Illicit Financial Flows in the Mining Sector in South Africa: Implications for Industrialisation

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Abstract

The paper focuses on illicit financial flows in the South African mining sector as a threat to industrialisation by draining the economy of a potentially rich resource, domestic capital, which is required to promote industrial development in the country. Arguably, the capital that illicitly exits South Africa as far as the mining sector is concerned could well be reinvested for further beneficiation /processing of raw materials into intermediate and finished products and in the development of productive capacities in manufacturing or firm expansion. The problem of illicit financial flows is not unique to the South African economy, literature reviewed indicates that countries highly dependent on natural resources are most severely impacted by the problem of illicit financial flows. In South Africa, trade mis-invoicing is found to be the biggest contributor to illicit financial flows in the mining sector, and is likely motivated by a desire for tax evasion. The paper concludes by highlighting mechanisms and programmes required to curb illicit capital flight in the country. These will help to ensure that the surplus generated from the South African mining sector is reinvested back into the economy. To ensure that export trade under-invoicing is restricted, the paper recommends that the South African Revenue Services (SARS) working with International Trade Administration Commission of South Africa (ITAC), have customs personnel with the competencies to evaluate and determine export values or prices of mineral commodities. Furthermore, an examination of how illicit trading impacts on South Africa's trade policy prescriptions or evaluations is also needed - especially because trade policy is widely used as an instrument to promote industrial development.

[1] **NOTE:** This is a revised and updated version of the draft paper that was presented during the TIPS Forum 2016.

1. Introduction

South Africa, similar to many other African countries, has in recent years renewed its commitment to industrial development.[2] The objective is to place the country in a manufacturing-led growth path with a view of employment creation, reduced inequalities and eliminating poverty, and in turn develop the South African economy further. As indicated by, Ramdoo (2015) for those economies highly dependent on natural resources industrialisation is no longer a choice - it is a timely imperative, in particular, in the aftermath of the triple shock of the sharp rise in food prices, in energy prices (until 2014) and due to the 2008/09 global financial and economic crisis that the world economy is yet to overcome. Moreover, the collapse in commodity prices has rendered a majority of economies whose production and exports that continue to be highly dependent on primary commodities vulnerable. But, Ashman, Fine, Padayachee and Sender (2014: 68), tell us that South Africa suffers low levels of domestic investment that is required for there to be any prospect for development policy to be successfully implemented. According to Ashman, et.al, (2014: 69), South Africa fails achieve adequate levels of investment not because of an inadequately generated level of surplus from the domestic economy, but simply due to the high levels of surplus taken out of the country, much of it illegally.

In 2015 the Global Financial Integrity Report ranked South Africa 7th place globally among the top ten source economies for illicit financial flows (IFFs). IFFs are defined as the money that is illegally earned, transferred or utilised (Kar and Spanjers, 2015). IFFs pose intricate development challenges for developing economies. The Report of the High Level Panel on Illicit Financial Flows from Africa, highlights these challenges to include draining scare foreign exchange resources, reducing government tax revenues, deepening corruption, aggravating foreign debt problems and impending private sector development.

The paper thus focuses on illicit financial flows in the mining sector in South Africa as a threat to industrialisation in the country. The mining sector remains critical for a number of African countries - it continues to dominate economic activities with commodities accounting for the

[2] The South African approach to industrial development is set out in the National Industrial Policy Framework (NIPF), and the Industrial Policy Action Plan (IPAP) as the implementing mechanism.

majority of total exports. Consequently, these economies are reliant on successfully mobilising the potentially rich natural resources for their economic development. Instead, many of the countries that are highly dependent on natural resources have been severely affected by the problem of illicit financial flows (IFFs).

The paper is structured as follows. Section 2 contextualises the problem of industrialising in South Africa by reviewing industrial development trends in post 1994. Section 3 discusses linkages in the mining sector that would benefit industrialisation in resource rich countries. Section 4 highlights illicit financial flows in South Africa and the role of the mining sector. Section 5 provides concluding remarks.

2. Contextualising the problem

It is widely agreed that the development of a viable manufacturing sector is essential and key to self-sustaining development of any economy. According to Malan, Steenkamp, Rossouw and Viviers, (2014: 6), industrialisation is a process that is enabled by structural change that is seen to follow three stages. In the first stage the production of primary goods is the dominant economic activity. In the second stage industrialisation takes centre stage by ensuring that manufacturing becomes a source of value to an economy. In third stage the developed economy emerges. Therefore, as stated by Gumede (2015) industrialisation refers to the process of increasing manufacturing output or expanding the manufacturing sector broadly. Roberts (2014: 184), goes further to say that at the core of industrialisation is the development of productive capabilities in manufacturing that would result in increased productivity, quality and design of products. These production capabilities are not simply about acquiring technology or skills, but are to do with the internal know-how of the firm, including routines and working practices, and the linkages within clusters and supply chains (Roberts 2014: 189).

The following subsections review (using statistical data), and briefly explains South Africa's industrial developments trends in post 1994 South Africa by focusing at the performance of the manufacturing sector.

2.1 South African Industrial Developments - Post 1994

First looking at the economic performance of the manufacturing sector in terms of gross domestic product (GDP). Table 1 shows that the share of manufacturing in South African as a percentage of GDP declined from 21.4% in 1995 to 13% in 2015. Notably, in the same period the share of finance in GDP soared from 15.3% in 1995 to 20.9% in 2015. The shift in the performance of the manufacturing sector is an indication of the broader structural changes that have taken place in the South African economy post 1994. [3]

Table 1: Sectoral share in GDP at basic prices (at current prices), 1995 -2015

Sectors	1995	2005	2015
Agriculture, forestry and fishing	3.9	2.7	2.3
Mining and quarrying	6.8	7.3	8.0
Manufacturing	21.4	18.1	13.0
Electricity, gas and water	3.3	1.9	3.6
Construction	3.4	2.9	4.0
Wholesale, retail, motor trade and accommodation	14.4	14.2	15.0
Transport, storage and communication	9.3	10.9	10.0
Finance, real estate and business services	15.3	20.8	20.9
General government services	16.6	14.8	17.4
Personal services	5.6	6.4	5.7

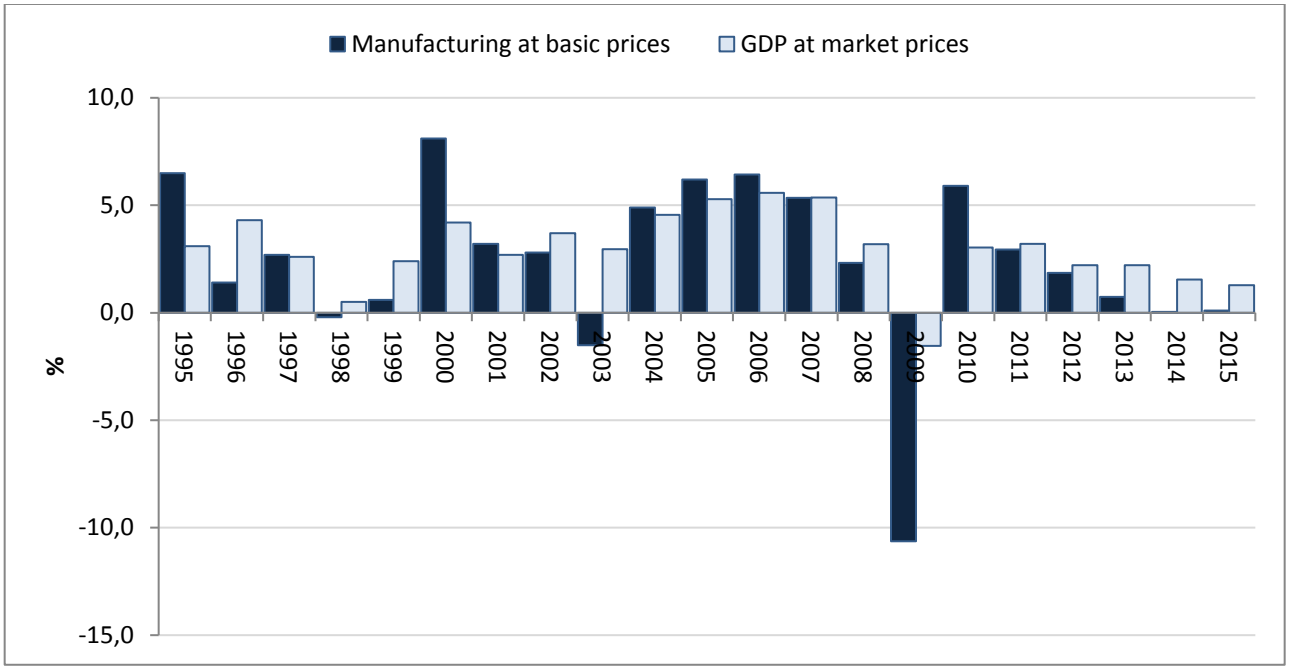
Source: Own calculations, Statistics South Africa data

When looking at how the manufacturing sector has performed in terms of annual growth rates. Graph 1 shows that in the period 1995 to 2007, the average annual real growth rate for the manufacturing sector was 3.6% and only 1.9% in the post-recession period of 2010 to 2015. Graph 1 also shows that during the 2008/09 global financial and economic crisis the manufacturing sector experienced a severe contraction that saw the annual real growth rate

[3] Bhorat, Hirsch, Kanbur, and Ncube (2014: 2) also highlight that the key set of structural shifts that the South African economy has undergone in the post-1994 period are manifest in four key outcomes: the decline of the share of mining in GDP; the stagnation of the manufacturing sector; the rise of the share of finance in GDP; and the subtle increase in the share of transport and telecommunications sector in GDP.

decline by 10.6% in the year 2009, and the recovery to pre- crisis growth rates has been very slow.

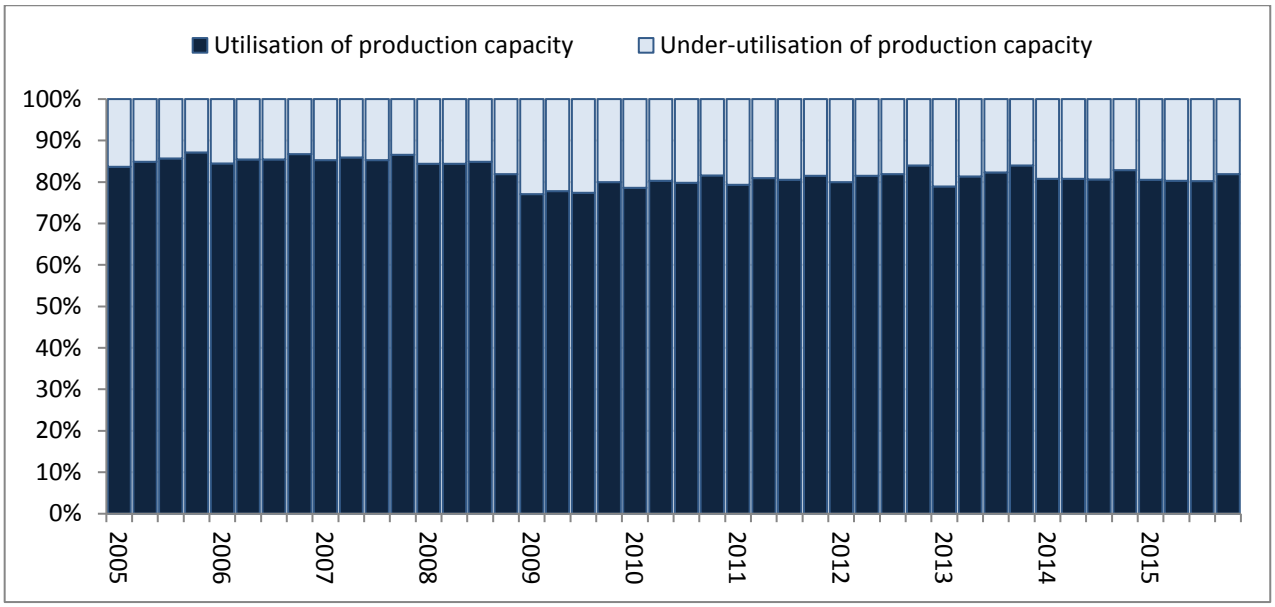
Graph 1: Annual Real Growth Rates (constant 2010 prices), 1995 - 2015



Source: Own calculations, Statistics South Africa data

It is acknowledged that increased productive capacity over time leads to increased levels of output. Thus the degree of production capacity constraint experienced, due to raw materials, labour, or insufficient demand, has a direct impact on production volumes. Graph 2 shows that in the period 2005Q1 to 2015Q4 production capacity utilisation by the manufacturing industry was on average around 82% with under-utilisation averaging a t 18%. According to Statistics South Africa (Stats SA), South Africa's large manufacturers have over the years reported insufficient demand as having a major impact on the capacity constraint experienced by the industry; and labour having the least effect.

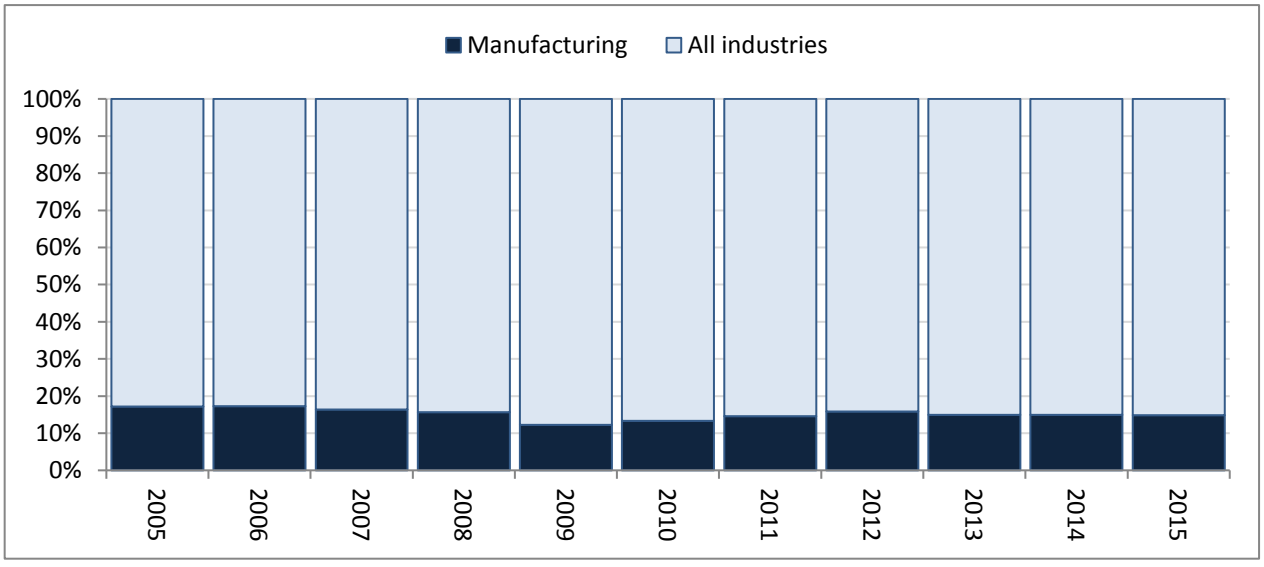
Graph 2: Utilisation of production capacity, 2005 -2015



Source: Own calculations, Statistics South Africa data

For any industry to improve productivity, expand and increase competitiveness, domestic investment is crucial. As shown in graph 3, domestic investment in the South Africa manufacturing sector has over the years remained very low. Of the total Gross Fixed Capital Formation (GFCF), in the period 2005 to 2015, the manufacturing sector accounted for only 19.9% of domestic investment.

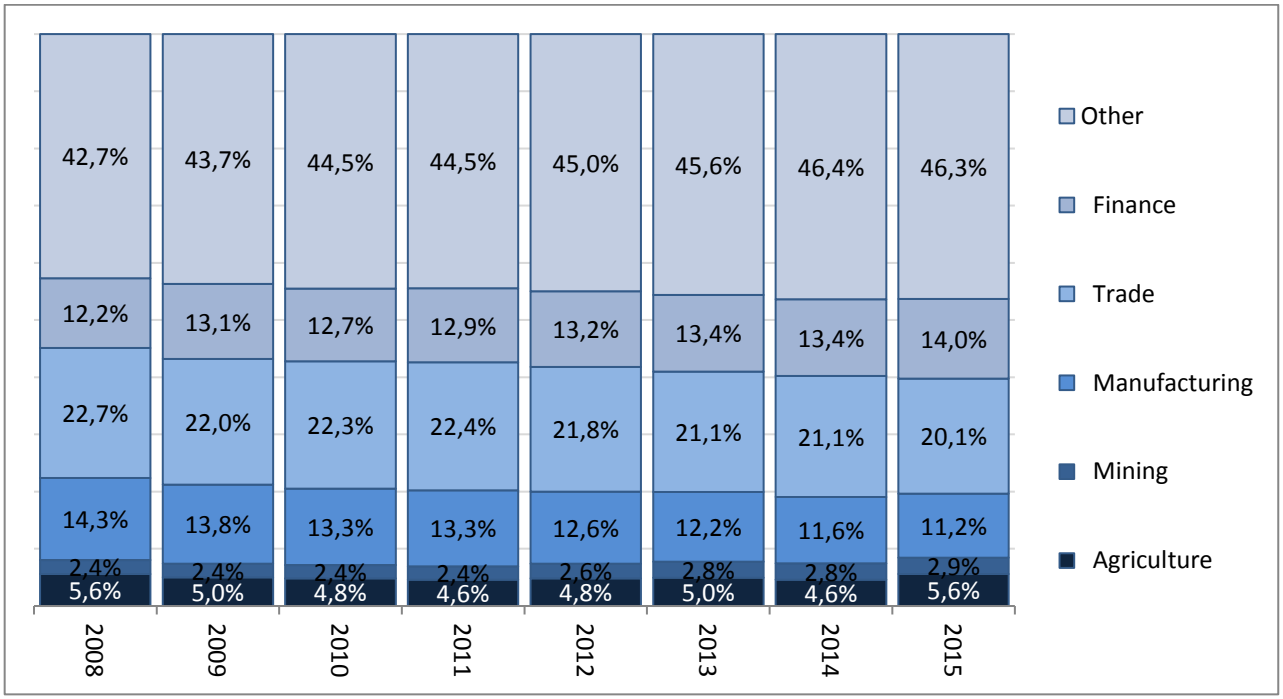
Graph 3: Gross Fixed Capital Formation (Investment), 2005 -2015



Source: Own calculations, South African Reserve Bank data

Employment in the manufacturing sector was also severely affected by the 2008/09 global financial and economic crisis. As seen in graph 4 the share of manufacturing in total employment declined from 14.3% in 2008 to 11.2% in 2015. The manufacturing sector has lost over 131 500 jobs the 2008 to 2015. The sector has struggled to recover its pre-crises employment figures.

Graph 4: Sectoral composition of employment in South Africa, 2008 - 2015



Source: Own calculations, Statistics South Africa data

An overview of industrial developments in the post 1994 South Africa reveal that the country has experienced maajor structural changes, in particular the decline in the performance of the real sector towards financialisation.[4] The South African manufacturing sector is also experiencing a problem of long term low levels of domestic investment. This is of critical concern given that the expansion of firms, as does the entry of new firms require investment, and even a movement towards a more labour-intensive production technology may require additional capital (see, Rankin 2014: 197).

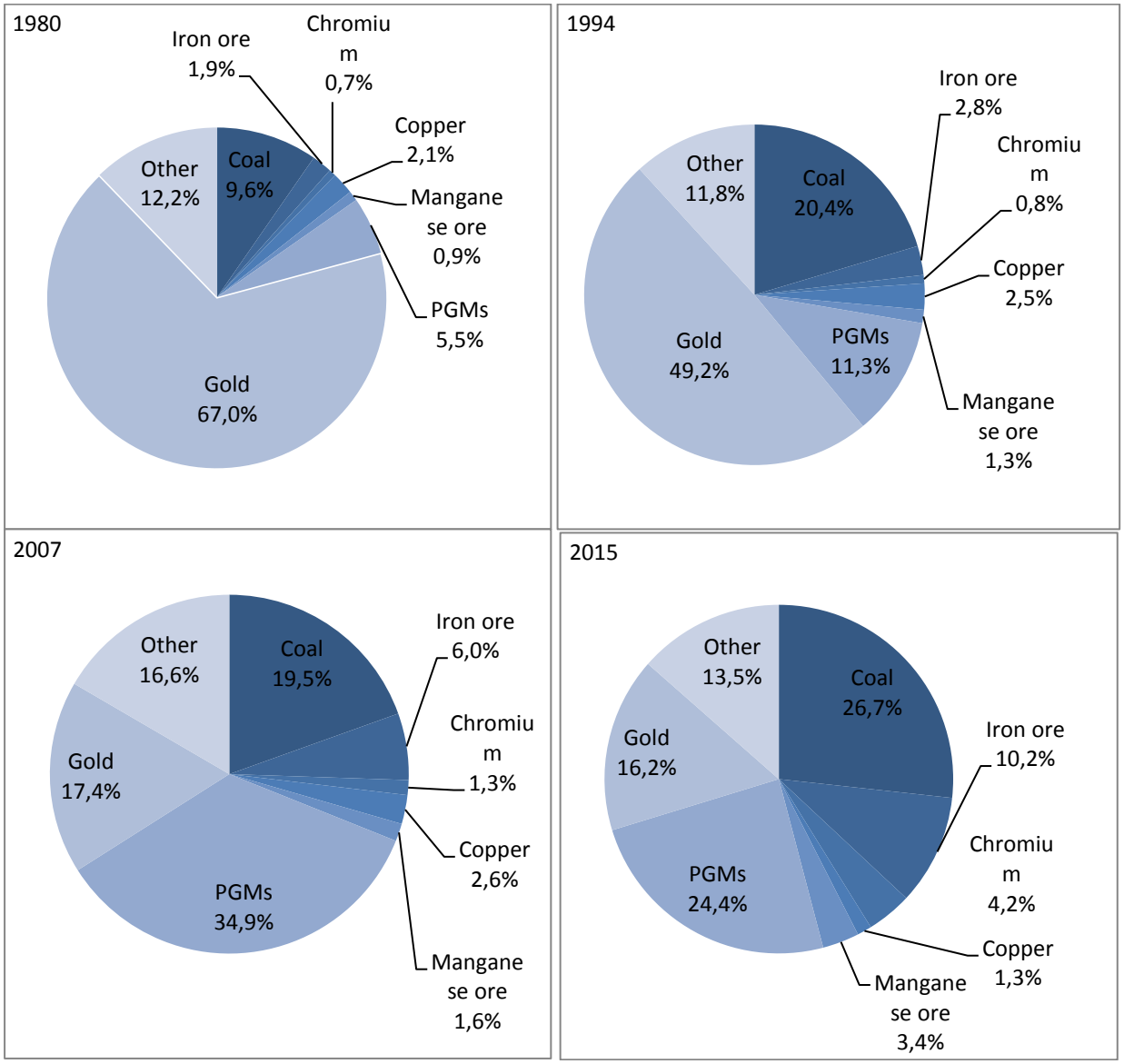
[4] According to Stockhammer (2010), financialisation is the term used to summarise a broad set of changes in the relation between the 'financial' and 'real' sectors which give greater weight than heretofore to financial actors or motives. Chen (2015) adds that due to the gradually expanded gaps between financial and manufacture investments, financialisation is suggested to work against industrialisation.

3. Industrialisation and the mining sector in South Africa

The mining sector is a critical sector for many African economies. For instance, De Kock (1924), Lumby (1983), Jones and Müller (1992) argue that historically the minerals revolution of the 19th century laid the foundation for the emergence of the modern South African industrial state. Even post-1994, South Africa's industrial developments still remained to be dominated by what Fine and Rustomjee (1996) termed the 'minerals-energy complex'. According to Fine and Rustomjee (1996:71) the minerals-energy complex includes the mining and energy sectors and a number of associated sub-sectors of manufacturing, which have constituted and continue to constitute the core site of accumulation in the South African economy. Roberts (2007: 14) says that the minerals-energy complex has ensured that rapid expansion of productive capacity occurs mostly in those sectors closely related to minerals beneficiation. Consequently, those sectors which have been identified to have weak linkages to the minerals-energy complex are inadequately developed (Mohamed 2007: 82). Ashman, Fine and Newman (2011: 11) also adds that the 'minerals-energy complex' that has dominated South Africa's industrial developments had also embraced the processes of financialisation in which the export of domestic capital has played a leading role, much of it illegally.

Still, South Africa remains is one of the most geologically blessed regions in the world. As highlighted by Malhere (2000: 5), the country has more than half of the world's reserves of manganese, chromium and platinum group metals; and 40 per cent or more of the world's vanadium, gold and vermiculite reserves. Looking at a number of statistical data from Statistics South Africa, it reveals that the structure of South African mining economy become more diversified over the years. As shown in graph 5, this has seen a decline in the dominate share of gold from 67% in 1980 to 16% in 2015, and an increase in the share of the platinum group minerals (PGMs) from 5% in 1980 to 24% in 2015, and coal from 9.6% in 1980 to 27% in 2015.

Graph 5: Structure of the mining sector (sales at current prices), 1980 -2015



Source: Own calculations using Statistics South Africa data

Arguably, South Africa's natural resources and its diversified mining economy continue to present real opportunities for 'resource-based' industrialisation in the country. Ramdoo (2015) discusses three linkages in the extractive sector that when fully explored would benefit industrialisation of resource rich countries like South Africa.

Production linkages: include forward or upstream (processing and transforming extractive produce into manufactured products) and backward or downstream (producing inputs that will be utilised in commodity production) linkages. According to Ramdoo (2015:18) production linkages are more likely to stimulate the development of a more diversified economy. The linkages between South Africa's mining and manufacturing sectors remain strong. According to Industrial Development Corporation (IDC, 2013) in the period of 1992 and 2012 the share of

manufactured goods as intermediate inputs for the mining sector was 50% and 31% respectively. Whereas the share of demand for mining products by local manufacturing sector for further beneficiation/processing was 86% in 2002 and 77% in 2012. Thus focusing attention to the production linkages between the mining and manufacturing sector, as well as other sectors in the economy, for example agriculture and services sector, would avail prospects to diversify and develop other industries.

Consumption linkages: are associated with the demand for outputs produced by other economic sectors resulting from the expenditures incurred by the extractive sector. According to Ramdoo (2015:18) in countries with a weak industrial sector, the domestic economy would be unable to respond these demands and therefore the country would need to resort to imports to meet the demand. In order to respond to demands associated with consumption linkages South Africa needs to recognises the weakness of its industrial sector and the significance of renewed commitment to developing its industrial base.

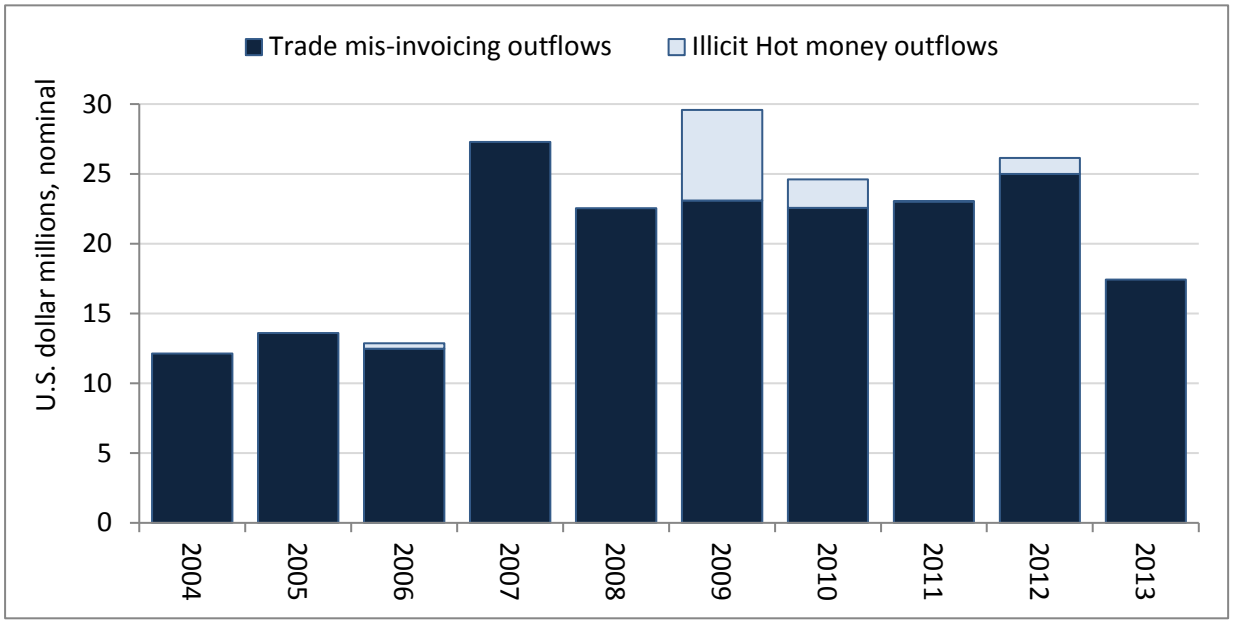
Fiscal linkages: relate to the resource rents, collected by governments from the commodities sectors in the form of corporate and income taxes and royalties. According to Ramdoo (2015:18) even though these fiscal revenues have been used for budgetary purposes, they can potentially serve to promote industrial development in the other sectors of the economy. Certainly fiscal linkages are directly affected and reduced by illegal capital flight occurring in the mining sector.

4. Illicit financial flows and the South African mining sector

The problem of IFFs is known to most severely affect countries that are highly dependent on natural resources and this is mainly due to specific factors that make extractive sectors prone to illicit financial flows. According to Le Billon (2001:3-4) the specific factors that make resource rich countries prone to illicit financial flows are: the high-level discretionary political control under which extractive sectors tend to come; blurring of public, shareholder, and personal interests with regard to extractive sectors; limited competition; complex technical and financial processes that require a high degree of expertise; and the high degree of integration into the global economy through resource exports and imports of food and manufacturing goods. As a result, in the case of resource rich countries the three main drivers of illicit financial flows are corruption, illegal exploitation and tax evasion.

The 2015 Global Financial Integrity Report, ranks South Africa 7th place globally among the top ten source economies for IFFs. The report reveals that during 2004-2013, South Africa's cumulative IFFs amounted to US$ 209,220 million in nominal value, as shown in graph 6.

Graph 6: Illicit financial flows from South Africa, 2004-2013

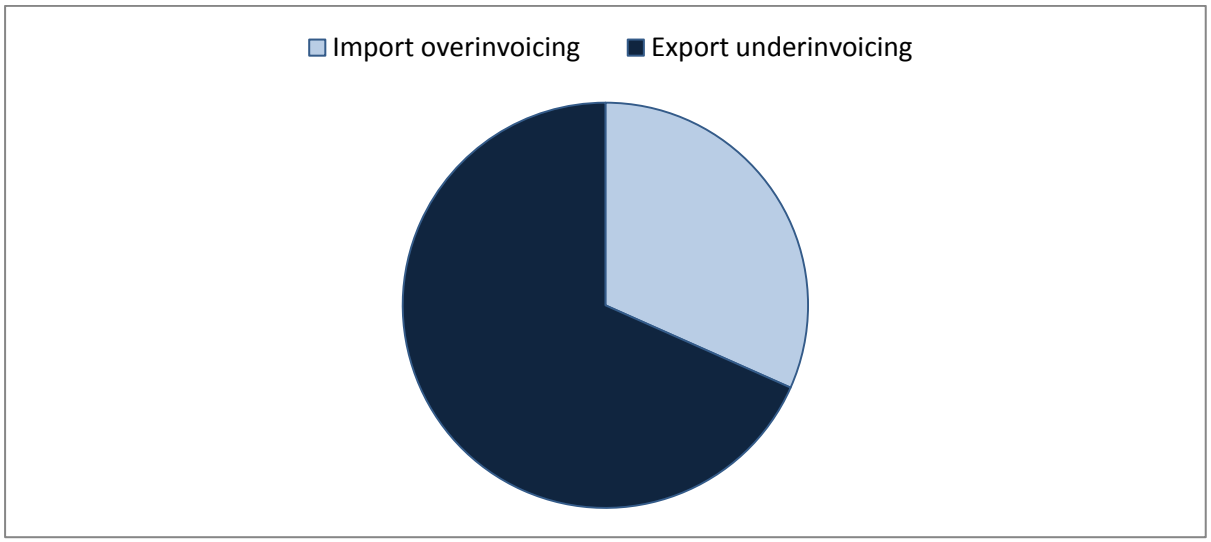


Source: Own graph using Global Financial Integrity data.

Graph 6 also shows that trade mis-invoicing is the primary measurable means for shifting funds out of South Africa, accounting for about 95% of the total IFFs between 2004 and 2013. Trade mis-invoicing is, explained by Nitsch (2012: 314) as, the movement of capital abroad by misreporting or mispricing the value of international trade. Mispricing in international trade results to either trade mis-invoicing inflows, when exports are over-invoiced and imports are under-invoiced), or trade mis-invoicing outflows, when exports are under-invoiced and imports are over-invoiced. According Nitsch (2012), in the case of trade mis-invoicing outflows, under-invoicing of exports rather than over-invoicing of imports, is more often used as a vehicle of capital flight, and this is because export controls are less restrictive. Nitsch (2012: 314) says that under-invoicing of exports allows firms to acquire foreign exchange that is not disclosed to national authorities; the foreign currency can then be freely used by exporters without complying with controls and regulations (for example, a potential option may be the sale of foreign currency in the parallel exchange rate market). Also, because authorities may use information on the export activities of firms to infer the production of these firms, as a result, firms that seek to hide output to evade domestic taxes will automatically also seek to hide exports.

As seen shown in graph 7 the majority of trade mis-invoicing outflows from South Africa are due to export under-invoicing.

Graph 7: Components of South Africa's Trade mis-invoicing Outflows, 2004-2013



Source: Own graph using Global Financial Integrity data.

When looking at South Africa's trade mis-invoicing outflows by sector, it is revealed that the vast majority of trade mis-invoicing outflows occur in and around the mining sector, as shown in table 2. Table 2 also shows that during 1995-2006 the mining sectors cumulative trade mis-invoicing outflows amounted to about US$167.19 million, and peaked at as much as US$31.7 million in the year 2006.

Table 2. South African trade mis-invoicing outflows by sector (U.S dollar millions)

	All food items	Agricultural raw materials	Ores, metals, precious stones and non-monetary gold	Fuels	Iron and steel
1995	1,59	1,06	7,83	2,25	2,18
1996	2,05	0,93	10,81	2,52	2,21
1997	2,05	0,90	7,94	2,47	1,38
1998	2,55	0,98	7,81	2,27	2,01
1999	2,80	0,90	12,69	2,33	2,49
2000	2,11	1,02	12,18	2,42	3,27
2001	2,79	0,98	9,49	3,02	2,36
2002	2,71	1,11	10,22	3,08	2,44
2003	3,50	1,36	14,39	3,63	3,39
2004	3,95	1,51	18,88	5,06	6,10
2005	4,06	1,55	23,27	5,65	5,90
2006	3,27	1,34	31,68	4,50	6,16

Source: Ashman, S., Fine B., and Newman, S. (2011). Amnesty International? The Nature, Scale and Impact of Capital Flight from South Africa.

As asserted by Jill Nattrass, in 1986 “mining appears to provide an almost perfect means of transferring the investible surpluses that are generated within the economy supplying the mineral… until these surpluses can be re-directed for use within the region itself, little economic development is likely to take place”. For South Africa and equally for much of Africa, this has particular significance.

5. Conclusions

It can be concluded that the post 1994 South Africa is experiencing the problem of deindustrialisation. Still, South Africa’s mineral endowment and its diversified mining economy continue to present real opportunities for ‘resource-based’ industrialisation in the country. However, South Africa has been severely affected by the illegal capital flight occurring in and around the mining sector via trade mis-invoicing. Arguably, the capital that illicitly exits South Africa as far as the mining sector is concerned could well be reinvested for further beneficiation /processing of raw materials into intermediate and finished products and in the development of productive capacities in manufacturing or firm expansion.

To ensure that the surplus generated from the South African mining sector is reinvested back into the economy required a number of mechanisms and programmes aimed at curbing illicit capital flight. These include reviewing the major weaknesses of the existing institutional measures and/or structures in curbing IFFs; ongoing training programmes to skill and capacitate personnel in key economic institutions to undertake measures to curb IFFs; and undertake deliberate domestic resource mobilisation by investigating and sanctioning organisations that are involved in illegal capital flight in the country.

To ensure that export trade under-invoicing is restricted, the paper recommends that the South African Revenue Services (SARS) working with International Trade Administration Commission of South Africa (ITAC), have customs personnel with the competencies to evaluate and determine export values or prices of mineral commodities. Furthermore, an examination of how illicit trading impacts on South Africa’s trade policy prescriptions or evaluations is also needed - especially because trade policy is widely used as an instrument to promote industrial development.

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