in place, and by carrying out surveys and research into what citizens and economies need to thrive.

7. ADJUSTING POLICY:

Regulations and guidelines for tackling financial crime and money laundering are already in place in the MENA—most countries are members of the OECD›s Financial Action Task Force (FATF) regional body MENA-FATF. However, enforcement of such laws is weak, and more public-private cooperation is needed to reduce illicit crimes. Additionally, initiatives to improve taxation in much of the MENA has been haphazard at best, in large part due to insufficient transparency, accountability, and confidence in the public sector.

On the tax and trade level, governments should consider restructuring tariffs on imports and comprehensive sales taxes to raise tax collection on the one hand, while on the other hand lowering tax evasion, smuggling and trade mis-invoicing. Import monopolies and trade oligopolies also need to be addressed. For instance, research by the GFI has shown that "higher tariff rates leads to a reduction in import over-invoicing by raising the cost of moving capital out of a country."

ADDRESSING IFFS, FINANCIAL CRIMES AND TAX EVASION SHOULD BE A CORE PART OF ANY ECONOMIC AND POLITICAL REFORM FOR THE MENA REGION.

Major disparities in taxation rates across the region contribute to tax evasion within the MENA. As such, the issue must be addressed at the multilateral level, as well as by imposing strict domestic legislation and enforcement.

Other necessary policies will be equally hard to implement, but necessary for long-term economic sustainability. MENA countries, for instance, need more ‹policy space› to develop policies that are more applicable to their economies with regard to free trade, namely protectionism, foreign investment regulation, and intellectual property rights. These are all policies that developed countries initially used to advance their economies but in the case of the MENA they have been externally imposed without taking into consideration the specific local contexts. Applying economic policies suited to the region would provide more incentives for capital to stay within MENA countries.

Reform is needed at the global level, in the financial and regulatory system as well as in international bodies such as the World Trade Organization, the World Bank, the International Monetary Fund, and the Bank for International Settlements. This is a tall order, and one that requires a great deal of coordination at the diplomatic, political and economic levels. While such reform is needed internationally, further domestic reforms at the political and economic level is required in the MENA.

To move forward, more research is required into the scale of capital flight at a national and regional level; what structural and institutional characteristics affect MENA capital flight; and what measures are needed to monitor outflows of untaxed international trade transactions. Only then can policies that should be adopted at a country and regional level be discussed in a comprehensive manner.

8. CONCLUSION:

Illicit financial flows out of the MENA region need to be addressed to bolster funds available for economic development and investment. If the current pattern of increasing illicit capital flight continues, there will be a corresponding negative impact on MENA economies and a wider inequality gap. Addressing IFFs, financial crimes and tax evasion should be a core part of any economic and political reform for the MENA region. However, it will require overcoming vested interests of the regional and global elite. International efforts may bolster any initiatives to curb IFF, but MENA specific policies are equally required.

Given the current political instability in much of the MENA, the outlook is not rosy for effective regional coordination to tackle IFF, but with the future of the region under discussion, capital flight, tax evasion and trade mispricing should be a part of any policy decisions. The success of the OECD initiative on taxation offers a glimmer of hope for progress at the global level.

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