The Effects of Corruption Control, Political Stability and Tax Level on Illicit Financial Flows from African Countries

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Abstract
This paper examines the effect of corruption control, political stability and tax rate on illicit financial outflows for African countries based on a balanced panel data for 32 countries covering the period 2005-2014. The empirical evidences support the hypotheses that illicit capital outflow reduces with higher political stability and corruption control but it increases with tax rate. More specifically, the regression estimates reveal that a unit increase in political stability and corruption control reduce illicit financial outflow by an average of US$ 27.5 million and US$ 21 million respectively. Likewise, the empirical results show that a one percentage increase in tax rate reduces illicit financial outflow by an average of 35.8 million. The major recommendation underlines that governments in Africa countries must strengthen institutions responsible for fighting corruption, tax evasion and enhancing political stability and good governance infrastructure.

Keywords: Corruption, political stability, tax rate, illicit financial outflow, Africa

I. General Background

Illicit financial Flows (IFF) is defined as 'cross-border transfers of funds that are illegally earned, transferred, or utilized' (GFI, 2013a). It should be recognized at the outset that illicit flows differ from the broadest definition of capital flight which also includes "normal" or "legal" outflows due to portfolio choices. GFI (2016) defines such flows as illicit if the funds crossing borders are illegally earned, transferred, and/or utilized. IFF to take the form of currency smuggling, over invoicing of imports and under invoicing of exports, declaration of un-existing foreign debts, kickbacks in foreign contracts, oversees investments from drug trafficking, corruption, illicit activities related to tax evasion and exchange rate controls (Vukenkeng and Mukete, 2016).

There is a general consensus that these flows not only surpass official development assistance, but even the sum of those aid flows and foreign direct investment (OECD, 2013). It is estimated that for every euro of development assistance as much as nearly 10 euros flows illegally out of the developing countries (Purje et al, 2010). GFI (2016) estimates that each year approximately $1 trillion flows out of the developing and emerging economies illegally. This sum exceeds the total amount that these countries receive yearly from Foreign Direct Investments (FDI) and aid.

Coming to Africa, Illicit Financial Flows (IFF) to and from African countries presents a stunning paradox. On the one hand, African countries are heavily indebted and must make difficult decisions with regard to the allocation of national resources between debt payments and provision of vital social services to their populations. On the other hand, African countries have experienced massive outflows of private capital towards western financial centers. Indeed, these private assets surpass the continent's foreign liabilities, ironically making sub-Saharan Africa a "net creditor" to the rest of the world (Boyce and Ndikumana 2001).

It is obvious that the people benefiting from capital flight are the elites who engage in trade mispricing of imports and exports or those who have the power to unlawfully appropriate and transfer resources abroad. Even in countries where capital flight is mainly driven by portfolio considerations, it is the wealthy who benefit as they have access to foreign investment instruments that average citizens do not (AfDB et al., 2012). As can be shown in Figure 1, illicit financial flows often involve legally questionable practices, including the falsification of trade documents (trade misinvoicing), the embezzlement of export revenues, and kickbacks on public and private sector contracts (Ndikumana and Boyce, 1998).

The main reasons for continuing capital flight are illicit motives such as tax evasion and the concealment of corruption (Ndikumana, (2013). Generally, most of the studies show that capital flight from developing countries depends, inter alia, on currency exchange risks, perceived growth opportunities, government instability, the danger of civil strife, and various other political risks (Lensink et al., 2000; Collier et al., 2001, Le and Zak, 2006).

Figure 1: Illicit Financial Outflow from African Countries
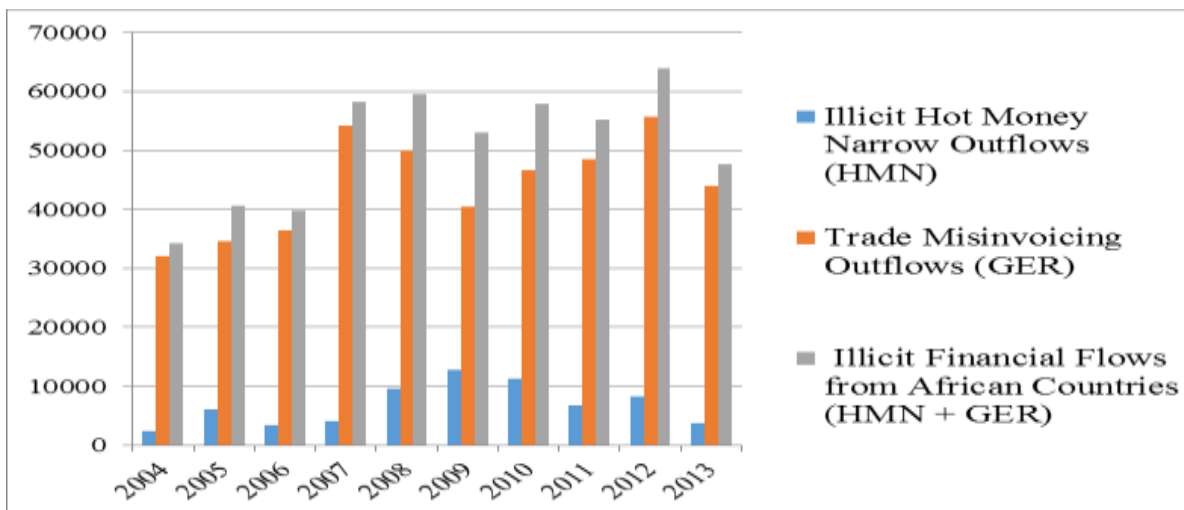
II. Overall Objectives

The *overall objective* of this study is to thoroughly examine the explicit effects of corruption control, political instability and tax evasion on illicit capital flows from African countries based on a panel data of 32 countries from 2004 to 2013. Thus, this study is expected to contribute to add knowledge in the field. Accordingly, an attempt has been made to answer the following key policy questions.

III. Research Questions

(a) What are exactly the explicit effects of corruption control, political instability and tax level on illicit financial outflows under the context of African countries?

(b) Other than corruption, political instability and tax level, what other factors may cause the differences in illicit financial outflows from African countries?

(c) What makes some countries more prone to illicit financial outflow than others?

IV. The Data and Stylized Facts

This study has made an intensive empirical analysis for a panel of 32 countries from Africa for the years 2004 to 2013. We only included countries for which complete data was available for all factors, and hence list of countries are shown in Table I. Moreover, the independent variables were identified based on economic theories and previous empirical works.

Table 1: Countries included in the study

Number	Country	Number	Country	Number	Country
1	Algeria	12	Egypt, Arab Rep.	23	Mauritius
2	Angola	13	Ethiopia	24	Morocco
3	Benin	14	Gabon	25	Mozambique
4	Botswana	15	Gambia	26	Rwanda
5	Burkina Faso	16	Ghana	27	Senegal
6	Burundi	17	Guinea-Bissau	28	Sierra Leone
7	Cameroon	18	Kenya	29	South Africa
8	Central African Republic	19	Lesotho	30	Tanzania
9	Chad	20	Madagascar	31	Uganda
10	Congo, Rep.	21	Malawi	32	Zambia
11	Cote d'Ivoire	22	Mali		

V. Model and Estimation Methods

Since panel data was used for the analysis, we explored the appropriateness of both random and fixed effect models by conducting the Hausman post estimation test. The null hypothesis of the Hausman test is that individual effects are uncorrelated with any regressor in the model against the alternative hypothesis that individual effects are significantly correlated with at least one regressor in the mode (Hausman, 1978). Accordingly, it has been found that probability values of the Hausman tests are insignificant and this implies that the random effect estimates must be preferred to those of the fixed effect. As a result, we specify the random effect model as:

$$IFO_{it} = \alpha_{0 +} B_1 X_{it} + Z_{it} + + \mu_{it} + \varepsilon_{it} \tag{1}$$

Where i indexes the countries under study, t denotes the year, α_0 is the constant term, μ_{it} is the between entity error, and ε_{it} is the within entity error. Similarly, B_1 is the vector of the coefficients and X_{it} is the vector of the explanatory variables including the variables of interest (control of corruption, political stability and tax rate) and Z_{it} represents the set of control variables including inflation, degree of openness, etc., as mentioned in table 2. From equation 1, the empirical estimation model can be specified as:

$$IFO_{it} = \alpha_0 + \beta_1 Ccontrol_{it} + \beta_2 Pstability_{it} + \beta_3 TaxRate_{it} + \beta_4 INFL_{it} + \beta_5 Openess_{it} + \beta_6 Debt_{it} +$$
$$\beta_7 Credit_{it} + \beta_8 Saving_{it} + \beta_9 Income/capita_{it} + \beta_{10} GDP Growth_{it} + \mu_{it} + \varepsilon_{it} \tag{2}$$

Where; $\beta_1 < 0, \beta_2 < 0, \beta_3 > 0, \beta_4 > 0, \beta_5 > 0, \beta_6 > 0, \beta_7 > 0, \beta_8 < 0, \beta_9 < 0$ and $\beta_{10} < 0$

VI. Regression Results and Main Findings

The empirical results using Random Effect Model (REM) with heteroscedasticity corrected standard errors are presented in Table 2. Accordingly, the evidences support the hypotheses that illicit capital outflow reduces with higher political stability and corruption control but it increases with tax rate. More specifically, the regression estimates reveal that a unit increase in political stability and corruption control reduce illicit financial outflow by an average of US$ 27.5 million and US$ 21 million respectively. Likewise, the empirical results show that a one percentage increase in tax rate reduces illicit financial outflow by an average of 35.8 million. The study also confirms that increase in inflation and trade openness significantly and positively trigger illicit financial outflows while increase in income per capita and annual GDP growth reduce illicit financial outflow. The major recommendation underlines that governments in Africa countries must strengthen institutions responsible for fighting corruption, tax evasion and enhancing political stability and good governance infrastructure.

Table 2: Regression results using REM and the dependent variable IFF has been captured with three different variables scenarios.

Variable	Illicit hot money narrow outflows (HMN) (1)		Trade misinvoicing outflows (GER) (2)		Illicit financial flows (HMN + GER) (3)	
	Coef/SE.	P > |Z|	Coef/SE	P > |Z|	Coef/SE.	P > |Z|
Control of corruption	-12.63 (2.41)	0.01***	-21.96 (9.85)	0.03**	-20.98 (10.70)	0.05**
Political stability and absence	-18.57 (8.15)	0.02**	-32.29 (13.34)	0.02**	-27.48 (14.85)	0.09*
Tax rate (% of comercial profits)	9.16 (3.43)	0.01***	16.68 (8.41)	0.03**	35.82 (16.05)	0.04**
Inflation (CPI)	0.07 (0.02)	0.00***	0.25 (0.14)	0.09*	43.42 (14.96)	0.00***
Degree of Openness	10.42 (5.25)	0.06**	16.94 (8.65)	0.05**	13.69 (7.12)	0.07*
External debt stock of GNI	-0.79 (1.07)	0.46	3.67 (2.49)	0.14*	3.54 (2.91)	0.22
Domestic Credit	-23.3 (33.3)	0.48	40.40 (14.24)	0.01***	34.32 (16.34)	0.03**
Saving	-19.6 (53.0)	0.71	-12.73 (14.85)	0.39	-14.08 (17.33)	0.42
Income/Capita (PPP)	-3.4 (0.8)	0.00***	-7.56 (5.77)	0.19	-12.81 (6.31)	0.04**
Annual GDP growth	-0.27 (0.07)	0.00***	-1.74 (1.67)	0.29	-23.85 (19.46)	0.22
Constant	-21.8 (5.7)	0.00	-73.34 (34.59)	0.10	-11.04 (4.87)	0.02
Number of observ.	320		320		320	
Number of groups	32		32		32	
Observation per group	10		10		10	
Wald chi2(9)	29.35		32.83		27.14	
Prob > chi2	0.001		0.0003		0.002	
R-sq: overall	0.208		0.182		0.187	

Note: *, **, and *** represent statistical significance at 10%, 5%, and 1%*

VII. Conclusion and Policy Suggestions

This study analyzed the effects of corruption control, political stability and tax level on cross-country differences in illicit financial outflows (IFF) among African countries. Accordingly, the empirical results from this study supports the hypotheses that corruption control and political stability reduces illicit capital

outflow, while high tax rate increases illicit financial outflows. The study also confirms that increase in inflation and trade openness significantly and positively trigger illicit financial outflows while increase in income per capita and annual GDP growth reduce illicit financial outflow. The major recommendation underlines that governments in Africa countries must strengthen institutions responsible for fighting corruption, tax evasion and enhancing political stability and good governance infrastructure.

In line with this, as tax evasion is a major driver of the underground economy, efforts to expand the tax base and improve tax collection can be expected to curtail illicit flows. Likewise, more efforts should be undertaken in creating more stable macroeconomic and institutional environment so as to develop strong confidence for local as well as foreign investors.

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