SPEED – Support Program for Economic and Enterprise Development

ILLICIT FINANCIAL FLOWS AND THE CASE OF PIGEON PEAS

Note[1]

One if the issues described as the basis for the decision to introduce a surcharge on the export of pigeon peas is that companies are declaring a purchase price on export lower than the price which they have paid to producers, and lower than the global pigeon pea commodity price. This type of action is likely to be indicative of misinvoicing and therefore of illicit financial flows.

Global Financial Integrity (GFI) highlights the problems for various developing countries as a result of illicit flows of capital arising from misinvoicing. GFI defines misinvoicing as "the intentional misstating of the value, quantity, or composition of goods on customs declaration forms and invoices, usually for the purpose of evading taxes or laundering money". Usually the transaction takes place with the knowledge of the buyer and the seller.

Misinvoicing can take place on imports or exports and can involve over or under invoicing. The benefits of each to those involved are:

- Export under-invoicing: avoid corporate profit tax in country of origin, balance of foreign exchange deposited into a foreign bank account;
- Export over-invoicing: extra export credits (where these exist);
- Both types of export: disguise capital flows to avoid foreign exchange controls and anti money laundering rules;
- Import under-invoicing: avoid duties and VAT;
- Import over-invoicing: legitimise sending out foreign exchange, reduce corporate taxes

Misinvoicing is technically a form of smuggling, based on manipulating documents presented to customs, banks and other institutions in order to misrepresent the quantity, quality, type or value of goods moving across borders.

GFI finds that "cumulative gross illicit flows from trade misinvoicing through Mozambique amounted to $5.27 billion over the nine-year period 2002–2010. Average annual illicit flows were $585 million, which represents a massive 8.9 percent of annual average GDP over the same period". The study finds that both under-invoicing on exports and over-invoicing on imports are basically equivalent, but are used for different purposes at different times. The study estimates that in the period analysed 9% of annual imports are under-invoiced and the

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annual tax loss to government is estimated at $187 million per year. To put this in perspective in 2010 the government spent around $222 million on social expenditure. The lost of tax revenue would therefore have had a potentially massive impact on the fight against poverty.

The government introduced the Janela Unica customs system in late 2011. Trade figures from 2011 – 2013 have not yet been analyzed, which is somewhat surprising given the new electronic system, which should improve the quality and availability of data. It is expected that this system will begin to support efforts to bring misinvoicing under control. However without access to data it is not yet possible to determine if this is happening.

At the same time Mozambique's trade profile is likely to change dramatically over the short to medium term as coal and gas exports grow, and the import of goods and services required to service these industries also grows. There is however a need to ensure that the existing control systems are adequate to managing this growth and to responding to the challenge of reducing misinvoicing.

While Mozambique is a member of EITI (Extractive Industries Transparency Initiative) and has signed up to anti money laundering peer review mechanisms such as the Eastern and Southern Africa Anti-Money Laundering Group, the legislation required to effectively manage these issues (Law 14/2013 of 12 August – the Law Against Money Laundering and Financing of Terrorism – *Lei de Prevenção e Combate ao Branqueamento de Capitais e Financiamento ao Terrorismo*) has yet to be effectively implemented. The recently introduced Financial Sector Development Strategy also does not address these issues.

It appears that in other countries studied by GFI the introduction of complex computerised trade management systems such as the Janela Unica have not had the desired effect of reducing misinvoicing, a phenomenon which is reportedly growing globally. These systems do not for example reference the prices quoted against international market norms. Customs officers therefore focus on collecting the correct duty payments on what is in front of them, rather than assessing duties based on what the market price should be based on international data. It is important therefore that the customs authority is not only supported in rolling out the new system, but also in maximising its benefits by being able to leverage internationally available and verified data to support analysis of particularly risky types of cargo.

There is also a need for increased cooperation between countries to detect and deter misinvoicing. Transparency and accountability are essential in the fight against smuggling. Having invested in modern customs technology Mozambique could now take the lead with its key trading partners in sharing and requesting information to assist in monitoring trade flows and quoted prices. This could include automatic sharing of tax information with trading partners, and increased transparency about company ownership. At the same time reforms to the financial sector, including implementation of Law 14/2013 should be undertaken to reduce the likelihood of using trade manipulation as a method of money laundering.

Trade misinvoicing is undermining development efforts in Mozambique. It is depriving the government of crucial revenue which could significantly contribute to the fight against poverty. While introducing the Janela Unica and passing Law 14/2013 are significant steps in the fight against smuggling and money-laundering these tools need to be implemented effectively to maximise their impact. At the same time the country needs to focus on increased transparency and information-sharing with trading partners to strengthen its ability to detect irregularities and end a practice which is causing significant damage to the country's progress.

Illicit financial flows are increasingly the focus of the United Nations and African Union with the African Union's High Level Panel on Illicit Financial Flows having recently reported providing a series of recommendations in line with those discussed above.

At no point during the discussion of misinvoicing and illicit financial flows is the introduction of export surcharges recommended as a measure to be used in managing this issue. Indeed the existence of increasingly complex surcharges and taxes is found by both GFI and the AU to increase the likelihood of illicit behavior. Both organizations, supported by the UN recommend increased transparency, openness and simplification in trade procedures in developing countries, reductions in the number of charges and fees and benchmarking of reference prices for commodities using international trade software which is being rolled out globally.

That being said, as regards pigeon peas in Mozambique, there is reasonably small-scale production and exports are by a limited number of companies. This suggests that it should be possible to control any misinvoicing simply by auditing these companies within the scope of the controls available to the Tax Authority. Any company legally licensed to export must be duly tax registered and must therefore have its financial accounts filed in line with Mozambican and international accounting requirements under IFRS or IFRS for small business. Every company so registered in Mozambique must provided documented proof of all purchases and all sales and this must be recorded on approved software with documentary backup available for audit and inspection. It would therefore be simpler, more transparent and less likely to create a precedent detrimental to Mozambique's international trade reputation, to audit the four or five companies which export pigeon peas to determine why they are exporting for a price lower than that which they paid for the raw material, as the government alleges.

In terms of illicit financial flows in general, as the country's economy grows and is increasingly dependent on the export of natural resources and commodities, this issue is one which will be of increasing concern. The government has already taken the first steps by reforming the tax authority and introducing the Janela Unica. It now needs to go further down the road to transparency by ensuring that the overall fiscal and trade systems are sufficiently simple and transparent to ensure that illicit flows can be quickly identified and stopped. The African Union, UN and other organizations stand ready to assist Mozambique in doing this.

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