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## The Private Sector as Culprit and Victim of Corruption in Africa

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# The Private Sector as Culprit and Victim of Corruption in Africa

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## **Abstract**

Corruption causes severe waste and misallocation of financial, human, and natural resources, thus retarding growth and social development. It suffocates private sector activity and entrepreneurship, perpetuating the dominance of an inefficient public sector, and undermining economic diversification and structural transformation. While traditionally corruption has been seen as a public sector phenomenon, private sector corruption deserves as much attention as public sector corruption due to its equally debilitating effects on economic activity. In fact private sector operators can be both culprits and victims of corruption. This paper examines the symptoms and impacts of private sector corruption in Africa, from the perspective that corruption arises from both relations between the private sector and the public sector as well as transactions falling strictly within the private sector domain. The paper documents key channels of corporate sector corruption, especially anti-competitive and speculative behavior in key sectors such as banking and services; capital flight and trade misinvoicing; transfer pricing especially in the natural resource industry and the manufacturing sector; and tax evasion by multinational corporations operating in Africa. The consequences of private sector corruption and synergies between private sector corruption and public sector corruption are reviewed. The paper stresses that in their fight against corruption, African countries need to leverage the existing initiatives at regional and international level aimed at tackling the problem of corruption, and it highlights major innovations in these anti-corruption instruments that may serve well the anti-corruption agenda on the continent.

JEL Classification: O1; O55; O17; H2; H11

Key words: corruption; Africa; private sector; public sector

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## 1 Introduction

During the nine pre-recession years of this decade (2000-08), Africa's income grew by 5.8 percent per annum and by 3 percent in per capita terms.<sup>1</sup> Sub-Saharan Africa (SSA), which has been historically seen as a laggard, posted a real GDP growth rate of 4.9 percent and a per capita income growth of 2.4 percent during the same period.<sup>2</sup> At this pace SSA's income per capita was on track to doubling from the current levels of \$640 in 29 years. Even during the global economic crisis, SSA posted a 2 percent real GDP growth rate, which was higher than in most regions. Africa has staged a quick post-crisis recovery, in major part due to prompt and effective counter-cyclical policy interventions by African governments complemented by sustained external financing (Kasekende, Brixiova and Ndikumana 2010; Ndikumana and Brixiova 2013). The recent strong performance has inspired new optimism and even exuberance vis-à-vis Africa's economic destiny, some referring to an 'African renaissance', others even crowning African 'lions' (emulating Asian 'tigers').<sup>3</sup>

At the same time, Africa continues to face critical development challenges. It is the host of the highest poverty levels in the world and growing youth unemployment; it faces high vulnerabilities to shocks as its economies are too dependent on a narrow production base. There is a growing consensus that efforts to resolve these structural problems are frustrated not only by lack of resources but also by inefficient use of resources due to poor governance, or more specifically corruption in the public sector as well as in the private sector.

Thus today the problem of corruption has assumed a high level of attention in national and international policy discourse for several reasons. First, corruption causes severe waste and misallocation of financial, human, and natural resources, thus retarding growth. Second, corruption suffocates private sector activity and entrepreneurship, perpetuating the dominance of an inefficient public sector, and preventing economic diversification and structural transformation. Third, corruption has substantial distributional effects as it widens income gaps between the rich and politically powerful on the one hand and the ordinary workers on the other hand. Finally, in the globalized world, endemic corruption is contagious through cross-border trade and financial relations. Thus the fight against corruption is a global public good as it leads to a healthier, more transparent and more sustainable international economic order that benefits all economies. These reasons explain the strong impetus in the national, regional, and international arena to find effective solutions to the problem of corruption.

Traditionally corruption has been seen as a public sector phenomenon whereby public officials sell political commodities to private actors. While public sector agents play an important role in corruption, it involves two parties in willing-buyer willing-seller transactions that violate the law

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<sup>1</sup> African Economic Outlook (AEO), a production of the African Development Bank, the OECD Development Center, the United Nations Economic Commission for Africa (UNECA) and the United Nations Development Program (UNDP). The AEO data is accessible online at [www.africaneconomicoutlook.org](http://www.africaneconomicoutlook.org).

<sup>2</sup> World Bank, World Development Indicators (online).

<sup>3</sup> McKinsey Global Institute (2010). "Lions on the move: the progress and potential of African economies." (June 2010)

in one way or another. Thus, even in corruption deals initiated by public sector actors, private sector actors are not always innocent victims. Private sector operators not only benefit from corruption by securing contracts and business-enhancing privileges, but they also often are the initiators of bribery.

Private sector corruption deserves as much attention as public sector corruption due to its equally debilitating effects on economic activity. Private sector corruption is typically facilitated by weaknesses in the regulatory and institutional framework that make it difficult to monitor the enforcement of rules and fraud deterrent mechanisms. It operates through three key mechanisms. The first is the manipulation of pricing mechanisms to gain monopoly profits through mispricing in international trade and transfer pricing involving transactions within subsidiaries of the same corporation. Transfer pricing allows corporations to benefit from operations which may be legal in principle but are nonetheless illicit from a moral perspective. The mispricing of imports and exports leads to heavy losses in foreign exchange and trade tax revenue. It is estimated that over the period 1970-2010, exports misinvoicing in Sub-Saharan Africa amounted to \$859 billion (Ndikumana and Boyce 2012; Boyce and Ndikumana 2012). The second channel is exploitation of insider information, which is most prevalent in the financial sector. Here, private operators derive monopoly profits by selling or “banking” on information gained from their privileged positions as decision makers or employees within a particular financial institution. The issue of insider trading has gained attention in the wake of the global financial crisis which originated from irresponsible unchecked decision making in the investment banking and mortgage sectors. In the case of African countries, Nigeria has experienced severe problems of speculative decision making that brought a dozen banks to their knees in 2009 (Apati 2011).

The third channel is capital flight and money laundering, two related by different phenomena. Capital flight involves unrecorded outflow of funds for the purposes of either evading public scrutiny on the origin of the funds or for avoiding taxation by keeping assets abroad. Money laundering involves various mechanisms through which dirty money, or funds obtained from the sale of illegal goods such as drugs, human trafficking, or smuggling of legal goods, and all forms of fraud and corruption, is integrated into the formal banking system. African countries have suffered massive financial hemorrhage through capital flight and money laundering for a long time and the phenomenon shows no sign of abatement. It is estimated that between 1970 and 2010, Africa lost up to \$1.3 trillion in real terms in the form of capital flight or \$1.7 trillion including foregone interest earnings (Ndikumana and Boyce 2012; Boyce and Ndikumana 2012). This is especially troublesome given the massive financing gaps faced by the continent and the slow progress in reaching national development goals.

Another important reason for the attention on private sector corruption is that even in countries that have experienced an expansion of the private sector, primarily led by resource booms, this has not translated in commensurate improvements in social development. For example, Zambia was recently reclassified as a middle-income country, thanks to large revenues from its vast mineral wealth (gold, copper, emeralds, silver and others). However, despite this natural resource bonanza, poverty levels remain stubbornly high. In 2006 77 percent of the Zambian rural population was below the national poverty line (World Development Indicators). An important reason is that the country has not received its fair share in the resource bonanza, a large share going to the multinational companies engaged in resource extraction and trade. Ghana also

recently broke into the middle-income club, also riding on the oil bonanza. It is also likely to face the challenge of managing a sector prone to corruption.

Corruption by multinational companies robs African countries twice: corporations pay little or no taxes; and they bribe government officials to negotiate deals that short change African countries through unfair sharing of rents and generous tax holidays and pervasive tax exemptions. A report by Transparency International estimated that the Zambian government is losing up to 76 million British pounds per year in mining tax revenue due to transfer pricing by international mining companies.<sup>4</sup> The continent probably loses much more from corruption by multinational corporations than from corruption by the multitude local small and medium enterprises, which tend to attract more attention from governments in their efforts to combat corruption. Thus far even when cases of private sector corruption have been detected, the prosecution and punishment has been uneven, with the burden falling asymmetrically on the African party. However, there has been progress recently in expanding the scope of anti-corruption legislations to cover offenses by corporations operating in foreign lands, especially in the United States through the Foreign Corrupt Practices Act since 2006 (Le Billon 2011). The United Kingdom has moved in the same direction with its Bribery Act 2010, and there is pressure on other advanced countries to follow suit, although progress is less visible elsewhere.

This paper seeks to contribute to the existing literature on corruption in Africa with an emphasis on the private sector. The objective of the paper is to explore the symptoms and impacts of private sector corruption in Africa, as well as strategies for curbing and preventing private sector corruption at national, regional and international level. The paper begins by setting the stage by highlighting key trends in private sector development in African countries, and by discussing the nature and contours of corruption and why we care about private sector corruption. The paper takes a broad view that considers corruption as arising from both relations between the private sector and the public sector as well as transactions falling strictly within the private sector domain. It examines key channels of corporate sector corruption and their implications for African economies. Key mechanisms and manifestations of private sector corruption examined in this paper are: anti-competitive behavior in key sectors such as banking and services; capital flight and trade mispricing; transfer pricing in the natural resource industry and the manufacturing sector; and tax evasion. The paper discusses the consequences of private sector corruption and synergies between private sector corruption and public sector corruption. It reviews initiatives at national, regional and international level aimed at tackling the problem of corruption, and it highlights major innovations and weaknesses in these anti-corruption instruments. The paper concludes with concrete recommendations on how to advance the agenda of the fight against private sector corruption in Africa.

## **2 Background: signs of a growing private sector in Africa**

Since the turn of the century, African countries have exhibited signs of dynamism, illustrated by rising growth rates, seen by many as evidence of a continent turning its back on the past ‘lost decades’. Real GDP growth for the continent remained above the 5 percent mark for all the years after 2000 except for the crisis years of 2009-10. While a substantial part of the growth spurt was

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<sup>4</sup> Khadija Sharife, “Transparency hides Zambia’s lost billions.” Al Jazeera.Net, June 18 2011.

driven by natural resource booms, as the prices of oil and mineral reached historic levels in 2000-07, many countries have also experienced substantial growth in non-resource sectors, especially agriculture and services. In fact East Africa, which is the least endowed region in oil and minerals, has led the continent in growth for several consecutive years, thanks to strong performance in agriculture including non-traditional products such as horticulture, as well as tourism and telecommunications.<sup>5</sup>

Along with this resurgence in growth in African countries, it is also worth noting signs of expansion of the private sector, not just in Africa's middle-income economies such as South Africa, Mauritius and North African countries, but also in many low-income countries. The African Development Bank's *2011 African Development Report* documents in detail some of the advances but also the remaining challenges in the private sector, which the report calls an 'engine' of economic development in Africa<sup>6</sup> (AfDB 2011). Naturally there are substantial disparities across countries in levels of private sector development. Even within countries, the private sector is diverse, comprising a large informal sector that remains difficult to apprehend empirically, and a smaller but expanding formal sector that is primarily concentrated in the urban agglomerations. The formal sector is also diverse in terms of size of firms and sectors of activity.

Some sectors have grown particularly fast, mostly in the service sector. Tourism, telecommunications and banking sectors have expanded substantially, with an increasing regionalization of key players in the industry. Thus major South African, Nigerian and Kenyan banks have become dominant regional players. This is the case also for telecom powerhouses such as MTN, Vodacom, Celltel, etc. The contribution of the telecommunications and banking sectors to GDP has increased steadily over the past decades as can be seen in Figures 1 and 2. The signs of dynamism in the private sector are encouraging as private sector development is key to building resilience of African economies through diversification, and also a source of innovation and competitiveness. A vibrant private sector is indispensable for addressing the continent's challenges of rising unemployment of the educated youth, which, beyond being an economic development problem is becoming a source of social and political instability as demonstrated in the 'Arab spring'.<sup>7</sup>

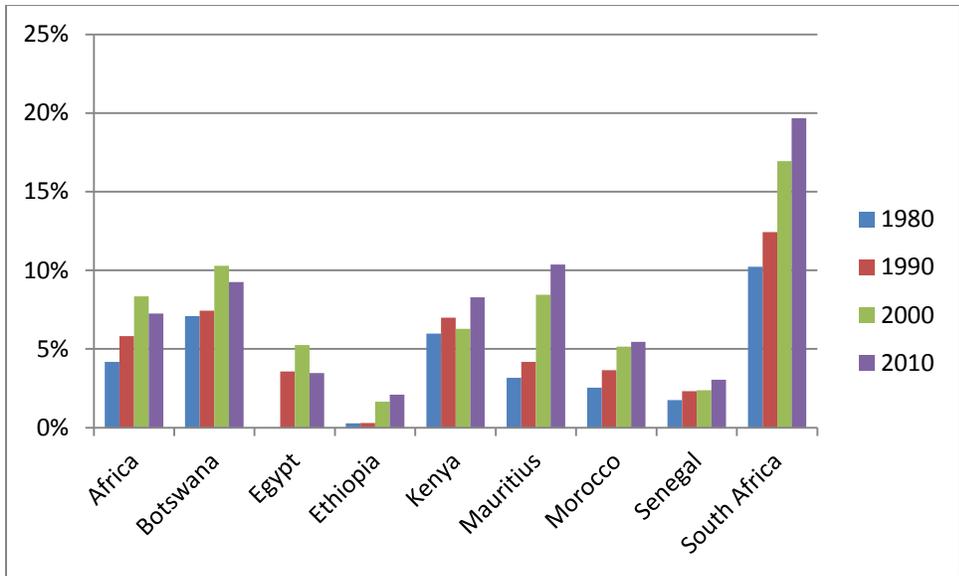
### Figure 1: Banking value added, % of GDP

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<sup>5</sup> See *African Economic Outlook* (various editions) by the African Development Bank, OECD Development Center, UNECA and UNDP ([www.africaneconomicoutlook.org](http://www.africaneconomicoutlook.org)).

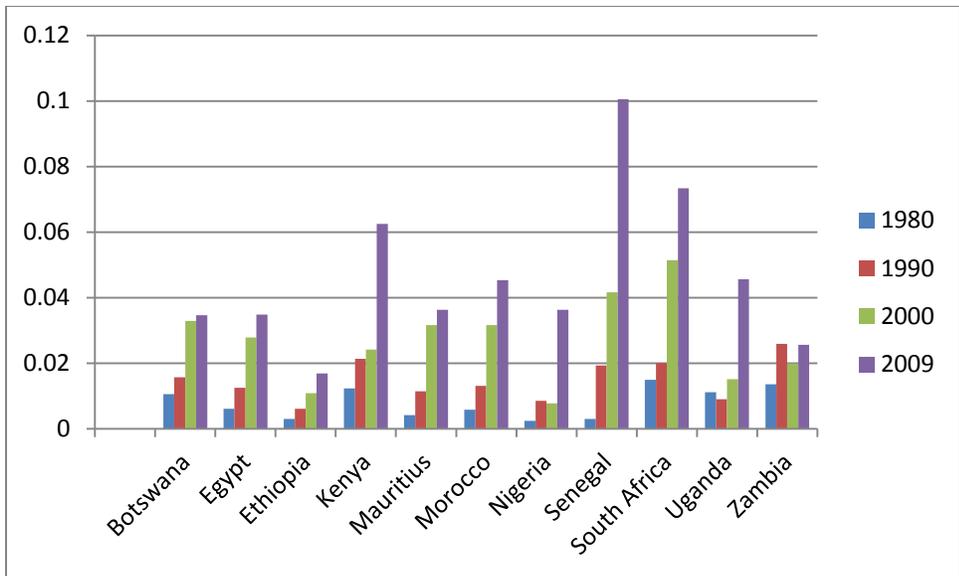
<sup>6</sup> The private sector in Africa is certainly not yet the 'engine' of growth. But a vibrant private sector is critically necessary for African countries to achieve high and broad-based growth.

<sup>7</sup> 'Arab spring' refers to wave of popular revolutionary uprising that originated in Tunisia in December 2010, leading to the overthrow of the regime of Zine El Abidine Ben Ali and spread to Egypt, leading to the fall of the Hosni Mubarak regime, and to the Middle East.



Source: World Bank, World Development Indicators.

**Figure 2: Telecommunications revenue, % of GDP**

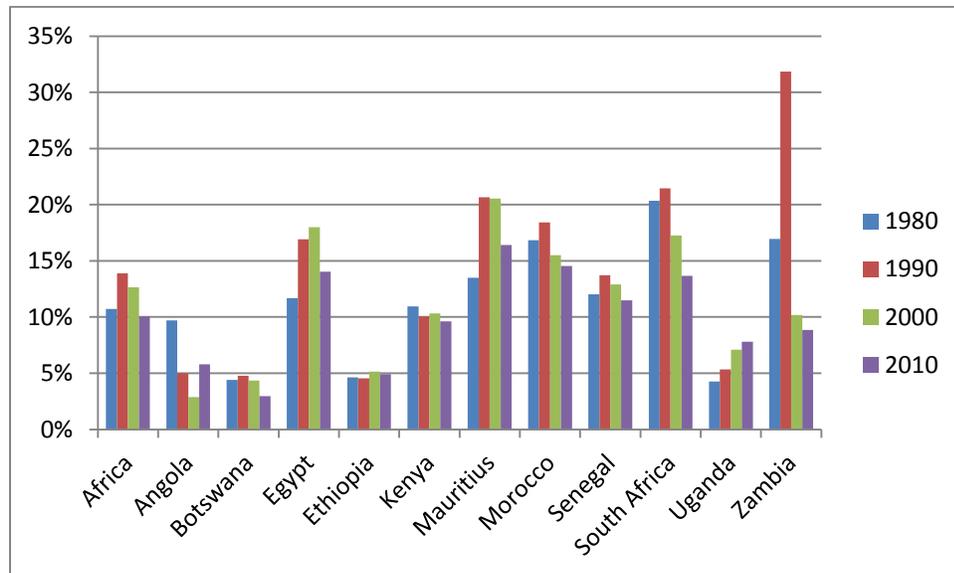


Source: World Bank, World Development Indicators.

The evidence shows, however, substantial weaknesses of the private sector and many structural challenges. Private sector growth remains driven by the service sector while the manufacturing sector is stagnating. In fact many African countries are experiencing a process of deindustrialization with a shrinking contribution of the manufacturing production to GDP (Figure 3). The poor performance of the manufacturing sector is typically attributed to lack of effective industrial policy at the national level. This is compounded by an increasingly difficult global context characterized by stiff competition from emerging economies and rigid regulations in advanced economies that undermine market access for African products (Page 2010). At the

same time intra-Africa trade has not been a viable boost to manufacturing sector development on the continent.

**Figure 3: Manufacturing value added, % of GDP**



Source: World Bank, World Development Indicators.

The importance of the private sector for economic development, the positive signs of dynamism in the sector as well as the untapped potential of the sector justify the increasing attention by policy makers to strategies to further stimulate private sector development. The attention has also turned to the factors that hinder the development of the private sector, among which institutional constraints have been singled out as a major concern (AfDB 2011).

### 3 Nature, scope, scale and dimensions of corruption in the private sector in Africa

#### 3.1 What is corruption and why do we care?

*Conventional view: corruption and “vertical transactions” between the state and the public*

Traditionally corruption has been viewed as a public sector phenomenon, involving “vertical transactions” between the state and private agents whereby those who control state institutions and regulations extract rent from producers and consumers (Acemoglu and Johson 2005; Acemoglu 2006; Shleifer and Vishny 1998). Corruption takes various forms, although it is most often understood as bribery, a transaction whereby public officials impose or accept informal payments to perform official tasks that are otherwise provided for by law either free of charge or with a legally defined fee. Corruption also takes the form of state capture whereby the bureaucrats are enticed through illegal or semi-illegal forms of lobbying to accept bribes or other favors in exchange for the provision of preferential treatment to private actors. Another form of corruption is political patronage, nepotism or cronyism.

In that context, corruption is seen as a symptom of systematic decay of state institutions. As the UNDP puts it, “corruption is a symptom of something gone wrong in the management of the state” (UNDP 1997: xi). According to sociologists, corruption is a symptom of a dysfunctional relationship between the state and the public, characterized by bribery, extortion and nepotism (Alatas 1968: 11). It consists of the “subordination of public interests to private aims involving a violation of the norms of duty and welfare, accompanied by secrecy, betrayal, deception, and a callous disregard for any consequence suffered by the public” (Alatas 1968: 12).

There are three main types of corruption (Riley 1998): incidental, systematic, and systemic corruption. Incidental corruption or petit corruption involves small-scale operations by individuals and small enterprises. While it may be prevalent in scope, the associated volumes of bribery, extortions and theft are relatively small. Systematic corruption involves a larger number of public officials and an element of organization and conspiracy (Riley 1998: 139). It is corruption at the higher levels of the bureaucracy involving senior decision makers and large volumes of resources. This is typically observed in large public procurements by government departments, state-owned companies, aid programs and projects, and NGO-led programs. Systemic corruption is when corruption has become a system of government. This is akin to “kleptocracy” (Andreski 1968), or government by theft. Well known examples in Africa include the former regimes of Mobutu in ex-Zaire and Siaka Stevens’ regime in Sierra Leone, as well as the successive military regimes in Nigeria, Gabon, and Equatorial Guinea, to name a few. These regimes have orchestrated a genuine plunder of national wealth in collusion with external private associates and with the blessing of foreign allied governments that were happy to promote national strategic interests at the detriment of African countries’ development goals. These countries have experienced massive smuggling of public funds in the form of capital flight. During Mobutu’s three-decade reign in Zaire, the country incurred capital flight in excess of its external debt, and at one point, Mobutu’s personal wealth exceeded the country’s liabilities to the rest of the world (Ndikumana and Boyce 1998; Askin and Collins 1993).

A corrupt environment is characterized by institutionalized impunity, resulting in an erosion of the norms of integrity and responsibility. Because of institutionalized impunity, corruption tends to be a self-perpetuating phenomenon. On the one hand, bureaucrats manipulate the legal and regulatory systems, and establish laws and regulations that create opportunities for rent-seeking and private wealth accumulation. On the other hand, private actors learn to expect corruption and behave accordingly; that is, they internalize bribery and extortion in their investment and trade decisions. A vicious circle thus ensues where corruption creates expectations of corruption which generate demand and supply for bribes, extortion and nepotism. Therefore, corruption becomes “the natural result of efficient predatory behavior in a lawless world” (Charap and Harm 2002: 137). Corruption may thus be endogenous, an outcome of deliberate decisions by rent-maximizing agents that manipulate and exploit the institutional and regulatory systems to create the “lawless world” that generates and perpetuates corruption.

Corruption typically occurs where three conditions hold (Klitgaard 1988):<sup>8</sup> monopoly, discretion, and lack of accountability. Public officials or private actors are able to exploit their monopoly

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<sup>8</sup> Understanding the working of the “corruption triangle” is important for designing policies to reduce and prevent corruption. Typically, anti-corruption strategies have focused on innovations and reforms that reduce the monopoly and discretionary power of the state and strengthen institutional mechanisms to enforce accountability. These

position to extract rents and gain unofficial additional incomes or profits. Discretionary power, coupled with pervasive regulation and expanded public procurements provide opportunities for rent extraction and extortion by the bureaucrats. Lack of accountability, partly due to high centralization of economic and political power, perpetuates corruption. Thus the public sector domain becomes privatized, and the web of patronage and connivance that develops erodes the foundations of accountability while further expanding opportunities for corruption.

Once corruption is rooted into a society, it also tends to persist because of group reputational dynamics (Tirole 1996). In a regime with a bad reputation of being corrupt, individual leaders or bureaucrats have little incentive to behave honestly because individual behavior is imperfectly observable while individual reputation is tied to group reputation. It therefore may not seem rational for an individual bureaucrat to attempt to be “clean” when the system which he/she is associated with is known to be corrupt. Behaving honestly is costly (foregone monetary gains) while it may generate disproportionately low moral rewards in a corrupt environment. All these forces tend to perpetuate corruption. As a result, “once a society becomes corrupt there are powerful forces tending to keep it corrupt” (Collier 2000: 197).

In addition to undermining overall economic performance and efforts towards poverty reduction (Ndikumana 2005), corruption has important distributional effects. Corruption somehow has a ‘Robin Hood in reserve’ character (Riley 1998: 131). The burden of corruption falls disproportionately on the poor and the marginalized segments of the population. In the private sector, evidence shows that corruption disproportionately affects medium-size firms. An illustration is given in Table 1 from firm-level data from Mauritania (Francisco and Pontara, 2007). A possible explanation is that while large firms may be well positioned to both internalize the costs of corruption and exploit their connections with influential politicians, small firms (many of them being informal) are able to swim under the radar. In contrast medium sized firms are visible enough to attract the attention of the bureaucrats and regulators but they are not connected enough to avoid corruption. At the same time it is the medium-size firm segment of the private sector that is generally most dynamic and creates jobs especially for the unskilled and semi-skilled labor. Thus corruption hampers private sector development notably by suffocating growth of medium sized firms.

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strategies have involved liberalization of the economic systems, and institutional reforms to increase participation and fair competition. These efforts have been guided by the view that corruption is a government phenomenon and therefore downsizing the government would reduce corruption.

Table 1: Incidence of corruption at firm level in Mauritania: percentage of firms reporting incidence

Operation/service	By firm size				By sector			All firms
	Micro	Small	Medium	Large	Manufacturing	Retail and IT	Other services	
Telephone line connection	28.2	30.3	63.6	38.9	40.0	33.3	24.5	34.7
Electricity connection	27.8	31.8	71.4	50.0	58.8	25.0	18.1	35.6
Water connection	36.4	75.5	50.0	100.0	75.0	37.5	-	56.5
Construction permit	26.7	45.4	75.0	75.0	70.0	26.3	16.0	46.9
Import license	42.9	25.0	33.3	20.0	11.1	44.4	7.5	28.6
Operating license	20.0	27.3	50.0	50.0	25.0	14.3	6.4	30.0
Inspections: bribes requested	34.3	51.9	61.4	36.4	55.7	53.3	43.4	44.0

Source: Francisco and Pontara (2007) using the 2006 Mauritania Investment Climate Survey

### *The Beckerian argument and the focus on the state*

Gary Becker once claimed that getting rid of corruption would only require abolishing the state (Tanzi 2002). Becker considers corruption as a byproduct of the functioning (or rather malfunctioning) of the state rather than the outcome of individual agents' decisions. The famous French philosopher Jean Jacques Rousseau argued, however, that "it is not the corruption of man which destroys the political system but the political system which corrupts and destroys man" (Heidenheimer, Johnston, and LeVine 1989: 19). Limiting corruption to the domain of the state in the Beckerian view has two problems. First, not all states are corrupt and corruption varies over time even in the same country. Second, from a practical perspective, countries can't do without a state. Modern economies require state regulation that sets and enforces the rules of exchange, which is key to economic performance and social stability over time (North 1990). Therefore, the issue is not the existence of the state, but rather how to establish and enforce the appropriate mechanisms that make the state efficient at promoting economic exchange.

In associating corruption exclusively with the state, the Beckerian view is conflating two different phenomena: the existence of the state and the control of power within the state. Corruption is generated not by the existence of the state *per se*, but by the concentration of power within the state and extensive discretionary leverage in the bureaucracy. Lord Acton said it all: "all power tends to corrupt and absolute power corrupts absolutely" (Heidenheimer, Johnston, and LeVine 1989: 16). It is the lack of checks and balances that generates corruption by allowing individuals in power to manipulate the law in order to create opportunities for bribes, extortion and patronage. Friedrich's law suggesting that the degree of corruption varies inversely to the degree that power is consensual (Friedrich 1989) is fairly borne by historical evidence. The analysis on corruption in the public sector has important insights for corruption in the private sector where monopoly power and lack of transparency are also key factors that generate and perpetuate corruption.

### *Corruption and horizontal transactions among private agents*

Corruption is not limited to dealings between public sector agents and private actors, or vertical corruption. It also occurs in transactions involving only private sector agents, where public officials are not directly involved. In such transactions, private agents engage in transactions that increase their individual or corporate benefits to the detriment of others or society in many ways. These include:

- Obstruction of competition rules to keep competitors out of the game and thus secure monopoly profits.
- Breaking labor laws to advance business interests (by minimizing wages and other labor-related obligations) or to promote the interests of business associates (including patronage in the hiring process).
- Manipulating the pricing system to increase profits through tax evasion and usury charges to customers (including government where the public sector is a consumer of services). This form of private sector corruption is probably the most costly to society; it is further elaborated below.

Private sector corruption is therefore inherent to profit maximization and is facilitated by a number of factors including the following:

- Asymmetric information between business operators and the regulator whereby private actors are able to leverage inside information, business or industry specific information that may not be accessible to the regulator, the consumer, the worker, and the public in general to secure above-normal profits.
- The complexity of business transactions that makes it difficult for the regulator and the law enforcement agencies to monitor and access the legality of transactions. This is especially the case in sectors that are highly specialized such as the financial system, information technology, and commodities trading. It is also the case where the sheer volume of transactions makes it impossible for the often under-resourced and under-equipped government enforcement agencies to keep track with the transactions.
- Globalization, the increasing integration of trade and finance, and the increasing sophistication of corporate structures that blurs the boundaries of ownership and domiciliation. Corporations are able to take advantage of these complexities to make 'strategic' decisions on the location of production and services, the destination of trade, and portfolio management to benefit from preferential treatment of business and investment across territories.

The sections below further elaborate on how these mechanisms facilitate corruption, and document the losses incurred by African countries from various forms of private sector corruption. The research conducted in the preparation of this study unveiled a dramatic shortage of information on private sector corruption especially at country and sector level. Investing in generating detailed quantitative, qualitative and institutional information on the various conduits of private sector corruption constitute a critical precondition for the success of Africa's fight against private sector corruption. For the continent to successfully engage

fighting private sector corruption, it needs to know what kind of beast it is dealing with. As the saying goes, what cannot be measured cannot be done.

### 3.2 Corruption undermines private sector

The relationships between corruption and private sector activity can in principle run both ways. In theory, the impact of corruption on private sector activity can be either positive or negative. At the firm level, it may be argued that corruption allows to grease the wheel of business, enabling firms to run their operations faster. In this respect, private operators with privileged links with corrupt bureaucrats, or who can afford to pay the bribes, will be able to maximize their profits more than their counterparts that do not have such advantages. In practice, however, there is little evidence for the argument of “corruption as efficient grease”. Firm level analysis does not support the view that payment of bribes helps buy lower red tape to speed up bureaucratic processes (De Rosa, Gooroochurn, and Görg 2010). On the other hand, corruption carries important costs for private sector activity in the form of production and transactions costs, uncertainty, and market distortions.

At the aggregate level, the negative effects of corruption typically dominate any positive effects at the micro level. As a result, corruption undermines economic activity (Gyimah-Brempong 2002; Ndikumana and Mina 2009; Ndikumana 2005). In addition to its costs and distortionary effects, corruption undermines economic performance by draining resources out of the country – in the case of capital flight and tax evasion – and by shifting resources away from the most productive activities into unproductive and speculative activities. This shift of resources arises from both decisions by bureaucrats and decisions by private operators. Corrupt bureaucrats make decisions on allocation of government resources – including aid – to advance personal and group interests rather than national economic wellbeing. Quite often governments build “roads that go nowhere” but serve the interests of individuals or groups. In the presence of high corruption, resource allocation will be predominantly driven by rent seeking rather than productivity maximization (Baumol 1990).

From the private operator side, corruption induces a preference for speculative high-return activities as a means of internalizing and hedging against corruption. Thus preferences shift towards commercial activities with high margins that allow to recuperate the investments faster compared to long-gestation investments as in manufacturing or agriculture. Private actors are also forced to devote time and effort to secure licenses, permits, and preferential access to markets rather than focusing on improving productivity (Murphy, Shleifer and Vishny 1991).

Corruption also adversely undermines economic performance in the private sector by repressing entrepreneurship. It can generate “vampire states”, where the public sector expands its reach to virtually all economic activities and suffocates private enterprise. The invasion of the private sector by the bureaucracy and political elite is driven by both economic and political motives. By encroaching into the private sector domain, politicians are able to accumulate private wealth. They are also able to strengthen political power by controlling and buying off the business class. In Tunisia, former President Abdel Azin Ben Ali and his wife, along with their extended kinships, controlled virtually all lucrative sectors in the economy including production, banking, tourism and international trade. Members of the presidential family and their associates

accumulated wealth also through opaque privatization deals whereby state assets and companies were sold below market value to the benefit of privileged off-takers.<sup>9</sup>

Corruption further undermines private sector activity and productivity by displacing potential entrepreneurial talent toward speculative and rent-seeking activities, including state institutions. In an environment with endemic corruption, talented individuals may find it optimal to invest in wealth appropriation rather than wealth creation (Murphy, Shleifer and Vishny 1991, 1993; Acemoglu and Verdier 1998; Tornell and Lane 1999; Torvik 2002). As a result, corruption suffocates innovation and entrepreneurship while creating congestion in the public sector, as bureaucracy is perceived as the primary avenue for enrichment. Hence corruption undermines overall economic performance not only through the waste of financial and human resources, but also by undermining technological innovation and productivity, which are key to long-run growth. This may explain why countries with high corruption grow more slowly than those with relatively low levels of corruption.

Empirical evidence corroborates these conceptual predictions of the negative impact of corruption on private sector development. Figures 4 and 5 show a negative relationship between a measure of corruption<sup>10</sup> and a composite measure of private sector development combining private investment and financial sector development as proxied by credit to the private sector.<sup>11</sup> The analysis is based on a sample of developing countries including African countries with available relevant data. The relationship seems stronger in the large sample of developing countries than in the African sample, probably due to the fact that there is less variation in the two indicators across African countries.

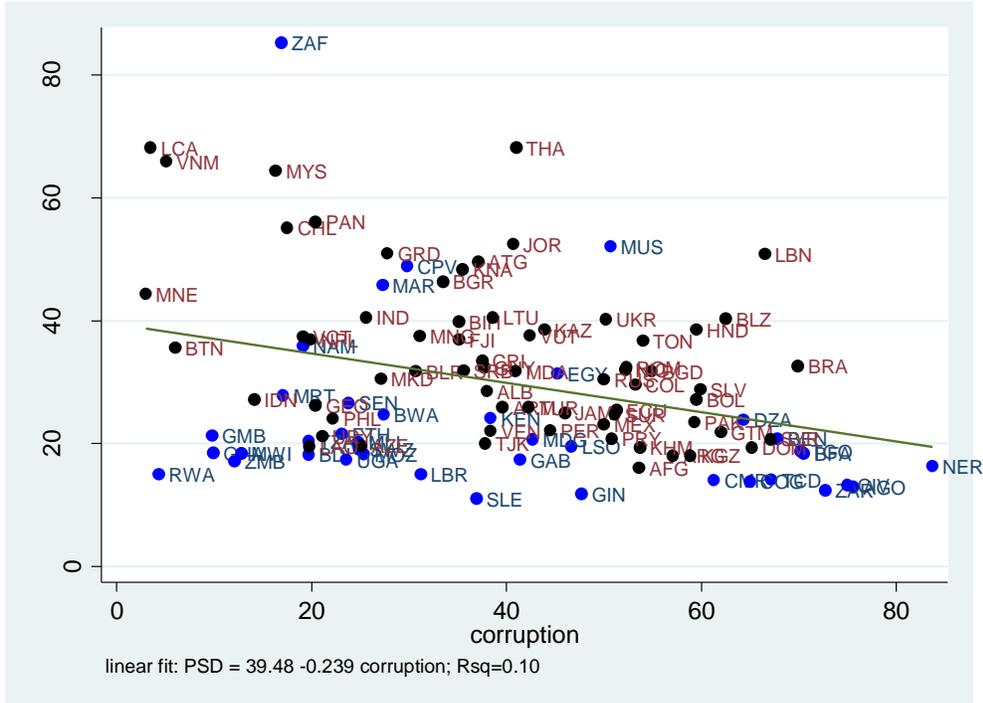
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<sup>9</sup> For example, the automobile company LE MOTEUR was privatized in obscure fashion and ceded to Ben Ali's daughter Cyrine Ben Ali and her husband Marouane Mabrouk. Similar deals were orchestrated on behalf of other members of the presidential family in the transport, banking, and tourism sectors.

<sup>10</sup> The measure of corruption used in these figures is the "percent of firms identifying corruption as a major constraint" as reported in the World Bank's *Doing Business* report, averaged over 2005-10.

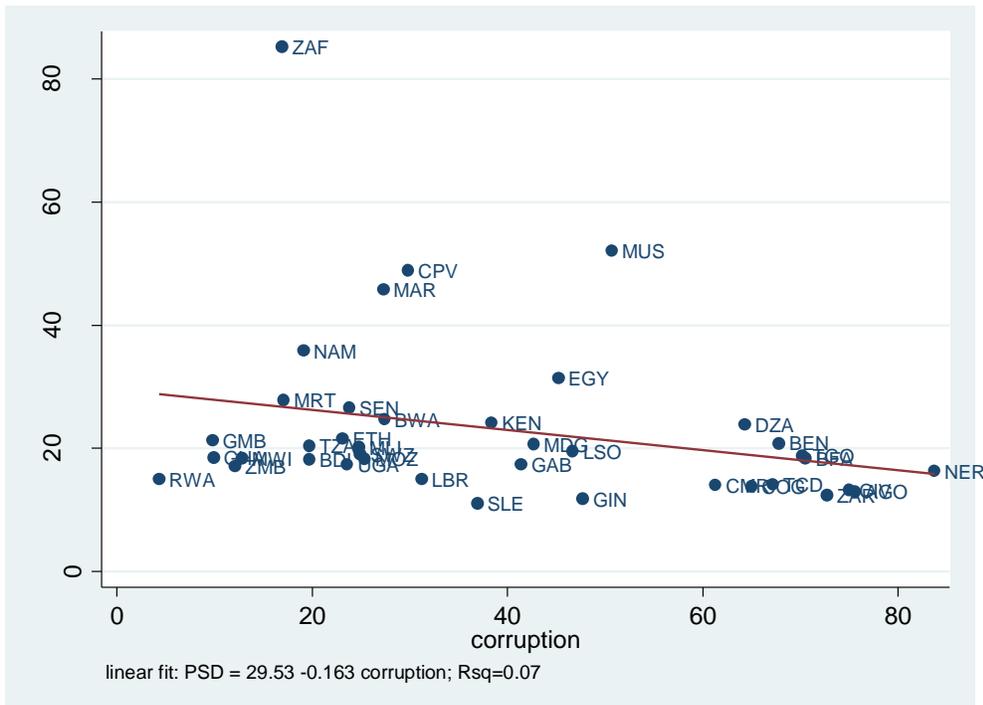
<sup>11</sup> The measure of private sector development is a simple average of the ratio of private investment to GDP and the ratio of bank credit to the private sector to GDP.

Figure 4: Corruption and Private sector development, full sample (2005-10)



Source: Author's computation from World Bank's *World Development Indicators*.

Figure 5: Corruption and private sector development in African countries, 2005-10



Source: Author's computation from World Bank's *World Development Indicators*.

### **3.3 Corruption declines with private sector development**

Private sector development has direct as well as indirect effects on corruption. Direct impacts of private sector development arise in two ways. On the one hand, private sector development is accompanied by rising income generation opportunities outside of the public sector. This reduces publically supplied corruption (Huntington 1968). On the other hand, private sector development implies increasing lobbying capacity of private individuals and corporations, raising the risk and incidence of privately supplied corruption. The net impact is expected to be a reduction of corruption as the private sector develops.

Indirect effects of private sector development on private sector corruption arise through the overall level of economic development. Historically, economic development has been accompanied by improvement in the quality of government institutions and more effective enforcement of the rules of the law. This is corroborated by the data, both globally and for African countries. As can be seen in Figures 4 and 5, private sector development as proxied by private investment and financial sector development (as measured by credit to the private sector) is negatively correlated with corruption. This suggests that medium term dividends from strategies to accelerate private sector development include a general improvement in corporate sector governance and a reduction in private sector corruption. In other words, there are important synergies between strategies for promoting private sector development and strategies to combat corruption: private sector development helps reduce overall corruption.

## **4 Causes and symptoms of private sector corruption in Africa**

### **4.1 Anti-competitive behavior in the manufacturing and services sectors**

A common feature of the industrial sector in most African countries is the high concentration of ownership often in the hands of family-based networks. These networks are generally connected to the existing and past ruling elite, a key source of access to markets, large government procurement contracts, and preferential treatment in taxation and import/export licensing. The monopolistic privileges enjoyed by large private companies is created and reinforced by regulatory barriers that constrain entry into select sectors. The monopolistic structure of the industrial sector prevents the emergence of new entrepreneurs because incumbency privileges enable the existing conglomerates to undercut prospective entrepreneurs notably using their links to the political regime. As a result, this limits the penetration of new technologies and modern business practices, thereby undermining productivity growth.

In the financial system, corruption and anti-competitive behavior by private agents can exert heavy costs to society as a whole. Anti-competitive behavior increases barriers to entry, perpetuating inefficient institutions in the sector. A common form of corruption in the financial sector is insider trading, which allows influential insiders including top ranking managers in the industry to make profits from moving ahead of the market. At the same time such speculative trading causes drastic losses for honest investors who are often stuck with undervalued assets.

While access to credit is generally limited in African banking systems, this co-exists with concentration of lending to insiders and connected individuals. In a detailed study on Burundi, Nkurunziza, Ndikumana and Nyamoya (2012) document systematic misallocation of resources resulting from corrupt and nepotistic lending policies whereby managers of banks, their associates and employees have access to credit at below market rates, while the outsiders struggle to get loans and pay usury interest rates. Exhibiting a clear bi-modal distribution, the rates charged on loans vary from 0 to 7.5% (with a mode of 4%) for insiders and from 18 to 23.5% for outsiders. Analysis at the account level confirms that in addition to managers and employees, the borrowers enjoying privileged treatment included politically influential individuals. The political leverage of these individuals not only allows them to obtain the loans at cheap rates, but also gives them a license to default on their loans with impunity. This process of corrupt and nepotistic management of the banking system accounts for the numerous bank failures observed in Burundi (Nkurunziza, Ndikumana and Nyamoya, 2012). Thus corruption in the banking sector has important political economy dimensions that explain both its genesis and its persistence.

Corruption therefore can have dramatic consequences on the financial sector as it may lead to financial instability. A recent example is the case of Nigeria where a number of commercial banks nearly collapsed as a result of speculative lending and investment decisions.<sup>12</sup> The culprits in this case were complacent regulation as well as patronage.

In addition to banking fragility, corruption in the banking system creates perverse incentives that promote speculation over real investment. As a result, the banking sector becomes an island of prosperity that is divorced from the rest of the economy. It is not surprising that the banking sector in a country like Burundi would still post such high rates of return to equity (in the range of 25-50 percent for the dominant banks) when the real sector is starving from a shortage of investment funds. Bank resources are channeled towards speculative activities, away from the bedrock of the economy – agriculture and manufacturing sectors. During the 2003-08 period, agriculture and industry received 0.8% and 2% of total bank credit respectively, compared to 67% for commerce. The same occurred in Nigeria where, as Apati (2011) concludes, the banking sector prospered at the expense of the real economy.

In his analysis, Apati (2011) documents how corruption and speculation allowed banks to artificially inflate their worth through creative manipulation of funds and the market. At some point, some of the leading Nigerian banks were estimated to be overvalued by up to 50 per cent. Banks inflated the value of their stocks through speculation, increasing demand for stock,

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<sup>12</sup> A joint investigation by the Central Bank of Nigeria (CBN) and the Nigeria Deposit Insurance Corporation (NDIC) found that nine of the 24 banks (Intercontinental bank, Oceanic Bank, Union Bank, Finbank, Spring Bank, Bank PHB, Wema Bank, Equitorial Trust Bank, and Afribank) have suffered from poor corporate governance, unethical insider practices and disregard for prudential limits by their management. These institutions were rescued \$41bn bailout at the condition that they achieve adequate recapitalization by July 15, 2011 (the date was extended to September 30, 2011). Three banks – Afribank, Bank PHB, and Spring Bank – were nationalized under the ownership of the Asset Management Corporation of Nigeria (AMCON), with a life line of \$4.5 billion in new liquidity from the government. Overall, the rescue mission was deemed a success. Incidentally the Governor of the Central Bank of Nigeria, Mallam Lamido Sanusi, went on to win the award of the Best Central Banker in 2011 for his courageous fight against corruption in the banking sector. (AllAfrica.com: “Sanusi Gets World Best Central Bank Governor Award.” By Kingsley Ighomwenghian, 5 January 2011).

resulting in ‘irrational exuberance’. Investigations revealed a number of practices behind the speculative bubble in the banking sector (Apati 2011): (1) use of ‘special purpose vehicles’ by banks to lend to their own subsidiaries which purchased their stocks; (2) insider trading in banks’ own stocks through third party stock broking companies; (3) warehousing and dumping other banks’ stocks to crush their price; (4) banks setting up shell companies to circumvent the single obligor limit allowing them to issue large loans to individuals for the purpose of serial purchases of bank’s stocks; (5) banks using depositors’ funds to purchase their own public offerings. All these practices violated banking laws, as a result of inadequate supervision. These problems were certainly not specific to Nigerian banking system. Any country is subject to similar speculative attacks on the banking sector in the absence of vigilant regulation.

The problems in the Burundian and Nigerian banking sectors demonstrate common features about private sector corruption. First corruption rides on weak governance and supervision of private sector activity. Managers of banks are able to circumvent the rules to advance their interests, and these practices persist due to ineffective supervision and regulation. Second, corruption thrives on either complacency or complicity of political power. In most cases the bankers enjoy cover from top ranking politicians who themselves have financial interests in the banks. Third, corruption arises from the actions or influence of former politicians turned either into bank owners directly or indirectly through bank managers who are their nominees. Apati (2011) tells the story of retired politicians who invest in banks or even create banks that are run by novice nephews and nieces, and how these banks become their avenue to golden retirement. The costs of corruption in the banking sector are high. Bank failures resulting from corrupt management imply substantial losses for depositors and impose stress on government resources as a result of bail outs. It is therefore clear that rooting out corruption from the banking sector should be on the top of the anti-corruption agenda.

These cases also demonstrate that the focus should not be only on problems of corporate corruption by large multinational corporations operating in Africa. Due attention should also be paid to corruption by domestic firms. The analysis also demonstrates that corruption often entails complicity between private agents and public officials who either provide privileges to the former or turn a blind eye on illicit behavior by rent-seeking private operators. Under the protection by influential politicians, corrupt private actors behave as though they were above the law, benefiting from impunity. This again demonstrates that private sector corruption political economy dimensions that must be taken into account in strategies to eradicate the problem.

## **4.2 Capital flight, trade mispricing and transfer pricing**

### *a. Capital flight*

Economists have worried about the problem of capital flight since the 1930s if not earlier (Kindleberger 1937). But attention to capital flight from Africa is more recent (Ajayi 1997). Capital flight is understood as illicit movement of capital across borders, motivated by (1) the need to conceal illegally acquired funds by safe-keeping them abroad, taking advantage of bank secrecy; (2) evading taxation on otherwise legally acquired wealth or income; or (3) smuggling of goods and money, including money laundering.

Various measures have been proposed in the literature, in the attempt to quantify unrecorded flows of capital using data reported in official documents such as the balance of payments, debt statistics, and bilateral trade statistics (see Ndikumana and Boyce 2001 for a review). The most commonly used measure of capital flight is the ‘residual method’ (Erbe 1985), which is based on the reconciliation between inflows of international financial resources (sources) and the outflows of funds (uses). The key sources are net external borrowing and net foreign direct investment. These resources are used to cover the current account deficit and the remainder consists of net additions to reserves. The residual between sources and uses of funds constitutes the baseline measure of capital flight.

Over time a number of refinements have been brought to the baseline measure of capital flight. First, an additional channel of capital flight investigated is the mispricing of international trade whereby exports are underinvoiced for the sake of keeping the difference abroad while imports are either over-invoiced for the same reason or under-invoiced for the purpose of smuggling.<sup>13</sup> We elaborate on this channel as a source of corrupt financial flows further in the next sub-section. Ndikumana and Boyce introduce further amendments taking into account exchange rate movements in the calculation of net borrowing and debt forgiveness, as well as adjusting for unrecorded worker remittances (Ndikumana and Boyce 2001; 2010).

The existing evidence demonstrates that African countries have experienced and continue to face heavy financial hemorrhage through capital flight. The responsibility for capital flight is equally shared by government officials and private sector operators. From the public sector side, capital flight arises through embezzlement of external debt, including outright theft of borrowed funds that are often directly deposited in the same banks that issued the loans through a ‘revolving door’. The public sector is also the scene of other mechanisms that facilitate capital flight including kickbacks and padded procurement contracts on debt-funded projects. Empirical analysis has revealed that a substantial fraction of capital flight from Africa is actually financed by external borrowing. Ndikumana and Boyce (2011a, 2011b) find that up to 60 cents out of each dollar borrowed flees in the same year as capital flight from African countries.

From the private sector, capital flight arises through smuggling of foreign exchange and mispricing of international trade (see next sub-section). The volumes of capital flight from African countries are staggering. It is estimated that from the 1970 to 2010, Africa lost as much as \$1.3 trillion due to capital flight (Ndikumana and Boyce 2012; Boyce and Ndikumana 2012). Assuming that these funds would have earned interest if invested in the market, cumulative capital flight amounts to \$1.7 billion. This is astounding in a continent that faces large and growing financing deficits and a region that is lagging behind in achievement of national development goals.<sup>14</sup> The stock of capital flight from Africa far exceeds cumulative official development aid to the continent, and they are far more than the debts owed by the continent, making the region a ‘net creditor’ to the rest of the world. However, while capital flight is in the hands of private Africans and disguised in various forms of liquid and physical assets abroad, the debts are public liabilities and are borne by the African people.

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<sup>13</sup> Early discussions of the phenomenon of trade misinvoicing can be found in Bhagwati (1964) and Gulati (1987).

<sup>14</sup> It is estimated that African countries need about \$93 billion a year to finance infrastructure alone. This means that private wealth stashed abroad through capital flight can easily cover 10 years of infrastructure investment.

### *b. Trade mispricing and money laundering*

Another manifestation of corruption in the private sector is the massive volume of money that goes missing through trade misinvoicing, a mechanism which is also used as a means of money laundering to recycle illicit and even criminal money into the formal economy. Trade misinvoicing is a process through which importers and exporters manipulate the reported values of their transactions to reduce the amount of foreign exchange to be surrendered to monetary authorities from export receipts and to inflate the amount of foreign exchange claimed from the authorities to pay for imports. Specifically, exporters understate the value of their export revenues, so as to retain abroad the difference between the true value and the declared value of exports. In turn, importers have incentives for both overinvoicing and underinvoicing: overinvoicing allows importers to obtain extra foreign exchange from the central bank at favorable terms, which can then be transferred abroad. Underinvoicing and outright smuggling allow importers to evade customs duties and regulations.

As a result of trade misinvoicing the current account deficit will be inflated by export underinvoicing and import overinvoicing; it is reduced in the presence of import underinvoicing. Consequently, the capital flight estimate obtained using balance-of-payments trade data will be too low if the true current account deficit is overstated: further capital flight is hidden in trade accounts. Symmetrically, the capital flight estimate will be too high if the true current account deficit is understated: some of the missing foreign exchange was in fact used to finance unrecorded imports. The net effect of trade misinvoicing can only be ascertained empirically.<sup>15</sup>

The amount of trade misinvoicing is estimated by comparing the African country's export and import data to those of its trading partners as reported in the IMF's *Direction of Trade Statistics*. Assuming that trade data from industrialized countries are relatively accurate, the discrepancy between these and data from their African trading partners is interpreted as evidence of misinvoicing. For each African country, export discrepancies with industrialized countries are computed as the difference between the value of industrialized countries' imports from the African country as reported by industrialized countries, and the African country's exports to industrialized countries as reported by the African country (accounting for the costs of freight and insurance). A positive difference indicates export underinvoicing. Import discrepancies with the industrialized countries are calculated as the difference between the African country's imports from industrialized countries as reported by the African country, and the industrialized countries' exports to the African country as reported by the industrialized trading partners. A positive difference indicates net overinvoicing of imports; a negative sign indicates net underinvoicing.

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<sup>15</sup> Even if the net effect amount of trade misinvoicing was zero, there is reason to consider misinvoicing as an important *mechanism* of capital flight. In such a case, it simply means that capital flight through export underinvoicing and import overinvoicing is offset by capital outflows to finance the undeclared portion of imports. Foreign exchange to finance the latter could have been moved abroad by other mechanisms, such as cash transfers and wire transfers (Boyce 1992). Moreover, unrecorded imports and exports are not taxed, implying revenue losses for the government.

Trade mispricing implies a double loss for African countries: foregone foreign exchange revenue, and lost taxes on smuggled imports and on under-invoiced exports. These costs are in addition to the direct effect of capital flight and money laundering.

### *c. Transfer pricing and tax evasion*

The globalization and increasing complexity in the governance and ownership structure of modern corporations has had dramatic impact on the nature of trade and financial flows. Today a large volume of trade takes place within rather than between large corporations, allowing corporations to engage in ‘self-regulated’ pricing to improve their bottom line. This complex structure creates a “corporate veil” facilitating transfer pricing among subsidiaries of the same company that trade with one another.

Along with this increasing complexity of the corporate structure, there has also been an increase in the number and importance of jurisdictions that offer uncompetitive and secretive advantages to corporations, commonly referred to as “tax havens” or “safe havens”. While the expression may sound as referring to alien and remote lands, the largest territories serving as safe havens include major cities such as London and New York, with Britain hosting the largest number of tax havens in the world.<sup>16</sup> Indeed transfer pricing takes place right in the centers of legal trade and finance. The move of economic activity to offshore behind the curtain of banking and fiscal secrecy implies heavy costs to African countries. As Nicholas Shaxson points out it is impossible to tell a complete story of African development without including offshore: “poverty in Africa cannot be understood without understanding the role of offshore” (Shaxson 2011: 149).

Transfer pricing is facilitated by a number of features in the taxation systems, banking systems and corporate structure, including the following:

1. Banking secrecy which allows to conceal the origin of funds, making it difficult for authorities to accurately assess corporate tax liabilities. Banking secrecy also helps in other dealings, including money laundering.
2. Thin capitalization, which allows a subsidiary of a multinational corporation (MNC) to make high-interest loans to another subsidiary of the same MNC in the same host country. This reduces the amount of taxable profits.
3. Use of “nominees” to hide the identity of the true owner of assets.
4. Limited or no disclosure of company accounts, which allows inconsistent reporting of corporate transactions and tax liabilities.
5. High-level client confidentiality in the name of banking secrecy, which prevents public scrutiny on trade, financial and fiscal records of multinational corporations.

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<sup>16</sup> The UK hosts more than half of the tax havens globally, including three in British Crown Dependencies (e.g., Jersey), seven in British Overseas Territories (e.g., Cayman Islands, British Virgin Islands, Bermuda); and two dozens of members of the Commonwealth (Shaxson 2011).

6. Low or zero tax rates across territories, including tax exemptions, allowing corporations to shift expenses and revenues across jurisdictions, through subsidiaries and shell companies<sup>17</sup> that own tangible assets such as trademarks or provide management services. The preferred destinations of transfer pricing operations are tax havens. As described in Table 2, tax havens offer important features that facilitate transfer pricing and illicit reporting of tax liabilities.<sup>18</sup>

**Table 2: Definitions of tax havens by the OECD and Tax Justice Network**

OECD definition	Tax Justice Network
No or only nominal tax on income	Strong banking secrecy
No effective exchange of information with other tax authorities	Low or zero taxation
Lenient or vague requirements vis-à-vis volume of activity on the territory to qualify for tax residence	No requirements for economic substance for the transactions booked
No transparency in legislative, legal and administrative provisions and regulations	Ring fence between domestic regime and regime offered to non-residents

Source: OECD and Tax Justice Network (online information).

Typically, corporations will use one or a combination of the above features to maximize profits in a legal but illicit manner. They use transfer pricing to shift the costs towards high-tax territories and sales proceeds to low- or no-tax jurisdictions. This ultimately inflates costs and reduces taxable profits in high-tax territories while increasing taxable profits in low-tax territories. The trouble is that according to current accounting standards, this creative accounting is ironically “legal”. But it is nonetheless illicit in the sense that it robs African countries of tax revenue that could have financed vital social needs such as education and health. Even from the perspective of the public in developed countries, these practices are viewed as illicit in the sense that they perpetuate inequality, allowing rich corporations and wealthy individuals to pay no taxes on their incomes while ordinary citizens whose incomes are easily tracked face the full burden of taxation. Hence workers end up subsidizing the wealth people’s consumption of public goods and services.

African countries host a large and increasing number of global corporations, especially in the natural resource sector, some of which operate on their own while others own shares in national companies. The complex corporate structure, the sophistication of operations in the natural resources sector throughout the entire value chain, and the large volumes involved in the transactions, make the industry a fertile terrain for bribery, graft, and transfer pricing. This results in substantial revenue losses for African governments, both through sub-optimal rent sharing covenants as well as underpayment corporate taxes. To illustrate the point, in Zambia a report by the Extractive Industry Transparency Initiative (EITI) found that while mining

<sup>17</sup> A shell company is an organization that exists but that does not do any business activity and has little or no own assets. The value of a shell company derives from its mere listing on a stock market and by it being used by real companies that seek to ‘hide something’ behind the shell.

<sup>18</sup> Tax Justice Network provides extensive analysis of tax havens. It has constructed an index that summarizes the level of secrecy offered by the 71 jurisdictions on its list of tax havens. See [http://www.financialsecrecyindex.com/#what\\_is\\_secrecy\\_jurisdiction](http://www.financialsecrecyindex.com/#what_is_secrecy_jurisdiction).

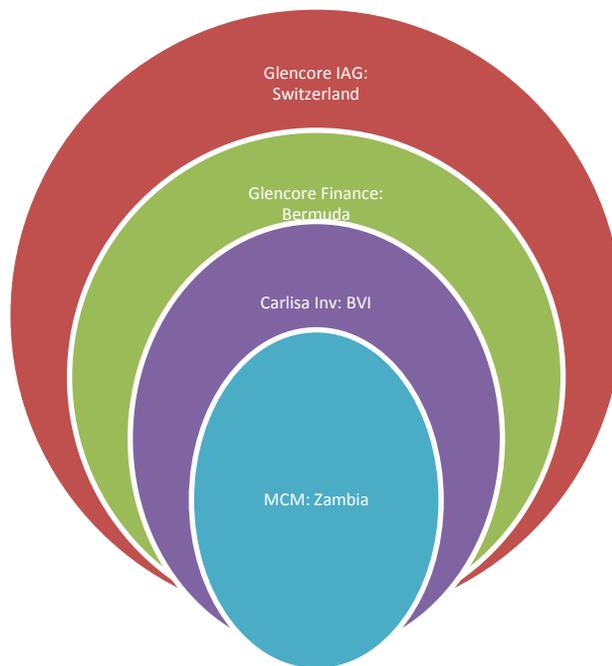
companies paid \$463 million in taxes to the government, there were \$66 million of “unresolved discrepancies” between actual payments and companies’ tax liabilities in the same year (Sharife 2011).<sup>19</sup> The same report notes that half of copper exports earmarked for Switzerland never made it there, “disappearing in thin air”. At the same time, copper price differentials between Zambia and Switzerland were six to one in favor of the latter, implying substantial profits for the companies from copper exports. The flip side is substantial losses for Zambia in terms of forgone tax revenue. It is estimated that the country may have lost up to \$11.4 billion in tax revenue in 2008, which is just below its total GDP in that year (\$14.3 billion) (Sharife 2011).

Mining tax revenue losses for Zambia are partly due to the fact that companies are able to take advantage of their complex corporate structure and the privileges offered by safe havens to reduce their tax liabilities on the Zambian territory. For example, copper mining giant Mopani Copper Mines (MCM), which is a Zambian registered company is integrated in a complex web of ownership and domiciliation spread throughout the world. In practice, MCM is almost entirely located in tax havens through its corporate ownership: 73 percent of the company is owned by Carlisa Investments which is based in the British Virgin Island, which in turn is 82 percent owned by Bermuda-based Glencore Finance, which is totally owned by Switzerland-based Glencore International AG (Figure 6). This complex corporate ownership structure provides some insights into the incentives behind the trade circuits of Zambian copper. Given that MCM is a subsidiary of Glencore, it makes business sense that it would prefer to take a low price for its products sold to Glencore even though it could sell for a higher price on the open market. This reduces the profits in Zambia, thus reducing the tax liabilities in the country. At the same time, the arrangement shifts profits in Switzerland where tax rates are lower, thus reducing total tax liabilities at the corporation level.

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<sup>19</sup> See the PricewaterhouseCoopers 2008 independent reconciliation report for a detailed analysis of discrepancies in the tax reported by the mining companies relative to tax authority’s records. PWC (2011). *Zambia Extractive Industries Transparency Initiative: Independent Reconciliation Report for Year End December 2008*. (February 2011).

**Figure 6: MCM's Corporate Ownership Structure**



Note: BVI = British Virgin Island. Source: Sharife, Khadija (2011) ‘Transparency’ hides Zambia’s lost billions. *Al Jazeera.Net* 18 Jun 20, 2011.

Transfer pricing provides a convenient route for international companies operating in the natural resource sector in Africa to maximize their profits while evading their key corporate responsibilities. This is in addition to the fact that in many instances, international corporations have negotiated very favorable deals with African governments involving long tax holidays. In the case of Zambia, mining companies generate only 2.2 percent of the government revenue. However, 95.6 percent of that is from withheld tax on labor income, with only 4.4 percent from corporate taxes (Sharife 2011). It is estimated that transfer pricing may be costing the government of Zambia up to 76 million British pounds a year (Action Aid [www.actionaid.org.uk](http://www.actionaid.org.uk)).

Tax evasion through transfer pricing plagues other sectors of African economies beyond the natural resource industry, especially the manufacturing sector whenever large multinational companies are involved. Action Aid reported a vivid example of “tax dodging” through transfer pricing by the giant corporation SAB Miller, which operates in a number of African countries, including Ghana, Mozambique, South Africa, Tanzania, and Zambia (Action Aid 2010). SABMiller owns Accra Brewery, which was the first West Africa’s brewery established in 1933. SABMiller is made up of 465 subsidiary companies in 67 countries, including 65 in tax havens: 17 in the Netherlands, 11 in Mauritius, 8 in British Virgin Islands, 6 in Switzerland, and 6 in British Commonwealth Dependencies. The group claims to have made substantial contributions to African economies through tax payments. But the company has paid little from corporate tax, taking credit for income tax levied on employees and sales taxes collected by dealers on its products, which are borne by customers. Action Aid estimates that while the group claims to

have paid \$4.4 billion globally in taxes, only \$620 million are from corporate taxes, while 86 percent are borne by employees and consumers.

Two key techniques are utilized by multinational corporations to dodge taxes: royalty payments to affiliated trade mark holders located outside of Africa and management fees paid also to affiliates and subsidiaries within corporate groups outside the continent. For example, during the 2007-2010 period, Accra Brewery paid £4.6 million in management fees and royalties, amounting to 10 times its operating profits. All these payments were made to two companies belonging to the SABMiller group: Bevman Services AG in Switzerland and SABMiller International BV in the Netherlands. It so happens that both companies are conveniently located in jurisdictions with very low tax rates relative to Ghana. In 2010 alone, Accra Brewery paid £1.3 million in royalties to SABMiller International in Rotterdam for using its brands (Castle Milk Malt and Stone Lager).

In South Africa where SABMiller also operates, the trade mark of Castle, a beer that has been produced for over a century in the country is registered and owned in Rotterdam. South African Brewery Ltd, one of SABMiller's largest operating companies pays £18 million per year in royalties to SAB Miller BV in the Netherlands.

Tax evasion results in large forgone government revenues for African countries. Action Aid (2010) estimates that African countries where SABMiller operates have lost as much as £10 million in taxes as a group due to shifting of royalty payments to tax havens and £8 million due to payments of management fees to subsidiaries also located in tax havens (Table 3). In an attempt to put a human face to these tax losses, Action Aid estimated that the lost taxes were "enough to put a quarter of a million children in school in the countries where SABMiller operates" (Action Aid 2010: 30). For Ghana alone, schooling for about 8,5000 children could be supported by the forgone corporate tax not paid by SABMiller's subsidiary Accra Brewery.

**Table 3: Estimated tax losses to African countries due to SABMiller's tax dodging**

Country	Royalty payments (thousand £)		Payment of management fees (thousand £)		Total estimated tax loss (thousand £)
	Royalties paid	Estimated tax loss	Management fees paid	Estimated tax loss	
Ghana	304	52	932	160	212
Mozambique	367	44	552	66	110
South Africa	18,300	5,100			5,100
Tanzania	2,280	340	5,660	1,100	1,440
Zambia	3,300	830	3,140	720	1,550
Total	42,800	10,100	40,200	8,100	18,200

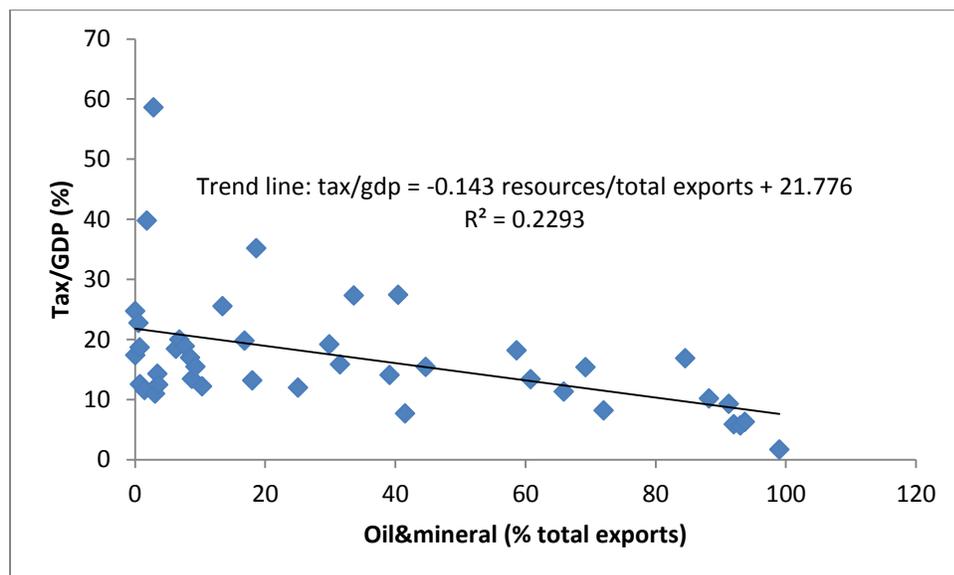
Source: Action Aid (2010). *Calling Time*. London: Action Aid.

### 4.3 Consequences of private sector corruption

There are varied and substantial consequences of private sector corruption with economic, social, and institutional implications. These include the loss of government revenue with implications for growth and undermining social development (Boyce and Ndikumana 2011a), financial instability and erosion of confidence in the banking system (Nkurunziza, Ndikumana, and Nyamoya, 2012; Apati 2011) and the national currency as a result of money laundering, the development of a large ‘shadow economy’, fostering an antagonistic relationship between government and the private sector, and systematic decay of national institutions.

The various mechanisms of private sector corruption are behind the poor performance in revenue mobilization in African countries. In particular, African countries have not been able to harness their resource endowment to generate revenue. The reason is that private operators are not paying their fair dues from exploitation and trade of natural resources. In fact the evidence shows that resource endowed countries have been underperformed by resource-poor countries in tax mobilization (Ndikumana and Abderrahim 2010). Figure 7 illustrates the negative correlation between natural resource endowment and tax revenue: high exports of minerals and fuel are associated with a lower tax/GDP ratio.

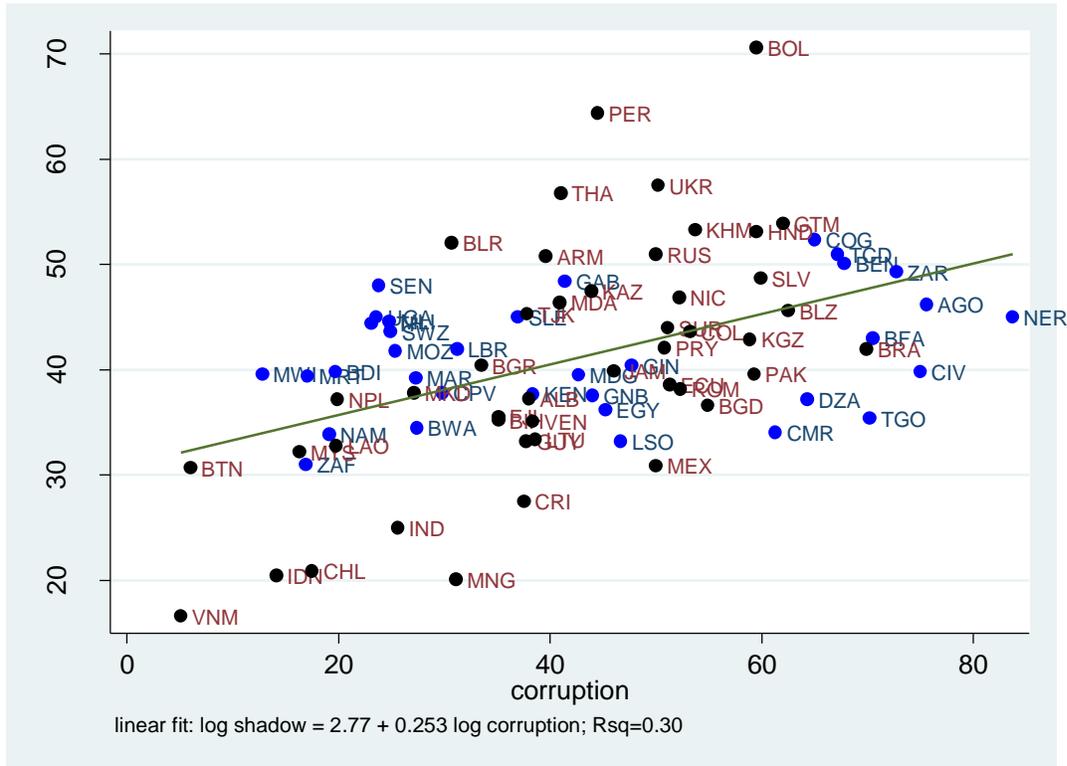
**Figure 7: Tax revenue and natural resource exports in African countries, 2005-07**



Source: Author’s computation using data from the World Bank’s *World Development Indicators*.

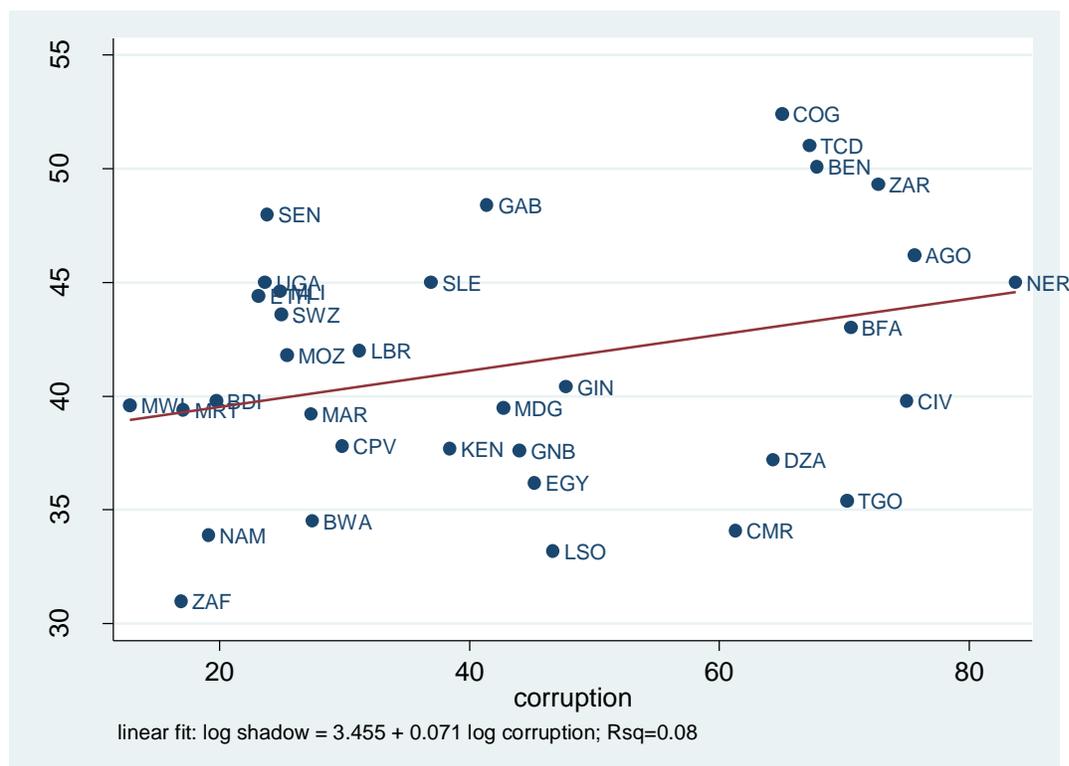
Private sector corruption also retards the formalization of informal sector activities, while instead encouraging existing official sector activities to go underground, leading to an expansion of the “shadow economy”. While there are no rigorous measures of the shadow economy, existing estimates suggest that the underground economy represents a sizeable fraction in African economies, up to fifty percent or more in some countries (Schneider, Buehn, and Montenegro 2010). The evidence also suggests a positive correlation between corruption and the size of the shadow economy (Figures 8 and 9). A large shadow economy implies high losses of government revenue as these activities are unrecorded and therefore not subject to taxation.

Figure 8: Corruption and the shadow economy, full sample (2005-10)



Source: Measures of the shadow economy are from Schneider, F., A. Buehn, and C.E. Montenegro (2010). “Shadow economies all over the world: new estimates for 162 countries from 1999 to 2007.” World Bank policy research working paper 5356. Data on corruption are from the World Bank’s *World Development Indicators*.

**Figure 9: Corruption and the shadow economy, African countries only (2005-10)**



Source: Measures of the shadow economy are from Schneider, F., A. Buehn, and C.E. Montenegro (2010). “Shadow economies all over the world: new estimates for 162 countries from 1999 to 2007.” World Bank policy research working paper 5356. Data on corruption are from the World Bank’s *World Development Indicators*.

#### 4.4 Synergies between private and public sector corruption

There are close linkages between private sector corruption and public sector corruption and it is often difficult to disentangle between the two. The boundaries between the public and the private can be blurred and it is difficult to determine who originates a corruption deal (the supplier), who is the target and whether it is a passive victim or otherwise a willing buyer (the demand side). This subsection discusses key channels that facilitate the synergies between private sector corruption and public sector corruption.

##### *“Cabs for hire” - revolving door between government and private corporations*

Transparency International called for regulation of employment of former UK government and parliament officials in the private sector as a means of combatting private sector corruption. The corruption watch dog called for a 3-year ban on lobbying by former public officials who have held positions in public offices responsible for awarding contracts to private companies. Some sectors are most exposed, especially those where the government is the largest consumer: defense, health, education and infrastructure (especially energy and transport). The concern is that after they leave office, former public officials serve as “cabs for hire”, promoting the interests of private contractors using their acquired insider information and established networks

within the government. This naturally offers unfair competitive advantage to the companies that hire these former government officials, while allowing the latter to extract rents on their past positions. In the meantime, this raises serious concerns about conflict of interest for officials still in office who may be influenced by prospects of securing privileged relations with private contractors to secure lobbying and consultancy opportunities upon leaving public office.

In the case of African countries, this issue has not gained prominence in the public or the media. But it does need serious attention as part of the overall agenda to combat private sector corruption. The reality is that there are already close links between the private sector and the government sector in most African countries, and success in the private sector typically requires close patronage by high-ranking public officials. Thus fighting private sector corruption requires serious attention to these revolving door relations between the private sector and the public sector.

#### *Government officials involved in management of corporations*

Another channel of synergies or contagion between public sector corruption and private sector corruption is through the direct involvement of serving public officials in the management of private sector corporations. As a matter of practice, government officials are appointed on the board of directors of companies where the government is a shareholder. Naturally these appointments are made on political and patronage grounds rather than on the basis of merit. Being political appointees, the government representatives therefore wield substantial formal and informal power that can be used to influence decision making in the company. These members of the board become target for bribery and lobbying on the part of private interests seeking to secure deals with the particular company where they sit on the board or with the government. Similarly, these government officials take advantage of their position to establish networks that eventually serve them to extract rents. To prevent corruption and malpractice, governments should establish and enforce clear codes of conduct for representatives on corporate boards of directors, which should be reviewed periodically. The terms of service of board members should be clearly defined and provisions should be made to avoid concentration of these privileges in the hands of a few as it commonly occurs in favor of officials in strategic ministries such as Finance, Commerce and Planning. Government officials who are members of the board of corporations should be subject to strict rules of disclosure of private wealth and potential conflict of interest to enforce ethical behavior and prevent corruption.

#### *The government sector as an oligopsonic consumer*

In some sectors, the government is naturally an oligopsonic consumer due to the nature of the services and goods produced. This is the case for defense, health, education and major infrastructure programs. This opens opportunities for rent seeking on the part of government officials in charge of decision making in these sectors. These sectors should therefore deserve special attention in the efforts to prevent private sector corruption or corruption in general. Procurement procedures in these sectors should be particularly transparent and open to public scrutiny.

## **5 Initiatives to address the problem of private sector corruption**

Recognizing the importance of corruption as a constraint to economic development in general and private sector development in particular, governments, international development

institutions, and the NGO community have initiated wide-ranging initiatives to address the problem. The approaches have taken two forms (Ofosu-Amaah, Soopramanien, and Uprety 1999): preventive instruments consisting of upstream rules and norms aimed at, *ex ante*, influencing or inducing good behavior on the part of public and private sector agents; curative instruments consisting of laws explicitly aimed at sanctioning acts of corruption *ex post*. In some cases, countries and institutions choose to fight corruption directly, by setting up laws and regulations that prevent and punish corrupt acts. In other cases, they elect to use indirect means through provisions embedded in constitutions and even informal rules of conduct without the force of law (Ofosu-Amaah et al 1999: 5). The anti-corruption apparatus in any given country or institution is a combination of these direct and indirect mechanisms.

The ultimate objective of anti-corruption strategies is to improve transparency and enforce accountability in the private and public domains. In the case of the private sector anti-corruption policies and legislations, they are motivated by the need to enforce fair competition domestically and a level playing field internationally. Governments also see these initiatives as critical for preserving high ethical standards in the business sector. For instance the UK Bribery Act states the following: “Bribery has no place in British business, at home or abroad. This new robust law reflects the UK’s role in the fight against bribery and paves the way for competitive but fair practice. Over time it will have a positive impact on the prospects of UK businesses through enhanced reputation for ethical standards, reduced costs and an international level-playing field.”<sup>20</sup> The 2010 UK Bribery Act has important innovations, including the provisions for personal liabilities of not only top managers but also “associated persons” of companies that are found guilty of bribery.<sup>21</sup>

With regard to accountability, the existing anti-corruption initiatives fall into two main categories: the *short route to accountability* and the *long route to accountability* (World Bank 2004) as summarized in Figure 10. The short route to accountability directly capitalizes on “client power” to enforce accountability on the part of the service providers. Obviously, the success of this approach depends on the bargaining power of the clients relative to the service providers whether public or private. In most African societies, the clients are poorly organized, economically and politically weak, and often ill-informed about their rights, resulting in low ‘client power’. In contrast service providers have either strong political power or monopolistic economic power in the case of private sector providers, yielding a highly un-level playing field. The lack of competition in the private sector further reduces the capacity of the clientele to exercise pressure for accountability on service providers. Furthermore, as discussed earlier, the increasing presence of large multinational corporations in the African private sector tends to erode competition. As a result, the effectiveness of the direct route to accountability is limited, and this explains the persistence of high level corruption in the private sector as well as public sector.

The long route to accountability relies on formal political representation to channel the demands of the clients and enforce accountability on the part of service providers. The effectiveness of

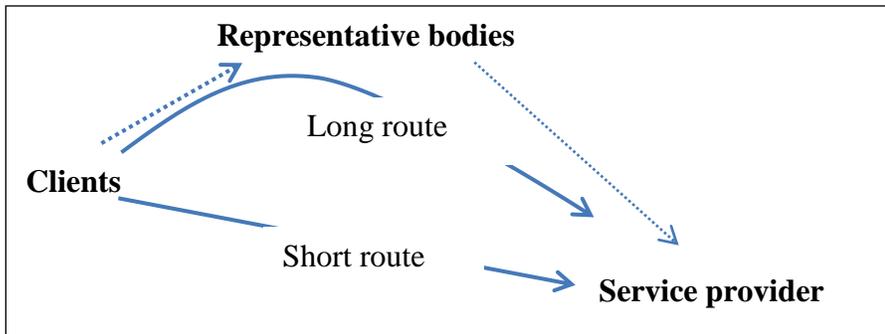
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<sup>20</sup> UK Government, Bribery Act 2010. [http://www.legislation.gov.uk/ukpga/2010/23/pdfs/ukpga\\_20100023\\_en.pdf](http://www.legislation.gov.uk/ukpga/2010/23/pdfs/ukpga_20100023_en.pdf).

<sup>21</sup> An “associated person” of a company under the UK 2010 Bribery Act is any person who performs services for the company, regardless of the capacity in which the person performs these services for or on behalf of the company. This definition covers employees, managers, as well as agents and subsidiaries.

this route in enforcing accountability relies on the quality of representative institutions and government effectiveness. This, in many instances, is the weakest link in this chain along the long route to accountability. It is in this context that countries and international institutions have moved towards establishing specialized bodies and legislations to fight corruption with the aim of increasing transparency and oversight. Prominent initiatives at national and international level are discussed in this section with the view to highlight key features, successes and weaknesses.

**Figure 10: The short route and long route to accountability**



Source: Adapted from World Bank (2004).

Addressing the problem of corruption is a challenging task given its complexity, the multiplicity of players involved and the importance of the institutional context. Corruption has both economic and political dimensions that interact in complex ways. It has important political economy aspects that need to be taken into account in designing strategies to address the problem. Thus while market-based solutions that emphasize rewards and incentives to influence the behavior of agents are critical to the anti-corruption strategy, measures to limit the abuse of influence by politically influential private operators are also critical for the effectiveness of the solutions proposed. It follows that in addition to enforcing corporate responsibility and ensuring a level playing field in private enterprise, strategies against private sector corruption must also include institutional measures to enforce transparency and accountability in the public domain.

## 5.1 National efforts against private sector corruption in Africa

### *A different problem requiring a different approach*

Given the nature of private sector corruption and the preferences and objectives of the actors involved in it, fighting this form of corruption may require different approaches than in the case of public sector corruption. For public sector corruption, a two-pronged strategy is typically pursued. The first tenet of the strategy is to change the incentive structure to reduce public officials' temptation by bribes. The assumption here is that public officials are corrupt because they are "in need" due to low pay; that is, absolute or relative pay of bureaucrats in relation to either their counterparts in the private sector or to their 'reservation living standards' (i.e., what they consider as respectable level of income for a bureaucrat at their level). The solution then is arguably to increase salaries and benefits, and to establish performance incentives with monetary rewards. The second dimension of the strategy is to establish specific rules and laws that deter

and punish corruption and provide the means to enforce them. African countries have implemented this strategy by establishing new laws and legislations explicitly targeting corruption, and by setting up and strengthening public anti-corruption agencies, and taking measures to increase the independence, effectiveness and efficiency of the judiciary.

The question is: can the fight against corruption in the private sector take the same approach? Certainly, it is not because of relative deprivation that private businesses engage in corruption and illicit trade and finance. It is also known that private sector employees enjoy relatively higher wages than their counterparts elsewhere. So it can't be a matter of low wages inducing temptation for bribery, fraud and unethical behavior by corporate employees and managers. As discussed earlier in this paper, large multinational corporations with massive profits are often the biggest culprits of corruption. This means that changing the incentives to raise profitability and private sector wages would not help as a means of deterring private sector corruption and business malpractice. In fact even when countries go out of their ways to provide conducive tax incentives to corporations, this still does not deter private sector corruption and corporate malpractice. The case of SABMiller in Ghana discussed earlier is not an isolated case but it is illustrative of what happens with many other companies in many sectors. This implies that to curb and deter private sector corruption and business malpractice in the private sector requires a different two prong-approach focusing on both inside and outside the firm. First, internally (inside the firms) the focus should be on establishing strong, verifiable, and dynamic internal controls to enforce ethical behavior. Second, internal processes will work only if the national regulatory environment is also conducive to good corporate behavior. This requires establishing strong national corporate laws and legislations, and equipping regulatory agencies with adequate resources to enforce the rules, monitor and track business malpractice, and strictly prosecute and strongly punish violations of the rules.

Another fundamental complication with the prevention and prosecution of corporate corruption using national laws is that it is difficult in most if not all jurisdictions to establish criminal responsibility of a company. This follows from the premise that “only living human beings are capable of forming the necessary intention to commit crime” (Pope 2000: 144). Even when there is evidence that a company has broken the law, it may be difficult to successfully prosecute it and establish criminal guilt “beyond reasonable doubt” without proving personal responsibility of specific individuals in the firm. Thus, strategies against corruption in the private sector should emphasize mechanisms that promote self-regulation and establishment of internal processes that enforce individual ethical behavior, including internal compliance procedures, guidelines for due diligence, effective ethics programs, and good corporate citizenship. These should be the focus in examining progress in the fight against corruption in the private sector in African countries.

### *Pillars of the national anti-corruption strategy in the private sector in Africa*

As African countries forge ahead in their fight against corruption, more attention needs to be turned to the private sector even as they continue to make effort at reducing corruption in the public sector as the two are closely related. A successful strategy to combat private sector corruption should be articulated around the following pillars:

- *Transparency as a “natural corporate sanction”*: Unethical business practices are perpetuated not only because they generate monopolistic profits, but most importantly because they remain below the radar screen out of the scrutiny of the public and the regulator. Thus, strategies to combat private sector corruption should primarily seek to promote transparency by institutionalizing a culture of systematic information disclosure. In this respect, corporations must embrace the practice of multilateral development institutions that are moving to broader disclosure of information as a means of increasing operational effectiveness.<sup>22</sup>
- *Improved corporate responsibility*: As the private sector takes on more provision of goods and services that traditionally fell in the domain of the public sector, it is seen increasingly as an indispensable engine of economic development. In this context, corporate behavior must be seen through the lenses of social responsibility whereby standards of corporate governance are tools to protect not just the corporations and their shareholders but all that have a stake in the success of the private sector, which is virtually everybody. Corporate sector responsibility is a tool for private sector development. It is in this context that anti-corruption strategies should be designed.
- *Regulatory structures for fair play in the corporate sector*: Corporate behavior cannot be left to the forces of the market and the rules of untamed capitalism. Even in the United States, the country of reference for free-market systems, the government has frequently intervened to break monopolies even when seen as “working” from a market perspective. For example, the government broke up the Bell Telephone company because it was seen as unduly dominant with adverse effects on pricing and consumer welfare. Similarly, in African countries, an important element of anticorruption legislation should be a strong anti-trust law.
- *Strong company codes of conduct, values statements, and ethics programs*: These are critical tools to enforce ethical behavior on the part of corporate employees and managers. They are also proofs to third parties (including government enforcement agencies and trading partners) of commitment to good business practices. Good corporate behavior is also good for the bottom line, brand name, and reputation. Thus it is in the company’s self-interest to self-regulate. However, a corporate code of conduct is good only if it is enforced, adhered to by those it targets, and publicly known to induce compliance. Thus codes of conduct and other internal instruments of corporate behavior should also be fully accessible internally and externally through company’s information disclosure mechanisms.
- *Extra-territoriality of corruption offenses*: what is not acceptable as good corporate behavior in a country should not be acceptable anywhere. The notion that foreign corporations engage in corruption and bribery in Africa because “when in Rome do as Romans do” is not only unacceptable but it is also offensive. African countries should require the same standards on foreign companies as they are bound by in their home

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<sup>22</sup> See, for instance the World Bank and the African Development Bank’s Information Disclosure Policies. These policies are developed with full participation of civil society organizations and are broadcast to the entire public. The current World Bank’s Policy on Access to information which supersedes its Policy on Disclosure of Information, and took effect on July 1, 2010 ([http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/06/03/000112742\\_20100603084843/Rendered/PDF/548730Access011y0Statement01Final1.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/06/03/000112742_20100603084843/Rendered/PDF/548730Access011y0Statement01Final1.pdf).) The African Development Bank initiated an open discussion on the revision of its policy on information disclosure in 2011.

countries. In this regard, officials of African anti-corruption agencies as well as managers of corporations (domestic and international) should fully engage with new developments in anti-corruption legislation in developed countries and international institutions especially the OECD and the United Nations. African anti-corruption policies should build on and leverage best practices in international anti-corruption instruments.

The quality and effectiveness of anti-corruption strategies targeting the private sector should be organized around these pillars and progress should be gauged against these yardsticks. Thus far, there is little detailed evidence on either the adequacy of existing corporate and national strategies against private sector corruption in African countries. But it is more than clear that there is a long road ahead towards establishing a culture of systematic ethical behavior in the private sector. This is an area where, sadly, foreign corporate presence has not generated positive externalities; quite to the contrary in many cases. Evidence of grand corruption, tax evasion, transfer pricing, and lack of transparency involving large multinational corporations sends corrosive messages to the domestic business sector. Corruption is then seen as fair game and indeed as a route to corporate wealth accumulation. Thus as a central part of the anti-corruption agenda in Africa, African governments, in collaboration with their counterparts where foreign companies are domiciled, should systematically enforce clean corporate behavior on the part of multinational corporations operating in Africa.

### *Challenges to national efforts against private sector corruption*

Some African countries have recorded substantial progress in the fight against public sector corruption mainly as a result of commitment of top leadership. In Kenya, for example, Mr. Kibaki and Mr. Odinga campaigned in 2002 on an anti-graft platform. While it has taken time, some modest fruits of the fight against corruption are being recorded as in resignations and sacking of high level officials in government and parliament on accusation of corruption. In Nigeria, several provincial governors and other government officials have been arrested for graft and embezzlement. In South Africa, even the President has had to answer to charges of corruption while in office. This would have been unthinkable decades ago even in South Africa; it is still unthinkable in the majority of African countries. Nonetheless, the tide is changing, but the road ahead is still very long; and it is high time that Africa seizes the momentum and accelerates the fight against corruption.

On the private sector side, the work has not even started. Private-to-private corruption has been dealt with mostly as part of broader instruments against corruption where the focus is on public sector corruption and public-private corruption. It is not even possible to adequately evaluate the results of anti-corruption efforts in the case of private-to-private corruption at the moment. The first challenge therefore is for countries to begin seriously looking at establishing and enforcing national legislations against private sector corruption.

The second challenge is the limited involvement of business operators in the design and implementation of anti-corruption strategies. This is where Chambers of Commerce would play an important role, but there are important constraints to their effectiveness. First, because membership to national chambers of commerce is voluntary, these organs therefore have little power to enforce compliance on the part of member companies. Second, because they are

dependent on member contributions, chambers of commerce cannot exert too much coercion due to the risk of alienating contributors. There is no easy solution to this dilemma. African Chambers of Commerce will gain from close collaboration with the International Chamber of Commerce (ICC) and chambers of commerce in partner developed countries, including supporting ICC's global initiatives against private sector corruption.

## 5.2 Continental anti-corruption instruments

Under the leadership of the African Union and the New Partnership on African Development (NEPAD), efforts at the continental level have been mobilized to establish mechanisms and institutions that promote the anti-corruption agenda. While the majority of the provisions relate to public sector governance, the existing frameworks also cover aspects of private sector governance which can serve as a basis for the fight against private sector corruption. The two key frameworks are the following:

- The African Union Convention on preventing and combating corruption, which opened for signature on July 11, 2003 and has been signed by 21 States;
- The African Peer Review Mechanism (APRM) of the New Partnership for African Development (NEPAD), which was created in 2001.

The AU Convention provides a broad framework for anti-corruption legislation both in the public and private domains. Its main objectives are (AU 2003):

- Promote and strengthen the development of mechanisms required to prevent, detect, punish and eradicate corruption and related offences in the public and private sectors.
- Promote, facilitate and regulate cooperation among the State Parties to ensure the effectiveness of measures and actions to prevent, detect, punish and eradicate corruption and related offences in Africa.
- Coordinate and harmonize the policies and legislation between State Parties for the purposes of prevention, detection, punishment and eradication of corruption on the continent.
- Promote socio-economic development by removing obstacles to the enjoyment of economic, social and cultural rights as well as civil and political rights.
- Establish the necessary conditions to foster transparency and accountability in the management of public affairs.

Evidently, implementation of the Convention is entirely dependent of the will of national authorities. Thus the Convention has no effective binding power. But it does serve a valuable purpose as a set of principles that can guide national efforts in the fight against corruption.

Led by the NEPAD Secretariat, APRM covers private sector governance, thus offering a means to support national efforts against private sector corruption. However, just like the AU Anti-corruption Convention, the APRM is non-binding in the sense that there are no provisions for forcing governments to agree and abide by the conclusions of peer reviews. This is a constraint to both its implementation as well as its effectiveness as a reform instrument.

Sub-regional economic organizations are also contributing to the anti-corruption agenda by enacting protocols aimed at coordinating efforts as the sub-regional level. Noteworthy initiatives

include the ECOWAs Protocol on the Fight against Corruption and the SADC Protocol against Corruption. As for the continental level initiatives, the challenge for these Protocols is that they rely on the good will of governments of member countries and have no binding capacity. This is an important impediment to their implementation.

### 5.3 International anti-corruption instruments

The international community has recently broadened its attention to corruption to include bribery and other corrupt practices between and within private enterprises. International organizations have identified private-to-private corruption as a priority, and they have embedded its prohibition into their regulatory instruments. The following are examples of such instruments:

- The United Nations Convention against Corruption (UNCAC), which opened for signature on December 9, 2003, entered into force on December 12, 2005, and has been ratified by 61 States;
- The United Nations Convention against Transnational Organized Crime, which opened for signature on December 12, 2000, entered into force on September 29, 2003 and has been ratified by 122 States;
- The Criminal Law Convention on Corruption of the Council of Europe which opened for signature on January 27, 1999, entered into force on July 1, 2002 and has been ratified by 34 States;
- The Civil Law Convention on Corruption of the Council of Europe which opened for signature on November 1, 1999, entered into force on November 1, 2005 and has been ratified by 27 States;
- The Framework Decision of the Council of the European Union of July 22, 2003 on combating corruption in the private sector.

The growing global interest in fighting corruption has resulted in the establishment of an increasing number of bodies and legislations with the explicit mandate of combatting corruption in all its facets including money laundering, tax evasion, fraud, embezzlement and all forms of illicit financial flows (see Table A1). An exhaustive coverage of all the initiatives is beyond the scope of this paper. The key provisions fall into two categories: (1) legislations to enforce transparency in the corporate sector, which disproportionately focus on the exploitation of natural resources; (2) legislations focusing on tax evasion, money laundering, and stolen asset recovery.

The initiatives on transparency in extractive sectors fall into three categories (Le Billon 2011): contract and revenue transparency management; certification instruments; and governance standards. Under the revenue transparency initiatives, noteworthy legislations are the Extractive Industry Transparency Initiative (EITI), the US Dodd-Frank Wall Street Reform and Consumer Protection Act, the reforms of International Financial Reporting Standards, and the Natural Resource Charter (Collier 2007).

The EITI's goal is to strengthen governance by improving transparency and accountability in the extractive sector. It provides for voluntary adherence on the basis of acceptance of minimum criteria: companies agree to publish payments to governments; companies agree to submit to independent audits to reconcile their financial reports with alternative official data; Civil Society

Organization should participate in the design, monitoring, and evaluation of the audit reports. A number of factors have hampered the effectiveness of the EITI (Le Billon 2011). First, its narrow focus on flows between government and companies leaves out inter-company and intra-corporation transactions that serve as channels of corruption and tax evasion notably through transfer pricing as discussed earlier in the paper. Second, the reporting under EITI is insufficiently disaggregated by company and project which does not allow full disclosure of transactions. Third weak civil society networks in most developing resource-rich countries as in Africa is a source of weakness of the EITI which relies on civil society mechanisms to enforce government and corporate sector accountability (Aaronson 2011).

The Dodd-Frank Wall Street Reform and Consumer Protection Act is by far the most aggressive anti-corruption legislation targeting the private sector at an extra-territorial level. The legislation includes key innovations relative to previous laws. First, it is mandatory to all US corporations regardless of the territorial basis of their business operations. Thus US corporations operating in African countries are held accountable to each of its provisions. Second, it mandates production of disaggregated information by type of transaction, project, and destination. Thus, unlike most other legislations, the Dodd-Frank Act covers revenue as well as expenditures, an area that is systematically overlooked by other legislations and which constitutes a fertile route for corruption and malpractice in the private sector. The law also requires information by destination, thus potentially enabling the regulator to track transaction originating or destined to secrecy jurisdictions. There has been a push back by US corporations claiming that they are put at a disadvantage relative to non-US competitors which do not have to abide by similar stringent regulations. But the hope is that the legislation will put pressure on governments of other developed countries to follow suit and enact similar comprehensive anti-corruption regulations, as has been done by the United Kingdom through its Bribery Act 2010 (Table A1).

Major NGOs have played a key role in promoting the adoption and implementation of these global provisions against private sector corruption. In particular, the Publish What You Pay campaign has been a key champion of the fight against corporate corruption and for the advancement of the interests of developing countries. The Publish What You Pay campaign was funded by UK NGOs and the George Soros' Open Society Institute. It now includes NGOs from 60 countries and is active in African countries. The Revenue Watch Institute, also sponsored by George Soros supports local advocacy on transparency in extractive sectors. Other global NGOs promoting transparency in the natural resource sector include Save the Children, Catholic Relief Service, Christian Aid, and Partnership Africa Canada. They continue to push for full disclosure of information on transactions related to the resource sector, including through stock exchange regulators and export credit agencies.

In the second cluster of legislations, emphasis is on combating tax evasion, money laundering and illicit financial flows in general as well as stolen asset recovery. This category includes the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, which evolved from the G20 call in 2004 to urge all jurisdictions to fully implement the international standards on transparency and exchange of information for tax purposes. Today the Forum includes 92 countries, but industrialized countries are the most active. African resource-rich countries could benefit from participation in the Forum; but as of now only three resource-rich countries participate (Ghana, Liberia and Nigeria).

In the same category there is the African Tax Administration Forum, an OECD-sponsored initiative to promote tax administration in Africa, including tracking and preventing transfer pricing. While ATAF has substantial potential to help African countries build stronger and more transparent tax systems and to maximize their tax revenue especially from resource sectors, the Forum has important weaknesses that limit its effectiveness. Most importantly, ATAF operates on the basis of the “arm’s length principle” and arbitrary allocation of costs (Le Billon 2011; Clausing and Avi-Yonah 2007).

Another major initiative with great potential impact on corporate practices in the areas of tax and money laundering is the US-based Financial Accountability and Corporate Transparency coalition launched in 2006 by 26 CSOs. The changes advocated by the CSO coalition which should apply to all US-listed companies have strong implications for companies operating in Africa. The coalition calls for: companies, trusts, foundations, and even charities to make available to law enforcement agencies and the public all ownership information that specifically indicates who controls the entities; country-by-country reporting of sales, profits, and taxes paid in all jurisdictions by all multinational companies; strengthening, standardizing and enforcing anti-money laundering laws; eliminating loopholes in the tax system to ensure that corporations pay their fair share of taxes. This is an important instrument that can help African countries increase their revenue mobilization from multinational companies operating on the continent.

A potentially powerful innovation in anti-corruption legislation is the US Foreign Corrupt Practices Act, which has made a substantial impact on the awareness of the private sector regarding corruption in domestic and foreign markets. It represents a major opportunity for African countries to leverage the political will of the US and its investigative and prosecutorial capacity to enforce transparency and fair play by foreign corporations operating in the continent. Under this legislation, corruption cases have already been prosecuted and penalties charged on US companies operating in the oil and gas sector in Nigeria. Obviously this is only the beginning and more needs to be done. But the legislation offers an opportune framework for all African countries to jump on the bandwagon and leverage the international momentum in the fight against private sector corruption. An important weakness of this US legislation, however, is that penalties levied on offenders are paid to the US only while African countries are not compensated for the economic costs associated with corruption by US corporations. This is an issue that African governments should take up with the US government.

### ***Country-by-Country Reporting***

The rampant private sector corruption in the form of trade mispricing, transfer pricing, tax evasion and other unethical corporate behavior is perpetuated in major part by inadequate flow of information across countries. Legislations are uneven and so is their enforcement. Thus corporations are able to hide behind the wall of information imperfections to game the system and perpetuate business malpractices. A key culprit is the lack of disaggregation of information on corporate operations, especially at the country and sector level. As a result, there has been a strong call to require companies to report on their transactions including profits, charges, and tax payments and liabilities on a country by country basis.<sup>23</sup> Today, a large and growing fraction of

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<sup>23</sup> Country by Country Reporting (CbCR) was first proposed by Richard Murphy of the Tax Justice Network. For details on the CbCR, see Tax Justice Network ([www.taxjustice.net](http://www.taxjustice.net)).

global trade takes place within corporate groups. This makes it incredibly difficult to track transactions when reports are disaggregated only at company level. Country by Country Reporting requires that each corporation reports systematically on the following (www.taxjustice.net):

- The name of each country in which it operates;
- The names of all its companies trading in each country in which it operates;
- Financial performance in every country in which the company operates, including:
  - o Sales, both third party and with other group companies;
  - o Purchases, split between third parties and intra-group transactions;
  - o Labour costs and employee numbers;
  - o Financing costs split between those paid to third parties and to other group members;
  - o Pre-tax profit;
- Tax charges included in company accounts for the country in question;<sup>24</sup>
- Details of the cost and net book value of physical fixed assets located in each country;
- Details of gross and net assets for each country in which the corporation operates.

Country by country reporting is a major innovation that would highly benefit African countries. It is in their best interest to support it.

### ***Stolen asset recovery***

In addition to combatting corruption and tax evasion, African countries also need to devote efforts to recover the proceeds of corruption that are hidden abroad in secrecy jurisdictions and disguised in various kinds of assets in financial centers. The Stolen Assets Recovery initiative of the UN and the World Bank was set up explicitly to achieve this goal. While developing countries as a group lose an estimated \$20-40 billion due to corruption every year, only \$50 billion have been recovered over the past 15 years (StAR 2011). Asset recovery efforts are hampered by a number of barriers ranging from institutional constraints, legal barriers, operational barriers and communication issues. A key institutional barrier is the lack of political will; that is the lack of “a comprehensive, sustained, and concerted policy or strategy to identify asset recovery as a priority and to ensure alignment of objectives, tools, and resources to this end” (StAR 2011: 2).

Legal barriers include onerous requirements to the provision of mutual legal assistance; excessive banking secrecy; slow and inefficient asset confiscation procedures; and burdensome procedural and evidentiary laws, including the need to disclose information to asset holders during investigations. There is a need for concerted international efforts to put sustained pressure on banks to provide information on large asset holders especially politically exposed persons (PEP). This must be part of agreements for automatic exchange of tax information. Inadequate

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<sup>24</sup> Further detailed information on tax charges would be required: (1) The tax charge for the year would be split between current and deferred tax; (2) The actual tax payments made to the government of the country in the period; (3) The liabilities (and assets, if relevant) owed for tax and equivalent charges at the beginning and end of each accounting period; (4) Deferred taxation liabilities for the country at the start and close of each accounting period (www.taxjustice.net).

skills and capacity also hampers progress in asset recovery. Thus, there is a need for substantial investments in the training of all parties involved in asset recovery as well as funding for operational needs of asset recovery units at national level. Moreover,

#### 5.4 Lessons learned and best practices

The rise in global awareness about private sector corruption presents a unique opportunity for African countries to leverage the momentum to advance the national efforts to combat bribery, tax evasion, money laundering, illicit financial flows, and unfair competition in the private sector. While some improvements can be noted, there is still a long way to go. Progress will still be hampered by structural and procedural weaknesses in the design and implementation of anti-corruption legislations and processes. The following merit special attention on the part of African governments and their partners in the international community.

- 1) Voluntary adhesion: in most continental and international anti-corruption frameworks, adhesion by countries and corporations is voluntary and in some cases, companies have large degrees of freedom in the nature and extent of information that they must file with the regulator. This undermines enforcement of the legislations. Relying on the countries' and companies' goodwill is problematic. Profit maximizing companies will seek to exploit all opportunities for tax dodging and unfair competition whenever there are no strict rules in place. Similarly, relying on peer pressure for countries to comply with anti-corruption prescriptions is ineffective.
- 2) Low involvement of and backing by the business community in Africa and abroad: Thus far, anti-corruption efforts have been led by governments and civil society organizations. The private sector has been largely on the sidelines, mostly taking a defensive position, which is rather unfortunate. Going forward, African governments and their development partners should seek effective participation of private sector bodies such as the chambers of commerce in the design and monitoring of legislations and procedures aimed at combatting private sector corruption.
- 3) Lack of harmonization of regulations and enforcement rules across countries within Africa and between African countries and their counterparts in the rest of the world: Enforcement of legislations and conventions against private sector corruption is hindered by the lack of harmonization of regulations and rules across countries. This not only slows down investigations and prosecution of offenses, but it also provides private sector actors with an opportunity to “game the system” and get away with corruption, bribery, and tax evasion. Harmonization of anti-corruption process must rise much higher on the agenda of both national policy and international cooperation.
- 4) Weak investigative and enforcement capacity in African countries: Detecting corrupt acts in the private sector requires efficient information systems and adequate human and financial capacity, which are lacking in most African countries. The business world is constantly a step ahead of the public sector in terms of information technology, creative innovations, and financial engineering. This makes it difficult for regulatory agencies to detect, track, and prosecute violations of the rules in the private sector. The issue is further magnified by the expansion of the use of safe havens or secrecy jurisdictions by multinational corporations operating in Africa. This blurs the origins and destinations of transactions. Furthermore, the sheer volume of transactions in some sectors such as

natural resources, and the increasing sophistication of the nature of products and services – such as in the banking sector – make it even more difficult for African governments to be on top of the game in the areas of monitoring of business practices. It has also been noted that regulations pertaining to private sector corruption in African countries are not robust enough to deter corruption. For example, Ghana’s law on transfer pricing is “too general and scanty” as noted by government officials interviewed by Action Aid (Action Aid 2010). This is one of the reasons why multinational corporations are able to manipulate their records to minimize their tax liabilities.

- 5) Delicate balance between attracting foreign investment and enforcing transparency, tax compliance, and revenue maximization: In their effort to increase private capital inflows, African countries use their tax systems to entice private investors through low profit tax rates, generous tax holidays, and other fiscal advantages. In addition to creating an uneven competitive environment at the disadvantage of domestic investors, these measures undermine revenue mobilization. African countries are caught in a quandary whereby multinational companies exhibit red financial balances due to tax evasion as a basis for claiming for tax breaks. The question one may ask is why companies that are losing money in a sector would continue to put more capital in the sector. More than likely, African countries are being short changed in their dealing with multinational corporations.
- 6) Asymmetries in the prosecution and punishment of corrupt practices: Traditionally the prosecution of corruption has exhibited two forms of asymmetries. First, in the event where corruption involves an African government official and an international private operator, the law has hit the African party while leaving the external co-conspirator free. The recent changes in anti-corruption legislations in the US and the UK are attempts to reverse this tradition. Secondly, in the prosecution of corruption offenses by foreign companies, penalties are collected by the country of matriculation of the company. African countries receive no compensation for the illegal and illicit practices by foreign companies. African governments need to negotiate with their developed country counterparts to ensure that they are fairly compensated for the damages resulting from unethical business practices by foreign companies operating on the continent.

## 6 Conclusion and recommendations

The analysis in this paper documented a rising momentum in the international arena in the fight against and prevention of private sector corruption. An encouraging development is the treatment of corporate sector corruption as both a domestic and an extra-territorial problem that is prosecuted and punished beyond national borders. Thus offenses committed by US and UK corporations abroad are punishable through national anti-corruption legislations. Important revisions have been brought to old legislations to give them a more prominent focus on extra-territorial corruption and to equip them with more teeth in the prosecution of corruption. This new brand of legislations presents a great opportunity for African countries to advance their anti-corruption agenda.

While some progress has been recorded in raising the profile of anti-corruption agenda in Africa, the focus thus far has been on public sector corruption. It is time to broaden the focus to include

corporate sector corruption. With the increasing presence of multinational corporations in Africa's resource, manufacturing, and service sector, it is critically important that African countries pay serious attention to private sector corruption. The consequences in terms of lost tax revenue, foregone domestic investments and employment, as well as the erosion of business ethics are high and are likely to rise unless concerted efforts are made to establish and enforce effective anti-corruption legislations targeting the private sector.

The discussion in this paper suggests a number of actionable policy recommendations that may advance the agenda of combatting and preventing corruption and malpractice in the private sector and overall corruption in general in African countries. The following are ten policy recommendations, organized at three levels: national policy level, corporate policy level, and global policy level.

### ***Corporate policy level***

#### ***Recommendation 1: Promoting transparency as a 'natural sanction' through a culture of full information disclosure***

The overarching objective of the anti-corruption agenda focused on the private sector is to promote and consolidate a culture of full information disclosure as a mechanism of corporate discipline, or a 'natural sanction'. In this regard, private firms should emulate the practice in multinational development banks of establishing *corporate information disclosure policies* that are developed in a transparent and participatory fashion with the involvement of employees, shareholders, as well as outside stakeholders (civil society and consumer associations). The mandate of full information disclosure derives from the social corporate responsibility impacted on all private firms as a result of the importance and impact of their activities on the social wellbeing of the entire community. Transparency will serve not only the firm's bottom line but also the national development agenda by fostering an efficient, competitive and stable business sector.

#### ***Recommendation 2: Institutionalization of verifiable and enforceable codes of good conduct***

While external mechanisms of corporate responsibility and accountability are important, these should be supported by strong internal mechanisms of good behavior of management and employees. Thus, in all African countries, legislations governing private sector activities should include provisions requiring all private firms to design and implement modern codes of conduct enshrined in the principles of transparency, accountability, and social responsibility. These codes should include provisions for systematic reporting and periodic independent reviews of their implementation as well as space for input and feedback from employees and other stakeholders. These reports should be filed on a regular basis – at least semi-annually – with the relevant office of the government ministry in charge of commerce.

#### ***Recommendation 3: Promoting ethical business Standards: establish an African Code of Internal Integrity Management Standards of the Private Sector***

The internal processes of good corporate conduct described in recommendation #2 should be supported by a sector-wide instrument aimed at promoting ethical business standards: an *African Code of Internal Integrity Management Standards of the Private Sector*. This instrument will provide detailed guidelines that form the benchmark for internal company rules of good conduct while also serving as a reference for regulatory agencies to assess compliance by individual companies. This instrument will further serve as a stamp of good behavior at national level, which would contribute to improving the image of the country internationally.

### ***National policy level***

#### ***Recommendation 4: Establishing, implementing and enforcing national competition policy***

A key element of any national strategy to combat and prevent corporate sector corruption is a comprehensive national competition policy. In countries where such a policy does not exist yet, this should be a priority immediately. In countries where there is already a national competition policy, authorities should undertake a comprehensive review of the policy to assess its effectiveness thus far in preventing and combatting private sector corruption. A national commission including representatives of relevant government regulatory agencies, members of the civil society, and representatives of the business sector should lead the review and revision of the competition policy. The commission's mandate will be to propose a clear and practical recommendations on improvements in the policy regarding the design, implementation and enforcement.

#### ***Recommendation 5: Establishing and strengthening Financial Intelligence Units (FIUs)***

Tracking and prosecuting corrupt transactions including tax evasion and illicit financial flows requires an effective information system and competent expertise within government. In the post-911 era, Financial Intelligence Units have proven effective in tracking illicit financial flows. In African countries where such units do not exist, governments should consider this as a priority and set target timelines for the establishment of such units. In countries where the FIUs exist, governments should commit to a periodic review of their performance and effectiveness. They also need to commit adequate resources for training and continuing education of FIU staff to keep up with developments in investigation technologies. In this regard, Africa's development partners should commit resources to assist African countries to establish and provide adequate capacity to FIUs. Moreover, FIUs are useful only if the tracking and reporting of suspicious transactions is done systematically and without any bias. However, FIUs need to strike a balance between reporting and the quality of information, and especially avoid the "crying wolf" trap. Furthermore and very importantly, FIUs should avoid politicization of anti-corruption tracking, which has damaged the reputation of anti-corruption agencies in some African countries where such agencies have been used by politicians to settle scores against their political enemies or inconvenient corruption watchdog agents.<sup>25</sup>

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<sup>25</sup> A good example of this problem is the notorious case of John Githongo in Kenya, who after 3 years as Permanent Secretary for Ethics and Governance in the Office of the President, was forced to resign due to lack of support and frustration. See Michela Wrong (2009).

### ***Recommendation 6: Increasing the role of private sector representation in the anticorruption agenda***

Going forward, African governments should foster higher and more systematic involvement of private sector bodies in the design, implementation, and monitoring of legislations aimed at fighting private sector corruption. Thus far the private sector has been on the sidelines, and this hampers ownership and compliance on the part of the corporate sector. African governments should seek to develop a culture of collaboration rather than antagonism between the public sector and the private sector. Chambers of Commerce need to play a more active role in promoting ethical rules of conduct in the corporate sector, including by facilitating the sharing of information and experience within the private sector and learning from external experiences.

### ***Recommendation 7: Undertaking national debt audits***

As discussed in this paper, one of the major symptoms of corruption in African countries is the financial hemorrhage from capital flight, resulting partly from embezzlement of externally borrowed funds. Therefore, as part of the strategy to combat capital flight, African countries should undertake systematic audits of national debts to establish the origin and utilization of external debts so as to assess their legitimacy. Then African governments should only honor legitimate debts while repudiating debts that are found to be “odious” (Ndikumana and Boyce 2011). They can learn valuable lessons from countries such as Ecuador which has successfully completed the process of debt audits. Norway is currently championing debt audits on the donor side, which will complement debt audits on the recipient side. Through debt audits and the resulting repudiation of “odious debts”, African countries will be doing justice not only to their populations and future generations, but also to the world community as more responsible lending and management of debts would pave the way to a more sustainable and crisis-free global financial system.

***Recommendation 8: Strong involvement of civil society:*** In line with the need to promote transparency as a means of fighting corruption, civil society organizations (CSOs) will have a major role to play as they serve as the eyes and ears of the public. CSOs help enforce discipline and accountability on private operators as well as transparency in the interface between the public sector and the private sector. Hence, the anti-corruption agenda must include the promotion of a vibrant and independent civil society.

### ***Global level policy***

### ***Recommendation 9: Establish Country by Country Reporting and automatic exchange of tax information as a systematic requirement***

Country by Country Reporting has potentially high rewards for African countries as it will enable tax authorities and regulatory agencies to correctly assess tax liabilities of all multinational corporations operating on African soil. All African countries individually and collectively should strongly support international efforts to establish country by country reporting and automatic exchange of tax information as a systematic requirement for corporate reporting in all countries.

### *Recommendation 10: Increasing knowledge generation and capacity building on anti-corruption in African countries*

While anti-corruption has been elevated on national and international policy agenda, information on the mechanisms, scope, magnitudes and impact of private sector corruption is still scanty. African governments should commit more resources to capacity building and knowledge generation in this area. Africa's development partners are called to allocate additional resources (beyond current aid commitments) to research and capacity building in relation with private sector corruption. The priority should be on country specific studies, studies on selected high-risk sectors (natural resources, banking, and manufacturing), training for officials of tax authorities and regulatory agencies in charge of legislations that directly or indirectly relate to private sector corruption. Scaling up allocation of resources to support the anti-corruption agenda will advance the overall aid effectiveness agenda while contributing to building a more competitive, transparent and productive private sector as a foundation for accelerating economic development in Africa.

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