THE PRIMACY OF ILLICIT FINANCIAL FLOWS (IFFs) IN DEVELOPING COUNTRIES: A COMPARATIVE STUDY ANALYSIS OF SOUTH AFRICA AND CHINA

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By

ASANDE CIKIZWA MAHLABA
Student Number: G15M6393

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Supervisor: David Fryer

ABSTRACT

The main objective of this study was to question and investigate the primacy of illicit financial flows (IFFs) in developing countries, specifically focused on two countries namely China and South Africa. Africa is estimated to have lost approximately $1 trillion to IFFs over the last 50 years, which exceeds the financial assistance that these nations needed over the same period. For years. Africa has been the feeding ground for exploitation and resource plunder, and the narrative has always been Africa is underdeveloped because of this crime. Although this statement holds true in most African countries, what this paper seeks to do is to question whether capital flight, IFFs and more specifically tax evasion and tax haven activity are the reason for the deterioration of African economies or are IFFs perpetuated by economies with unsustainable growth paths. IFFs are an important factor when it comes to obstacles of economic growth. But are they the cause or effect? A very strong case can be made that they are the latter however, it is beyond the scope of this article to resolve this question. Its purpose is merely to assert that the question is a valid one and that presuming the answer could divert attention from the real question of economic development. This study contextualized the way in which IFFs are currently viewed in the world economic system according to the two approaches to development finance, and discussed modern monetary theory as an extension off these theories. Due to the nature of the study, the methodology employed is a case study approach between China and South Africa by means of extensive numerical and document analysis. Upon conducting this analysis on the primacy of illicit financial flows in developing countries there was difficulty in measuring IFFs. The reason for this is because IFFs have a range of estimates so it was very difficult to produce precise and accurate results. The key findings of this paper were that there seems to be some kind of parallel between developing countries with large volumes of illicit financial outflows, and a dependency these countries have on external debt. This means it seems that weak economies, that are highly dependent on external debt and have large amounts of this debt, seem to have the largest volumes of illicit financial outflows. Weak regulation, high levels of debt and liberalised trade markets seem to be contributing factors to the degree to which companies evade taxes and partake in tax haven activity in these regions. Another key finding was that in 2012, despite China being ranked number one in the the countries which have the largest amounts of outflows on average, it still managed to achieve large amounts growth in the last 20 years. Indicating that there is some form of indication that IFFs

could be viewed as symptomatic of weak financial systems and weak economies, instead of IFFs being the core of the problem.

DECLARATION

I, Asande Cikizwa Mahlaba, student number G15m6393, hereby declare that this thesis is wholly my own work except where explicitly stated otherwise and acknowledged, and has not been submitted to any other University, Technikon or College for degree purposes.

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To my supervisor: *"If we don't believe in the freedom of expression of the people we despise, we don't believe in it at all" – Naom Chamsky*

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ACRONYMS AND ABBREVIATIONS

AML	Anti-Money Laundering
ANC	African National Congress
AP	Afghanistan and Pakistan
BEE	Black Economic Empowerment
BoP	Balance of Payments
BRICS	Brazil, Russia, India, China and South Africa
CCTV	Closed Circuit Television
DTA	Double Taxation Agreements
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GEAR	Growth, Employment and Redistribution
GFC	Global Financial Crisis
GFI	Global Financial Integrity
HPM	High Powered Money
IFFs	Illicit Financial Flows
IMF	International Monetary Fund
MENA	Middle East and North Africa
MMT	Modern Monetary Theory
MSSD	Most Similar Systems Design
NEEDS	National Economic Empowerment and Development Strategy
NMC	New Monetary Consensus
OECD	Organisation for Economic Development
RDP	Reconstruction and Development Programme
SA	South African Reserve Bank
SARB	South African Reserve Bank
SARS	South African Revenue Services
SEEDS	State Economic and Development Strategy
UK	United Kingdom
UNDP	United Nations Development Programme

UNECA	United Nations Economic Commission for Africa
US	United States
USD	United States Dollar
VAT	Value Added Tax
WDI	World Development Indicators

CHAPTER 1: INTRODUCTION TO THE RESEARCH STUDY

Illicit financial flows (IFFs) have been at the forefront of development policy debates globally and in Africa since the 2008/9 financial crises. It has also become a cause célèbre especially within left-wing politics. According to UNECA (2015), IFFs not only weaken the fiscal base needed for sustainable economic development but also contribute to the undermining of state capacity, more so in emerging market economies like most on the African continent. IFFs from the continent undermine the development finance needed for social services and infrastructure (UNECA, 2015). IFFs are evidently a growing concern for most African countries including South Africa, given that its economy struggles with the complexities of a dual economy as well as high poverty, unemployment, income inequality, and spatial socioeconomic disparities.

The purpose of this paper is to question and investigate the primacy of illicit financial flows in developing countries. The question this article addresses is: 'Should IFFs be at the forefront of the debate?'. IFFs like corruption, are undoubtedly an important factor when it comes to obstacles of economic growth, but are they the cause or effect? A very strong case can be made that they are the latter however, it is beyond the scope of this article to resolve this question. Its purpose is merely to assert that the question is a valid one and that presuming the answer could divert attention from the real question of economic development.

1.1 Conceptual Framework

1.1.1 Context

South Africa has made impressive socio-economic progress since 1994. However, a combination of rising government debt, low growth and high spending pressures has brought into question the sustainability of South Africa's developmental growth path. In 1994 the Reconstruction and Development Programme (RDP) was introduced to address poverty and socio-economic inequalities inherited from the previous regime. Austerity measures were also implemented which included the restraint on government spending to stimulate the economy. Subsequently the Growth, Employment and Redistribution (GEAR) strategy was introduced in 1996, as an extension of RDP in order to achieve sustainable economic from 1996 to 2000, and create 400 000 jobs in the process (Kearney and Odusola, 2011). GEAR had mixed outcomes - on one hand it is acknowledged as a policy that brought about greater financial discipline and macroeconomic stability because it succeeded in reducing the fiscal deficit from over 9 percent in the 1993/4 period to below 3 percent in subsequent years. (Kearney and Odusola, 2011) On the other hand, critics argue that its shortfalls were the failure to produce increased formal employment and more evenly distributed wealth (Kearney and Odusola, 2011).

During the 2000 - 2006 period, the South Africa economy grew at an average rate of 2.9 percent. The government also managed to systematically reduce its budget deficit for the same period. The South African economy reached its peak in 2006 with an economic growth rate of 5.6 percent, a budget surplus of 0.3 percent and a decrease in government debt-to-GDP ratio at 25.8 percent (IMF, 2017). South Africa continued to enjoy surplus revenue units, but due to the 2008/2009 global financial crisis and the sharp decline in commodity prices, the budget surplus became a budget deficit (SARB, 2011). With the debt-to-GDP ratio reaching its lowest point in 2008 at 21 percent and the decline of the economic growth rate from 3.1 percent in 2008 to 1.5 percent in 2009, the South African economy entered a recession in the last quarter of 2008 (National Treasury, 2010). Due to sound macroeconomic policies and prudent regulation in the banking sector, South Africa was mitigated against the devastating effects of the global financial crisis in the earlier stages (SARB, 2011). However, due to weak revenue after 2009, an increase government spending caused a continuous increase in South Africa's public debt with the debt-to-GDP ratio increasing from 21 percent in 2009 to 28 percent in 2010 (SARB, 2013). Many attribute the growth from 2000 – 2006 to the Mbeki and Manuel administration but, Du Plessis & Smit (2006) attribute most of the positive economic growth during the abovementioned period to improvements in total productivity which are attributable to the openness to international trade. The increase investment rates in South Africa were further stimulated by the lower cost of capital and lower risk in the economy due to improved economic stability, however, the reduction of unemployment lagged economic growth (Kearney & Odusola, 2011). As of 2015, South Africa's debt stood at 44 percent of GDP, increasing to 50.7 percent in 2016 and thereafter 54.7 percent in 2017. (IMF, 2017)

South Africa's current account deficit currently remains one of the highest among emerging markets, despite the large depreciation in currency (IMF, 2016). As a result of revenue deficiencies, the budget deficit increased from an estimated 3.3 percent in 2016 to 4.3 percent in

2017. Economic growth remained stagnant at an average rate of 1.8 percent from 2009 - 2015, and it fell to 0.3 percent in 2016 after reaching 3.3 percent in 2011 and increased to an average of 0.9 percent in 2017 (Stats SA, 2017)

Alongside rising government debt, a large current account deficit and low economic growth rates, the South African economy is plagued by deep rooted structural issues. South Africa is still one of the most consistently unequal societies in the world. With a Gini coefficient ranging between 0.660 and 0.696, approximately 50 percent of the population receives only 10 percent of all income without any form of material measurable wealth (African Development Bank, 2018). In addition to poverty, the economy is plagued by rising unemployment, inflation and a low-skilled workforce with minimal education. Between 2010 and 2015 the average unemployment rate was fixed at 24.8 percent and subsequently, this rate rose to an average of 26.7 percent in 2016 and a record high of 27.7 percent in the second quarter of 2017 (Stats SA, 2017). The average spending on education stood at 6 percent of the GDP for the period 2009 to 2016, yet only 19 percent of the population enrolled into university and 60 percent of the population has the educational attainment of at least upper secondary (IMF, 2017). According to Kearney and Odusola (2011), despite embarking on strategies orientated on growth and redistribution, the most disappointing economic performance of post-apartheid is extreme levels of unemployment, widespread poverty and the widening of inequalities.

It can be said that the period from 1994 – 2004 was associated with a strong budget consolidation in order to decrease the fiscal deficit. However, what became apparent under the Zuma administration was the underlying structural issues South Africa is faced with, and the need for social infrastructure. Therefore, it is relevant to question whether the Global financial crisis (GFC) and Zuma spoiled the ruling party or was the party and its post-apartheid policies unsustainable. Evidence of the deterioration of governance manifested in different ways in the South African economy. One example is the increase in social movements and strikes under the Zuma administration such as the Lonmin miner's strike at Marikana and the student lead Fees Must Fall movement. Another example is Finance Minister Malusi Gigaba's sparking controversy in the 2018/19 budget speech when he announced that South Africa will see its first VAT (Value Added Tax) increase in 25 years. (National Treasury, 2018). There are two themes here: a) the corruption of Zuma's administration and b) the underlying structural issues which were somewhat less prominent under Mbeki's presidency, which became more apparent during Zuma's term of office. Right-wing advocates tend to put emphasis on the former (corruption), whilst those on the left-wing emphasized the latter.

The consensus is that South Africa has huge demands when it comes to development and social infrastructure. However, the South African dilemma is that fiscal constraints such as the increase in public debt, and an increasing budget deficit restrict the funds directed towards the growth of social infrastructure. Weak social infrastructure is a key obstacle to economic growth and development which is why there is an increasing need for the expansion of the public sector in South Africa. The key question is then what should be done about this?

1.1.2 The Debate

If government spending is greater than taxes, orthodox economists such as Stiglitz (2002) and Rodrik (1998), argue that South Africa should embrace market reforms, keep the deficit under control through austerity measures which involve reducing government spending. Furthermore, this argument emphasises tightening up tax collection and measures against corruption and illicit flows. One could say that this approach has not worked in South Africa because of the high demand for social infrastructure, and it also seems to be counterproductive because the failure to invest in good social infrastructure is undermining growth.

The heterodox argument presented by economists such as Bond (2018) and Samson (2009) is critical of the market-based reforms particularly austerity, but agrees on the need to attend to illicit flows. Heterodox economists are in the opinion that the wealthy should be taxed in order to reduce fiscal deficits and provide funds for social infrastructure. If government spending is greater than taxes, reducing government spending is not an option under the heterodox argument therefore, an increase in taxation is the policy tool used to increase public finance. This then results in taxing the rich and corporates more, and then calling on the same group to cut down on tax evasion and avoidance in order to curb illicit financial flows. The above is how illicit flows have been framed in South Africa, as a detraction from available development finance. However, is this not putting the cart before the horse? Because one could say that weak tax revenue and illicit flows are all dependent variables caused by weak growth, lack of confidence and perceived high tax burdens.

There are two valid questions that emerge from the discussion above 1) Is it plausible to attribute the deterioration of development finance in South Africa to IFFs? Or 2) Has the development path that South Africa has chosen perpetuated IFFs in the economy? In order to get a fuller picture of this issue, a comparison can be made with emerging markets that are achieving sustainable growth levels despite high volumes of IFFs such as China.

Despite the high volumes of IFFs, China has experienced high volumes of growth over the past several decades and accomplished the almost impossible by transforming itself into the world's second largest economy (Yeuh, 2015). Countries like China are complimented for adopting authoritarian systems and are said to be much better equipped than majoritarian democracy to deal with the challenges of globalisation (Streeck, 2014: 44). China does not have a perfect economy, however according to The Organisation for Economic Co-operation and Development OECD (2017), capital accumulation of funds in China is supported by high savings. Which is fundamentally different to austerity policy measures where capital accumulation is supported by the increase in public debt. The economy in China manages to achieve large amounts of growth and provide sufficient social infrastructure.

1.2 Goals of the Research

The main goal of this study is to question the primacy of illicit financial flows: Are illicit financial flows a cause or a symptom of the nature of South Africa's development path?

Therefore, it follows the sub goals of the research are:

i) Explore the reasons for the deterioration of developmental finance in South Africa i.e. does the problem stem from a) the financial crisis and the Zuma administration or b) the nature of the fundamental growth path

ii) Explore whether IFFs are a cause or effect of the deterioration of public and development finance

iii) Explore the broader/international debate about the macroeconomics of development finance. The argument that IFFs are a symptom, is a corollary of the argument that South Africa has locked itself into a particular growth path i.e. the East Asian model.

1.3 Methodology

In order to address the research question adequately, the proposed study will follow a comparative case study method. The reason for this is because a comparative case study is an in-depth investigation, undertaken over a period of time that produces more generalizable knowledge about how and why particular programmes or policies fail or are successful (Goodrick, 2014). Moreover, Saunders *et al* (2012: 230) states that a case study can be useful in the following five critical ways: testing theories, creating theories, identifying antecedent conditions, testing their importance thereof and explaining cases of intrinsic importance. This study seeks to test and question theories, identify antecedent conditions and test their importance.

The method is a comparative research method because it will feature a comparative analysis of the South African case and Chinese case. Comparative case studies include the summarising examination of the similarities, differences and patterns across two cases that share a similar goal (Goodrick, 2014). In this case the similar goal is to identify the development path of South Africa and China, and the impact of illicit financial flows on economic development in China and South Africa.

According to (Lijpart, 1971), one of the most appropriate strategies for comparative research is Most Similar Systems Design (MSSD) which involves choosing political systems that are similar in an as many variables as possible with the exception of the variable being examined. However, for purposes of this research a most different design method by Przeworski and Teune (1970), seems more appropriate due to the fact that the study involves two very different economic systems. Comparative case studies often incorporate both qualitative and quantitative data. A systematic literature review, document analysis and critical data analysis will be used as data collection tools when conducting this research.

CHAPTER 2: CONCEPTUAL FRAMEWORK

2.1 Introduction

Since the 2008/09 financial crisis extensive research has been conducted on illicit financial flows and the impact this phenomenon has on economic growth and development effectiveness in impoverished countries. However, adequate attention has not been given to the primacy or causes of IFFs in these regions. Over the last 50 years Africa is estimated to have lost approximately $1 trillion to IFFs (Kar and Cartwright-Smith, 2010; Kar and Leblanc ,2013; IFF Main Report, 2016). According to the IFF main report (2016), the level of IFFs estimated for the abovementioned 50-year period exceed the official development assistance needed in the African region which stood at $46 billion in 2012. Additionally, Global Financial Integrity (2015) states that IFFs and offshore tax haven activity are a big driver of inequality in developing countries, this is because IFFs and tax havens undermine state capacity and the funds needed for developmental finance. Therefore, there is a consensus among economists that curtailing IFFs would improve the effectiveness of macroeconomic policies and improve social infrastructure in developing countries. (Global Financial Integrity, 2015).

There is however, another important dimension that needs to be explored and this is the issue of the kind of economic systems are affected the most by IFFs. Over the years policymakers and economists have often put emphasis on increasing foreign aid for development assistance and the stimulation of foreign direct investment as ways to promote economic growth in developing countries, but despite government spending, policy prescriptions and multi-national corporation investment, growth remains stagnant in these regions. This should consequently bring into question the approach that these governments use when it comes to developmental finance because according to Global Financial Integrity (2015) financial secrecy, tax evasion and tax haven activity are widespread and are engrained the modern financial system. So governments need systems that are strong enough to deal with the negative impact tax evasion and tax haven activity has on their economies.

Plagued by inequality, poverty and high rates of unemployment; modern developing societies are struggling to provide adequate social services and infrastructure for most citizens. It seems that these societies have not focused on developmentalism which lies at the core of the concept of social democracy. The biggest issue that developing countries have identified as an obstacle to creating social infrastructure is in fact funding. These countries and modern economics have managed to identify the reasons that the state lacks the capacity to adequately provide for its citizens. These obstacles include illicit financial flows, corruption, tax evasion, and stagnant economic growth. However, what most governments have failed to identify is the underlying system that undermines state capacity. What is meant by this is the fact that governments of developing countries have not been able to shed light on the kind of monetary policies and governance needed to enhance social infrastructure.

There are two approaches to developmental finance namely the orthodox New Monetary Consensus (NMC) approach, and the heterodox and Modern Monetary Theory (MMT) approach. The former seems to have guided South Africa's developmental strategy since 1996. The heterodox MMT approach seems much closer to the developmentalist/social democratic vision that seemed to underlie the RDP and MERG, and before GEAR it seemed this was the direction the South African government was headed. This chapter seeks to outline these two perspectives and their implication for capital flows, including illicit capital flows. Section 2.2 will outline the orthodox approach to development finance, section 2.3 will discuss developmentalism or the heterodox approach and explain how MMT adds an important dimension to it. The last section will extend MMT to the South Africa case and explain weak savings, taxation, corruption and capital flows as endogenous variables.

2.2 The Orthodox case: New Monetary Consensus

According to Rodrik and Subramanian (2009), it can be said that long-term sustainable economic growth is often based on the ability of the financial system to raise the rates of accumulation and human capital in order to use the resulting resources more efficiently, and to make sure the whole population has access to these resources. According to this view, financial development involves the establishment and the expansion of private institutions and markets that support private investment. Overall this view promotes a free market with few interferences by the state on both economic and social life. Both heterodox and orthodox approaches support the need for investment. What distinguishes them is the orthodox approach emphasises private finance.

In essence, mainstream and orthodox economics according to the new monetary consensus operates under the assumption and notion that the financial system and the economy is concerned borrowing and lending. This system consists of six elements; lenders, financial intermediaries, financial instruments, the creation of money, financial markets and price discovery. The orthodox argument in a nutshell is that developing countries are savings constrained so they need capital inflows. These should then be managed by private financial institutions and not the state because the state is inefficient. (Rodrik and Subramanian, 2009).

An orthodox monetary system type structure results in a scenario in which government expenditure will always exceed government income. According to authors such Stiglitz (2002) and Rodrik (1998) in an orthodox system, debt arises because of excess government spending and/or weak taxation. Consequently, this means that all money in the current world economic system comes from monetizing debt and therefore, the system will always inherently be characterized by shortages in public finance and in extension developmental finance.

This type of government is ‘bad’ for a number of reasons. The most direct effect of government debt is to place the burden on future generations of taxpayers. Future taxpayers will then face a difficult choice when this accumulated debt and interest is due. They will have to choose between paying higher taxes and/or enjoying less government spending, in order to generate the funds available to pay off the debt and accumulated interest. (Mankiw, 2004: 767). Or they can delay ‘judgement day’ and the government can further dive deeper debt by borrowing once again to pay off the old debt and interest. Essentially, when the government runs at a budget deficit it allows for current taxpayers to pass the bill or expense of government spending onto future taxpayers. Inheriting a large debt, spent on an unsustainable growth path, will not help the economy but lower the living standard of future generations (Mankiw, 2004: 767). Thus, even when this type of economy experiences growth, the government always has prior debt obligations to meet first before using those funds for social infrastructure.

This creates a restraint of finance. For example, if this type of economy was at full capacity and the government tried to undertake a major infrastructure national project, it may run into inflationary problems in order to suppress demand to reduce inflation. The government will then have to create unemployment somewhere in the economy by means of austerity of increasing taxes or reducing government spending, or even issue debt (Mitchell, 2009). However, none of these actions would raise funds for this additional spending, rather they create a restraint of finance and lack of will. This is a very important part of this story, and in simple terms it says that if you have a fixed amount of funds to a single social infrastructure, there will not be any funds remaining for anything else. This will then result in the increase in the demand for money, which then results in the increase of interest rates. Increased interest rates then lead to a reduction in private investment spending which is ironic because private investment is at the core of this approach. This then dampens the initial increase in total investment spending, which eventually results in the reduction of gross domestic product (GDP) and this known as the crowding out effect. (Parkin *et al*., 2008)

These mechanisms used to stimulate development funding usually result in an increase in unemployment as government spending decreases, shifting the focus from developmentalism to stabilisation. This type of macroeconomic policy is also followed by most countries around the world in order to firstly stabilize the economy by reducing inflation and public debt and secondly, to reap the benefits of globalization through liberalizing trade and capital markets (Burger, 2008; The Economist, 2018a; Goodfriend, 2007). However, in the context of developing countries there should be scrutiny on implementing a policy that does not focus on development. As illustrated by the above discussion, the orthodox system of monetary policy is designed to fail because just like an arsonist who sets up fires to justify putting them out, the system produces public debt and then has the excuse to practice austerity and 'neo-liberal' stabilisation policies.

In South Africa macroeconomic policy has sought to stabilize the economy using austerity measures since 1996 (Schneider, 2018). Monetary policy has received praise from orthodox economists and 'agents of the north' such as OECD (2010) and IMF (2013), for adhering and following the international New Monetary Consensus. According to IMF (2013) and Pressly (2015), although there were concerns about the post-2008 trajectory, the government had managed to achieve fiscal responsibility. But since 2009 the potential provided by macroeconomic stabilization has been demolished by misaligned microeconomic and sectoral policy (Fryer, 2016)

The fundamental critique here is that stability prior to Zuma administration was indeed a fallacy. President Jacob Zuma was used as a scapegoat for many orthodox economists and policy makers to justify the failure of policy prescriptions. This is not to say that Zuma was innocent, but rather to say advocates of right-wing politics in South Africa were under the impression that these neo-liberal policies were working, prior to Zuma administration. However, exogenous factors such as the Global financial crisis, Zuma's presidency and the work that had been done to achieve stabilization was squandered. This was not true, because two wrongs do not make a right. By following a monetary policy system that monetizes and produces debt, any progress made to achieve stabilization and move towards developmentalism will always be squandered. As stated in the introduction, the South African economy does not exhibit characteristics which are in line with a sustainable growth path. This is because of it has adopted a system that will always undermine state capacity and state fund raising. According to Fryer (2016), in South Africa ‘orthodox economics’ is not a spectrum that enables the country’s economy to penetrate beyond the surface. It is a bubble which only occasionally is penetrated.

Orthodox economists’ ideas about what is sustainable do not come from objectively observing and examining development history and objective conditions in most African countries including South Africa. For example, new finance law in Tunisia, which took effect on 1 January 2018, sparked protests because it involved widespread price hikes. Many of the changes in this new law were aimed at taxes on the wealthy however, value-added tax was also increased by a percentage point. The prime minister argued that the government had no choice but to raise tax in order to bring the budget deficit down (The Economist, 2018a:32). Another example is how Saudi Arabia also experienced a similar predicament as the kingdom imposed its first ever value added tax on the 1st of January 2018. The result was a 5 percent levy meant to help close the ‘yawning’ budget deficit (The Economist, 2018b: 32 -33). This sounds all too familiar to former Minister Malusi Gigaba sparking controversy in the 2018/2019 budget speech by announcing that South Africa will see its first VAT increase in 25 years, with the same objective to reduce the budget deficit. Additionally, the abovementioned countries have other parallels with South Africa such as: increasing inflation, diminishing value of currency and rising unemployment. These are all symptoms of a non-sustainable growth path and are in line with the characteristics of a stagnant economy which has adhered to the international New Monetary Consensus.

The outcome of all the above is that South Africa has become one of the most disembedded economic systems in the world. What this means is that macroeconomic policy is disembedded from ‘bottom up’ democratic control and responsiveness to domestic conditions and is re-embedded ‘from the top down’ in a global ideology and power structure, and this praised by the rest of the world as policy independence and autonomy (Fryer, 2016; Best, 2003; Segatti and Pons-Vignon, 2013). Like in most developing countries The South African Reserve Bank (SARB) and the Ministry of Finance are more responsive to ratings and US macroeconomic policy than to domestic conditions. This approach has not only failed to bring about the funds needed for development finance, but it has also produced an economy and financial system that seems to be stuck in 'stabilisation' which appears to be coming to an end. This is because of the failure to alter the growth path and the openness of the economy to highly distorted global goods and capital markets (Schneider, 2018).

2.3 Developmentalism: The heterodox approach and Modern Monetary Theory (MMT)

2.3.1 The heterodox approach: Keynesianism and Post-Keynesianism

For purposes of this section, Keynesianism and post-Keynesianism will be the main theories used to analyse and critique monetary policy and money creation under heterodox economics. Further references will be made to other theories such as, Chartilism and Circuitism. The purpose of this section is to shed light on the similarities and disparities across and within left-wing economic theory, with reference to monetary policy. The next section will then show MMT as an extension of these theories and how it is adding an important dimension to the debate in regard to development finance.

Keynesianism sets economic growth as its central goal, which immediately puts investment and employment under its surveillance. According to Wray (1998), the creation of money was always followed by an emergence of class structure, which gave birth to a form of governmental or state power. In consonance with most heterodox monetary economists, there are three reasons for the demand of money: transactions, precautionary money demand and speculative motive. Alternatively, orthodox monetary theory places exchange, store of value and unit of account as the three reasons for money demand. According to Chartilism, unlike the orthodox school of thought, the heterodox historical account answers the question of why a unit of account came to exist and persist in certain markets. Interest and inflation still form a part of Keynesianism however, debt management and regulation lie at the heart of this theory on monetary policy. It aims to promote full employment economic growth through four main goals namely; stability of prices, exchange rate, financial systems, liquidity and expectations. More specifically, post-Keynesianism monetary policy stipulates that policy makers have a commitment to public welfare, by requiring a high degree of transparency and credibility from the state when it comes to public finance (Vernengo, 2018). Furthermore, it also requires pragmatism and discretionary power.

Monetary circuit theory is often associated with post-Keynesianism. This theory holds that money is created endogenously by the banking sector rather than exogenously through central bank lending. (Juniper *et al*., 2014). This means that the economy creates money itself, through government spending, rather than money being provided by an external source or an outside agent. In a modern credit-based economy, the supply of money increases or decreases according to the demand of money balances unless there is credit rationing. This means Keynesians put emphasis on the fact the essence of a 'credit system' means the economy does not need funds in order to spend money. According to Keynesianism money, taxation and savings are endogenous, hence the 'crowding-out' hypothesis of orthodox, also known as mainstream economics, is rejected (Juniper *et al*., 2014: 283; Vernengo, 2018).

This is the crux of the story, at the most basic level Keynesians shift the development finance focus to investment. Orthodoxy identifies the lack of funds as the fundamental obstacle to development finance. According to Cesaratto (2016) Keynesians and post-Keynesians believe that private investment tends to be weak and misdirected, and this is because the global financial system demands very high returns on projects that are socially desirable and are not profitable. Hence the state engages in what Keynes called 'the euthanasia of the rentier class' which involves controlling finance, especially international finance so that the state can gain control of monetary policy and keep interest rates relatively low. This is done through the use of capital controls. Another important element of this approach is that Keynesians believe that interest rates are not enough to fund social infrastructure so the state itself needs to take an active role in directly leading investment through investment infrastructure and social infrastructure e.g. education, healthcare etc. This is the reason that post-Keynesianism also advocates for the absence of self-correcting macroeconomic mechanisms, arguing that these are at best negligible (Juniper *et al*., 2014). The orthodox critique of this by authors such as Mankiw (2004) is that the abovementioned programme is not viable because firstly, low interest rates will undermine savings which is line with the new monetary consensus that interest rates need to be high in order to attract foreign saving. Secondly, based on the New Monetary Consensus, governments do not have the money available to fund investment.

Post-Keynesians recognise and place imperative importance on the point of effective demand in determining the level of involuntarily unemployment and rate of capital utilization. This point refers to an equilibrium where expectations are fulfilled, and firms have no incentive to change their levels of unemployment and output. Post-Keynesians also recognise the significance of uncertainty and risk, as well as the time-varying influence of uncertainty aversion over key macroeconomic parameters including the marginal propensity to consume, the marginal efficiency of capital and the preference of liquid over liquid assets (Juniper *et al*., 2014: 283).

Post-Keynesians economists assume a change in government spending, *ceteris paribus*, results in a change in government revenue, in the form of taxes and sales of treasury bonds (Cesaratto, 2016). This theory then applies this assumption to investment, endogenous money creation by government finances investment which could be referred to as 'initial finance', whilst saving appears only at the end of the income multiplier process which then funds additional investments or so called 'final-finance' (Cesaratto, 2005). In summary the Keynesian logic is that the autonomous components of aggregate demand determine the level of output in the economy given the level of production capacity, this then makes induced consumption and leakages a reflected result in the income multiplier model. Therefore, Post-Keynesian endogeneity assumes that money creation by banks will sustain investment spending, and this assumption can also be extended to other variables in the economy such as; autonomous consumption and exports. Furthermore, according to the MMT, this can be extended to public finance/state spending and developmentalism.

In terms of developmentalism, Keynesian theory supports the notion of deficit spending by government. This means that the state must be willing to live with a large amount of debt if it wants to provide adequate social and economic infrastructure. Most economists believe that high volumes of borrowing to fund the cost of infrastructure is not wrong, provided that social and economic infrastructure efficiently fulfil a genuine need. This can be referred to as the adequate 'social' rate of return. Lerner (1943), picked up on the Keynesian prescription of deficit spending and believed that government should always use its capacity to achieve full employment and price stability.

Many left-wing policy prescriptions, such as Obama increasing taxation after the global financial crisis, put emphasis on the fact that developmentalism requires the government to raise money first, and therefore it should increase taxation and/or reprioritise spending. (Piketty, 2017). According to Keynes, recovery depends on the direct stimulus of production deliberately applied by the state. The pertinent point of inquiry here is that these 'funds' need to be generated endogenously, meaning that a significant increase in economic growth is needed to significantly increase the funds needed for development. However, there are two critiques of post-Keynesianism, the first is that spending needs to productive i.e. spending needs to generate future economic growth (Cesarrato, 2005; 2016; Gittins, 2009) The second is that post-Keynesians put emphasis on the consequences/ramifications of the state spending first meaning, the focus is on how the gap of the state spending first be financed if income is only expected in the future (Cesarrato, 2016; Gittins, 2009) This is important because according to MMT, which will be discussed later, the state spends in order to provide the economy and its citizens with social infrastructure, regardless of spending productivity.

The fundamental difference between post-Keynesianism and MMT according to Cesaratto (2016), is that MMT extends the endogenous money creation logic to state spending. Meaning that in the same way that investment in the economy is initially financed by endogenous money and only thereafter funded by saving, government spending must also consist of initial spending financed of newly created money and only subsequently funded by taxation/and or issues of Treasury bonds (Tymoigne and Wray, 2013: 11; Davidson 2002)

In the context of South Africa according to Fryer (2016), the overall macroeconomic framework underlies issues such as persistent inequality and unemployment. Therefore, the failure of prescriptive macroeconomic policy, state incapacity and corruption, flow from the weak foundations of the South African economy. Currently the adoption of neoliberal policies such as fiscal austerity, inflation targeting which accommodate the new monetary consensus, has led to South Africa being stuck in stabilisation, with a state that has been transformed into "cost-controlling rather than developmental engine"(Segatti and Pons-Vignon, 2013: 538). However, this was not always the plan.

The 1994 elections were meant to be the first step towards a development state, because it was known to the ANC that liberal democracy would not be enough to alter the trajectory of the South African economy. In fact, discussions centred around left-Keynesian and social democratic principles can be dated back to the late 1980s where the apartheid government was under international scrutiny, while the ANC gaining international support (Freund, 2013). The main features of these principals were; "a) an acceptance that the state would have to take a lead role in changing the socio-economic trajectory by creating a 'bottom-up' economy that would ensure the level and direction of investment was developmental, and directly addressing social inefficiencies and racial disparities. And b) the political model would embrace social dialogue and democratic corporatism" (Fryer, 2016: 128). Therefore, there was some kind of system that was a democratic mixed market system with features that Keynesians (including MMT) and social democrats converged on. This system resembled an 'interventionist' state, with democratic institutions and social welfare. South Africa was expected to be headed in this direction with the RDP in 1994, however GEAR in 1996 changed this trajectory.

Unlike the orthodox approach, heterodox reparation principles did not leave room for grey areas, i.e. this plan was not incomprehensible nor did make shallow assumptions about state capacity and the role of government (Fryer, 2016; Segatti and Pons-Vignon, 2013). Rather than the heterodox approach being considered wrong in South Africa, it was rather displaced as is the case with most developing countries.

Prior to 1994, the ANC initially proposed 'growth through redistribution', however this proposal transformed into 'redistribution through growth' after 1994. The reason for this is that in the late 1980s it was evident that apartheid was no longer economically viable for South Africa. Therefore, it can be assumed that the 1994 democratic elections were a predictable course of events. However, what became apparent after 1994 is that instead of reducing the social disparities created by the previous government; as promised under the freedom charter, the ANC hid behind the fallacy of liberal democracy. And because South Africa had to be reintegrated into the world economy in order to raise funds to provide for developmentalism, it was forced to adhere to and adopt the international New Monetary Consensus. This resulted in the continuation of the system of accumulation without concern for environmental, human and economical sustainability. This was then the beginning of a democratic South Africa characterised by unemployment, bottlenecks and inequality. According to 'modes of capitalism' theory (Brenner, 1977), the process of accumulation through exploitation is only necessary in order to create surplus units and the excess capacity of the economy should usher in liberal democracy which should result in the redistribution of wealth, reduction in inequality, and eventually a socialist system. Evidently this is not what happened in South Africa after 1994, democratisation can be regarded as an elite transition that served to stabilise the accumulation path. Therefore, the 'deracialisation' of capitalism has been rather hollow for most black people (Fryer, 2016: 126).

The Keynesian logic of endogenous money creation being dependent upon economic growth would have been very hard to follow in the South African context. This is because the economy was already characterised by stagnant growth prior to 1994 and after the 1994 elections, the adequate funds to follow this logic would have not been there. Therefore, instead of extending the MMT logic to the state, the Left proposed increases in taxation in order to increase government spending on development. Additionally, because of the pressure the government received to adhere to globalisation this made it difficult to raise taxation due to the competitiveness of taxation regimes in the world market economy.

It is also important to note that because of the displacement of the Left narrative in South Africa, the government also made poor decisions about where the funding obtained through taxation should go. For example, according to Keynesianism, government spending for an aircraft should generate an income multiplier process that generates fiscal receipts that may be covered by the initial spending. However, this was quite the opposite in the case of the state-owned airline South African Airways (SAA), which requested a R5bn bailout in the beginning of 2018 in addition to the R10bn bailout granted by the government in 2017 (Daniel, 2018). In addition to SAA bailouts, policies such as the grant system and land distribution have been plagued by corruption and have served as platforms that have allowed South African elites to integrate into a 'transnational capitalist class'. Which is why it can be said that in South Africa, the state's social policies, concessions to organised labour and 'Left talk' rhetoric can be regarded largely as minimalist 'lubricants' to neoliberalism (Bond, 2018).

Evidently in the South African case both the Left and the Right are not engaging in developmentalism. Post-apartheid policy failures can be regarded as a consequence of the broadly unchanged orthodox macroeconomic stance. Furthermore, even well-conceived Left-wing policies have had little success because they stood against the macroeconomic tide. Both the Left and Right are counterfactual and lack a coherent hypothesis. Both view problems in the economy such as illicit flows as independent variables, whereas these issues are symptomatic of unsound public finance and developmental policies. Therefore, the answer should be a monetary policy and development finance that allows for a greater capacity of ordinary citizens to exercise real power over the state as a countervailing force, which is against the power that flows from money or public office. Therefore, the ‘state spends first’ hypothesis of MMT could be an appropriate extension of Left rhetoric needed in South Africa.

2.3.2 Modern Monetary Theory (MMT) as an extension of developmentalism: Definition and main principles

2.3.2.1 Definition of MMT

Modern monetary theory (MMT) refers to a macroeconomic theory on development finance that describes and analyses, modern economies in which the national currency is fiat money that has been established and created by a sovereign government. MMT can be said to be an extension of post-Keynesian logic of endogenous money creation, by applying the same logic to government spending. A key feature of MMT is that sovereign governments are the only suppliers of physical and non-physical forms of national currency of a denomination. This means that these types of states have the unlimited ability to fulfil promised future debt payments and to pay for the things they wish to purchase for necessary development. Furthermore, MMT claims that this theme of endogeneity, provides these governments the additional unlimited ability to provide funds to other sectors. Therefore, this makes bankruptcy impossible for a government that issues its own currency (Abrahamian, 2017; Juniper *et al*., 2014).

MMT represents an “accounting-consistent, operationally-sound theoretical approach to understanding the way fiat money works and how policy changes are likely play out”. (Mitchell, 2011). MMT has been said to be an extension or enhancement of the post-Keynesian framework for monetary policy, by recognising the difference between an economy with a sovereign and non-sovereign currency. Both post-Keynesianism and MMT place importance on the role of the payment system and the implications that the design of macroeconomic policy have on economic development. The other principals that post-Keynesianism and MMT have in common are; the notion of uncertainty, the principle of effective demand, the endogeneity of the money supply by government, the absence of self-correcting macroeconomic mechanisms and finally, the notions of debt-deflation and financial instability (Juniper *et al*., 2014; Mitchell, 2011). However, apart from the broad theoretical consensus on the abovementioned principles many post-Keynesians still have reservations about MMT views and policy prescriptions (Juniper *et al*., 2014)

MMT advocates depart from post-Keynesians by firstly arguing for the consolidation of the Treasury and Central Bank and secondly, by introducing a distinction between vertical and horizontal transactions (Abrahamian, 2017; Juniper *et al*., 2014). The distinction between an economy with a sovereign and non-sovereign currency is a key feature of MMT and MMT advocates for full fiscal sovereignty (Juniper *et al*., 2014).

2.3.2.2 Consolidation and full fiscal sovereignty

Full fiscal sovereignty refers to a consolidation state in which that country issues a fiat non-convertible currency and operates with a flexible exchange rate. According to Juniper *et al.* (2014), a flexible exchange regime allows discretion regarding any foreign exchange market interventions, including monetary independence. As an issuer of currency, the consolidated state can always meet national currency denominated debt obligations. In contrast, governments that peg its currency must cover both the relevant overseas interest rates plus any risk premia that may be imposed by the market due to fear of default or delay in repayment. Thus, countries with pegged or fixed currencies can end up in a Ponzi situation where they must borrow to pay the interest on their lending and have little or no prospect of repaying any principal in the face of increasing interest rates (Juniper *et al*., 2014).

As stated in section about developmentalism, the MMT stance on functional finance is that if a lot if spending is required to provide adequate economic structure, the state cannot be chickenhearted about government debt. A debt-free society does not resign itself from an economy characterised by bottlenecks, inadequate rail and road transportation systems, inadequate public service delivery, poor education levels and high levels of poverty (Juniper *et al*., 2014; Mitchell, 2009). This means that the state should not be worried about filling the gap of the money spent on social infrastructure

MMT also suggests that concerns about rising government debt are misplaced as governments denominated in the national currency enjoy full-monetary sovereignty, and consequently, they have a greater scope for effective macroeconomic policy intervention. MMT argues that the sole reliance on traditional Keynesian policies of pump-priming and large-scale public investment should be relinquished because these policies often result in inflationary bottle necks before the achievement of full employment. MMT author Gittins (2009) reiterates this argument by saying, “if you want adequate infrastructure you have to be prepared to live with a fair bit of debts, and if you want to build all the additional economic – and social – infrastructure need to cope with a 60 percent increase in the population over the next 40 years, you have to be prepared to live with a huge whack of debt” (Gittins, 2009).

In the case of neoliberal monetary policy, government spending simultaneously occurs with a credit to a private bank account. The government then offsets that liability by crediting the bank's reserves at the central bank which becomes the asset of the "private bank". This process involves the central bank using open market transactions to purchase an existing bond in order to provide reserves needed for a private bank to buy a new security meaning, the central bank cannot directly buy new issue directly from the treasury. However, the outcome of this process is exactly the same as if the central bank had bought it directly from the Treasury, which is an element of the consolidation state hypothesis (Cesarratto, 2016; Mitchell 2009).

The way in which the money creation process works according to the orthodox approach is that the central bank is the adjudicator of the money in circulation through three essential and common functions which are: open market operations, reserve requirements and discount window lending. The central bank controls the rate of money creation growth by influencing the interest rate on bank loans via the non-negotiable repo rate it charges for loans to commercial banks. When banks make these new loans, they create deposits and therefore the interest rates that commercial banks charge lenders are primarily based on the repo rate. This is the style of monetary policy followed by most countries across the world (Faure, 2015: 15). This then results in there being virtually unlimited supply of bank credit which then leads to deposits, which then leads to the creation of money. The 'limit' on this credit is the price of money to the lenders which is the known as the interest rate. In addition to this the central bank also issues money to the government in the form of government securities such as government bonds (Faure, 2015: 17).

"Now the central bank does not simply issue money to government, it loans it to them with interest. Then through mechanisms of increasing and decreasing of supply of money, the central bank essentially regulates the value of the currency issued" (Joseph, 2007),

It sounds like a lot of economic jargon, but the main point or critique is that the entire structure of the economic and financial system can only produce debt in the long run. This is because all the money produced by the central bank and regulated commercial banks is loaned to the government, and therefore households, at interest. This means that the value of every unit of currency produced e.g. one dollar, is equals to dollar plus a certain percentage of debt based on that dollar. The question now is where does the money to pay for this debt come from? And the answer is that it can only come from banks because the banking system has the monopoly of the production of the currency, so they loan each dollar out with immediate debt attached to it (Joseph, 2007). This results in a system which is essentially slavery, because it is not technically possible for the government and thus the public to ever come out of this self-generating debt (Joseph, 2007).

Full fiscal-sovereignty makes the household/corporate/government analogy a non-factor, and in fact, it is a tactic used by mainstream economists to argue against deficits and justify 'moralistic' fiscal rules (Mitchell, 2009). This basically means government spending will be inflationary unless it creates the assets that increase aggregate supply sufficiently to match the increase in aggregate demand as a result of it spending money into existence. In this case the purpose of taxation should be to remove money from the economy when inflation rises due to government spending (Juniper *et al.*, 2014).

If macroeconomics is all about 'steering' fluctuations in the economy, then fiscal policy and monetary policy should be a steering wheel applied for functional purposes. A clear distinction should be drawn between the concept of 'functional finance' and the concept of 'sound finance'. Sound finance means having a balanced budget over the course of the business cycle and increasing the money supply in line with the real rate of output growth. Functional finance occurs when the government always uses its capacity to achieve full employment and price stability. (Mitchell, 2009).

Critics mistakenly claim that MMT asserts that obligation of taxation is the exclusive reason for the development of money (Palley, 2014: 3). However, Tymoigne and Wray (2013) state that MMT does not argue the imposition of obligations by the government (i.e. taxation, fees and fines) is enough to drive the acceptance of government currency. MMT just states that the demand for currency is determined by minimum tax levy and the government's capacity to enforce it (Tymoigne and Wray, 2013: 43)

MMT expresses the above responsibility as 'advancing public purpose', as opposed to the lack of will austerity creates. Lerner's criticism of the mainstream use of fiscal rules is that it divorces this school of thought from the functional context. A budget surplus may be necessary at some point however; it shouldn't be the focus of monetary policy. Lerner (1943; 1951), picks up on the post-Keynesian summary on prescribing deficit spending by arguing that "Governments should not be concerned with conventional morality but rather should consider only the results of their actions." (Lerner, 1943; 1951). Additionally, the main objective of government spending and taxing, is to hold total spending that is conducive to full employment at current prices.

> Taxes are essential because they help the government currency to circulate at par (thereby making the payment system more efficient) and because they promote price stability by removing some purchasing power from economic domestic economic units (Tymoigne and Wray, 2013: 7).

This means there should be no unemployment and no inflation. And according to Lerner (1943, 1951), in the process of achieving this objective the government should not be concerned with debt. Secondly, the government should only borrow funds or repay funds to extent to which it wants to change the proportions in which the public holds securities or money. If the only problem is financing public debt, Lerner (1943) says the solution is the government printing money. Lerner (1943, 1951) argued that the government should have the ability to put money into circulation or withdraw and destroy it as needed to affect the results called for by the first two principles. In mundane terms, the imperative should be 'balancing the economy' and economic development (Bell, 2000; Lerner, 1943; 1951; Wray, 1998). Furthermore, economists should not see financial imbalances, such as budget deficits as a reason to abandon this imperative.

2.4 Extending MMT to South Africa

2.4.1 Introduction and Background: Reasons why MMT should be a viable option to the South African government

The ANC is not prepared to acknowledge the deteriorating socio-economic position of the poorer half of the population. It does recognize that poverty, unemployment and inequality remain a very serious problem. The government continues to remain naively optimistic about how to solve these issues in the current capacity of the economy. According to Kagwanja and Kondlo (2009). After 1994 South Africa became fully integrated into the power and the ideology of globalisation and more specifically global capitalism. The most controversial characteristic of the transition period was the core leadership of the ANC who was willing to swallow the power of global corporatism, and the ideologies of neo-liberalism and market fundamentalism.

According to former President Thabo Mbeki (2004) South Africa has two economies. The first economy is the upper-level modern economy. The other economy is one in which people are impoverished trapped and plagued with high illiteracy rates, have no skills, with no access to clean water (Mbeki, 2004: 29). So According to Mbeki (2004) because of this dual economy, and the lack of government interest to promote economic development people in rural areas and poor areas of South Africa cannot read and write, and as result of this lack of skills, even with high economic growth they would not be able to enter and participate in the economy. However, Kagwanja and Kondlo (2009) disagree and say that South Africa does not have two economies, but rather a single integrated economy. They argue that it is only the people of South Africa who live in two different worlds. The first world is the poor living in a highly underdeveloped and stagnant environment and the second is the rich living in a highly developed and prosperous environment. This "second economy" is nothing but an ugly reminder of the underdevelopment that was created on the periphery of the capitalist core during the twentieth century. (Kagwanja and Kondlo, 2009) The majority of poor people are poorer because apartheid colonial accumulation path was re-institutionalised into a pro-rich economic system in 1994.

2.4.2 Current state of government capacity and taxation in South Africa

Within the South African power constellation, the ANC government does not have enough sovereignty, and it also does not have the power, authority or capacity to do what it ought to do to address the socio-economic problem created by one hundred years of the apartheid-colonial path. The ANC government is therefore, a weak government. This means that the deterioration in the socio-economic position of the poorest half of the population is not a consequence of wrong policy prescriptions (e.g. Affirmative action and BEE), but it is mainly a result of the wrong systemic choices. These choices involve the ANC's choice to adopt economic policy that perpetuates neoliberalism and capitalism. According to (Kagwanja and Kondlo, 2009), the powerlessness of the state is a direct result of the ANC government being captive to the "Johannesburg-New-York-Washington 'power chain'", and so it will remain powerless in addressing the social questions inherited from apartheid. By adopting neoliberal ideologies, the ANC has given the corporate sector more freedom to integrate South Africa into the structures of globalisation.

These structures include adopting neoliberal monetary policies which do not focus on developmentalism, but rather creates debt without any concern for the other dimensions of the economy. The South African government relies on two sources to pump money. The first is international institutions such the World Bank and the IMF, and when they borrow money abroad of which they must repay at a currency risk. The second source is banks and multinational corporations, and the problem with this is banks do not pump money into the economy. Firstly, the banks only lend for real estate, corporate aids and corporate loans and therefore, banks perpetuate the system of monetizing debt. The second problem with depending on multinational corporations to pump money into the economy is that in most cases these companies pump less money into the system than they take from it, meaning natural resources that could be used for development are used without adequate compensation (Carrillo *et al*., 2018).

This abovementioned lack of sovereignty results in budget deficits due to South Africa's indebtedness to international banks and multinational corporations, rather than budget deficits as a result of the government focusing on development. What then happens is that the government needs to raise taxes in order to remain solvent and run its affairs. The catch is that South Africa is integrated into and becomes part of the globalisation of the capitalist economy. The same globalisation which resulted in the non-western world serving as a laboratory of deregulation and financialisation thereof, and which led to the 2008/09 global financial crisis (GFC). Due to a lack of funds after the GFC, tax competition increased among countries because of the reliance on external finance. This then resulted in tax cuts for multinational corporations, banks and earners of high incomes. Giving the owners of capital more opportunities to evade taxation by moving assets between countries into tax havens (OECD, 2013). These structures perpetuate and support IFFs, tax evasion and the use of tax havens.

These structures also include the 'moral' economy of tax professionals. According to (Kagwanja and Kondlo, 2009), tax professionals who are licensed to protect the interests of all stakeholders use their knowledge and experience to support tax evasion and avoidance by their fee-paying clients. Tax havens are deployed as platforms from which fraudulent activity can be conducted with relative impunity (Ogle, 2017). In fact, Ogle (2017), refers to the entire offshore industry and the trillions of dollars that flow through it as a fraud beehive or fraud net and says that the neoliberal finance academy avoids looking at it microscopically, which is why it never studies the root of the problem. Additionally, Streeck (2014) says the main reasons for the use of austerity measures in the global market economy resulted from the new opportunities for tax flight, tax evasion, tax-regime shopping and the extortion of tax cuts from governments by corporations and earners of high incomes that were offered by global capital markets since the 1980s. Ogle (2017), reiterates this statement by saying the process of decolonisation from 1950s to the late 1960s, resulted in the expansion of tax avoidance and tax havens. During the period of the emergence of this tax haven offshore system there was an emergence of Keynesianism, the Bretton-Woods system, the UK welfare state and economic planning. Therefore, this was some kind of an indication that IFFs, tax evasion and the use of tax havens was not an abrogation of this of this liberal democratic capitalist order of the long mid-century, but rather an integral part of it (Ogle, 2017). What the author means by this is that, part of the reason for the expansion of the tax haven ‘offshore’ systems were because countries regulated their finance. So banks moved offshore to avoid this. So the avoidance was to a certain extent a “side effect” rather than part of the medicine. The problem got much worse after the 1970s

Globalisation and the liberalisation of global financial markets forced developing countries to adopt financial structures and tax administrative systems based on old colonial models, in order to enable these countries to compete in the global market economy. However, is this competition fair because the main theme of colonialism was the domination, plunder and exploitation of underdeveloped countries in order to increase capital accumulation of the world’s richest societies? Firstly, one of the ways in which taxes have been misused is that they have simulated legislative and other provisions to evade tax. Adopting old colonial models to rectify distortions in development is a process which is described by Onimonde (1988) as replacing direct colonial and imperialism with neo-colonialism. Thomas Piketty (2017) an expert on inequality, says that the wealth held in tax havens is probably sufficiently substantial to turn Europe into a very large net creditor with respect of the world. Another study done on the extent of tax evasion in rich countries using data from the ‘Swiss leaks’, the ‘Panama papers’ and wealth records in Norway, Sweden, and Denmark, found that tax evasion rises sharply with wealth. Additionally, 30 percent of the top 0.01 percent earners evade tax, this top 0.01 percent includes households with more than $45 million in net worth (Alstadsaeter, Johannesen and Zucman, 2019). Furthermore, Bilicka (2019) found that the ratio of taxable profits to total assets reported by foreign multinational subsidiaries is one-half of comparable domestic standalones.

Onimonde (1988), identifies oppressive taxes as one of the major sources of inequality and underdevelopment in Africa. The decapitalisation of foreign investment involves the replacing of foreign investment income in the forms of monopoly super-profits, dividends, interest, transfer-pricing and over-voicing. Onimonde (1988) identifies the last two as tax evading practices that multinational corporation use when transacting. Onimonde (1988) also identified South Africa at that time, as synonym of multilateral imperialism and says that the apartheid regime helped develop South Africa into the centre of sub-imperialism. Onimonde (1988), estimated that multinational corporations at that time repatriated more than $60 million in the 1980s from their super-profits in countries such as South Africa, and goes on to state that the profits extracted by multinational corporations in South Africa were among the highest in the world because the apartheid regime and its polices enabled these practices. The South African apartheid regime according to Onimonde (1988), was an incredibly profitable capitalist business and decapitalisation in South Africa during the apartheid regime and is playing a significant role in the total capital formation of big multinational corporations that remain profitable in the current global economy.

According to the most recent statistic estimates, currently ±7.6 trillion dollars is stashed away in tax havens which is 8 percent of global financial wealth. (IFF Main Report, 2016). Of this money ± 1.3 trillion dollars are owned by Africans and African corporations. The leak of the Panama Papers in 2016 led to international tax authorities having 6500 tax payers under investigation, and 1917 of these taxpayers were South African citizens or corporations in South Africa. (Steyn, 2017). However, the efforts of tax reform have been more persistent than this tax haven activity, especially because of the initiative of the OECD, which South Africa and other nations have begun to implement earnestly.

So, the critical questions are, what is the problem? Where is the disconnect? The answer according to Steyn (2017), is that these leaks bring up the fundamental underlying economic issues of developing countries. According to Tax Justice Network research, due to foregone economic growth to lack of development, poverty, unemployment and inequality in lower-income countries these regions bear most of the burden of global tax abuse activities (Steyn, 2017).

2.4.3. Extending MMT to South African state capacity and taxation

In South Africa, in order to fund public spending, the government taxes individuals and companies in order to fund its own spending, but what would happen if the government was ultimately the source of all money. This includes taxed or untaxed income, or if it spends money into creation applying taxes to counteract inflation resulting from increased demand. So, when the government funds programmes, it creates money by literally injecting money into the economy by essentially spending that money into existence. This would then give the South African government the sovereignty it needs in order to replace the US-controlled system of global capitalism because one of the key insights of MMT includes the national currency being fiat money, which is established and created by a sovereign government. MMT requires currency-issuing states to spend as much as they need in order to guarantee full employment and other social goods, which is exactly what South Africa needs.

The principle of that holds for taxation according to MMT is that taxation should only exist in order to reduce the supply of money to control inflation and to ensure that the currency remains in demand. According to Cesarratto (2016), MMT is centred around chartalist main thesis which is that the state should impose taxes to be mandatorily paid in the currency it issues which is also known as high- powered money (HPM). This process then to creates demand for that currency. Therefore, when the South African government spends, the private sector would have to accept this currency, considering HPM (reserves and banknotes), as the means of settlement. According to MMT, taxes should be imposed for two reasons the first being; to check and control inflation and aggregate demand, the second reason for the imposition of taxes is social justice, i.e. to rebalance or create more equal income distribution, (Tymoigne and Wray, 2013). In these instances, the government would only use taxation to fund social infrastructure and in order to effectively control both monetary and fiscal policy. Which is why it is important for the timing of spending and tax collection to be coordinated. (Fiebiger, 2012; Fullwiler, Kelton and Wray, 2012) The South African treasury must therefore synchronize and coordinate spending and tax collection with the South African Reserve Bank (SARB), because of the overlapping of monetary and fiscal policy. The financing of this deficit expenditure by the public sector will be by the issue of fiat money. In exact same way that the issue of credit money through bank advances is used to finance deficit expenditure by the private sector. Some of this new fiat currency will be willingly held in order to satisfy the private sector's liquidity preference and some will be retired by the selling of interest-bearing public debt (Cesarratto, 2016). What is important is to see that the South Africa needs to operate at a deficit in order to provide the necessary social infrastructure.

It is also equally important to note, as noted by MMT advocates Barba and Pivetti (2008), that the solidity of public debt in monetary sovereign countries is much higher than that of household debt as illustrated by the global financial crisis. This means that there is basically nothing prohibiting governments of developing countries, including South Africa, from adopting fiscal sovereignty because high public debt is core characteristic of most monetary sovereign countries.

To those who are sceptical of the laissez faire order of the 'free world', MMT has quite a lot of remarkable policy differences, in the sense that the importance of the hierarchy of money generation channel is more understandable. (Juniper *et al*., 2014). This is because this theory probes the state to be more transparent of the money it is receiving and how this money is going to spent (Tymoigne and Wray, 2013). This is another important factor when it comes to South Africa because as it stands the work done by the government to improve social infrastructure, reduce unemployment and inequality is often overshadowed by corruption. South African citizens are tired of paying taxes and not knowing how the government spends that money.

In essence, the focus needs to shift back to developmentalism, and public debt should not be at the centre of that debate or discussion. The government lacks the funds, and this creates lack of will which leads to low inefficient investment productivity levels. Which is the reason the level of saving in South Africa is low and ironically the level of private investment is not. This could be an indication that orthodox policies such as austerity are not working. Applying MMT will not only create funds in South Africa, but it will provide the momentum and investment needed in order to push the economy in a positive direction.

The point that both the Left and Right seem to miss, is that poor finance, including illicit financial outflows, reflect the weakness of that economic system. (Fryer, 2016). Therefore, it can be said that the degree to which a developing country is susceptible to poor finance and stagnant growth, can be linked to a higher degree of undermining state capacity. The issues pointed out in the above sentiments are not exogenous variables. This means a government cannot improve savings and investment by forcing people to save. Furthermore, it cannot reduce the budget deficit by raising taxes and it cannot stop capital outflow by trying to tighten up the rules and enforcement regarding expatriation of funds. In the same way that private firms and the private sector must rely on bank credit to 'finance' their initial spending by future revenue that does not exist, this should also apply to the state. In both cases, when the state and firms engage in spending, there must be money creation (Cesaratto, 2016)

2.5 Conclusion

The purpose of this chapter was to give a background for IFFs, tax evasion and tax haven activity in South Africa. The central theme of this chapter is that the South African government did not prioritise developmentalism after 1994, but rather it prioritised its integration into the capitalist global economy. The economy is embedded in neoliberalism, deregulation and financialisation, and has structures that perpetuate IFFs and allow multinational corporations to evade tax.

Another theme of this chapter was to show the misplacement of Keynesian policies in the global economy, especially when it came to prescribing policies for socio economic failures. These failures present MMT as an extension, as well as an alternative system that focuses on development.

The world economy and the upholders of the traditional doctrine of operating the economy, have tried to disguise the new doctrine so that it must not be easily mistaken for the old. When compared to the attainment of prosperity and sustainable economic growth and development, the size of the national debt should be of no concern and the fact that the budget may have to be unbalanced, should be insignificant in this regard. The difference between the two is that the new doctrine is proposed to disguise the size of national debt and unbalanced budgets by having an elaborate system of annual, cyclical, monthly capital and other special budgets. (Lerner, 1951: 15).

CHAPTER 3
THE ANALYSIS OF THE PRIMACY OF ILLICIT FINANCIAL FLOWS: TAX EVASION AND TAX HAVEN ACTIVITY

3.1 Introduction

The main purpose of this paper is to investigate the relationship between illicit financial flows (IFFs) and economic growth and development. The main objective is to question the primacy of illicit financial flows (IFFs) particularly tax evasion and tax haven activity in South Africa. Therefore, this paper also aims to critique a particular way of thinking about IFFs in both the African and South African context. The critique is that IFFs should not be viewed as the cause of underdevelopment, but rather as being symptomatic of weak economies plagued by weak economic and monetary policy.

The previous chapter contextualised this critique by analysing various types of monetary policy and their effects on economic growth and developmentalism. It also highlighted the importance of the relationship between monetary policy, taxation and development, and how this is related to tax evasion and tax haven activity. According to Fofack and Ndikumana (2014), theoretically monetary policy can impact capital flight and IFFs via the effect it has on the returns of investment through interest rates and its impact on investment risk such as macroeconomic uncertainty, especially inflation and exchange rate volatility. Furthermore, IFFs can impact the effectiveness of monetary policy. This is because it increases uncertainty and risk, as it reflects a lack of confidence in the local economy. This chapter will use this relationship to analyse the reasons for tax evasion and tax haven activity. It will then investigate the impact of IFFs on developmentalism in South Africa and China.

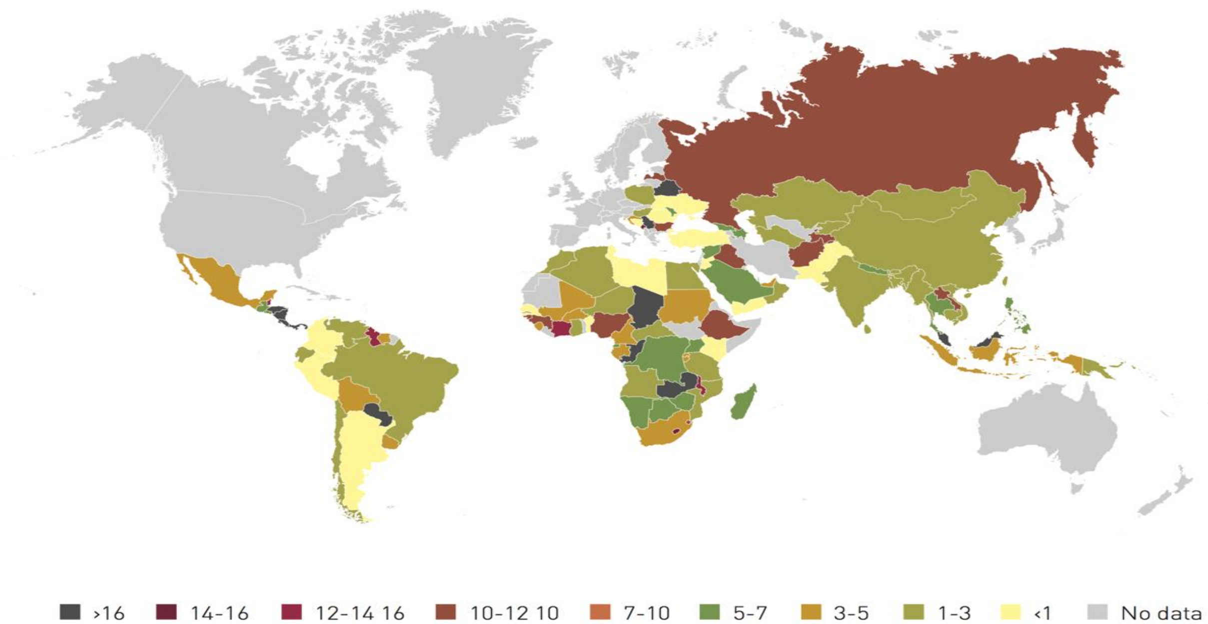
The first section will be a general background discussion about illicit financial flows in developing countries. The second section will discuss the main drivers of IFFs and tax evasion through a literature review. The third will be exploring the model of developmentalism, and developmental finance in China and comparing it to South Africa. The last section will be a documented and numerical analysis on the extent of IFFs in South and China and around the world.

3.2 Illicit financial outflows in developing countries: Background and Trends

Illicit financial flows (IFFs) are defined as “money that is illegally earned, transferred or used” (IFF Main Report, 2016). According to the IFF Main Report (2016), IFFs and capital flight are different because capital flight could involve activities that are completely legal if it is driven by governance and macroeconomic factors. The Global Financial Integrity (GFI) report (2019) defines illicit flows as a type of resource curse because a) the source of IFFs is unknown, b) illicit inflows are invisible and untraceable to governments, c) this money is not taxed and d) they often perpetuate further illegal activities such as drug trafficking.

Kar and Spanjers (2015) conducted a study on illicit financial flows from developing countries for the period 2004 to 2013, and found that the developing world as whole lost an estimated US$7.8 trillion to illicit financial flows in this ten-year period. In real terms, this means these ouflows increase at average rate of 6.5 percent per annum. Furthermore, after the economic slowdown caused by the 2008/09 GFC, IFFs have been persistently rising, and have been recorded to be over US$1 trillion since 2011, reaching a new peak of US$3.3 trillion in 2013 (Kar and Spanjers, 2015)

Figure 3.1: Heat map of illicit financial flows by country as a percentage of GDP



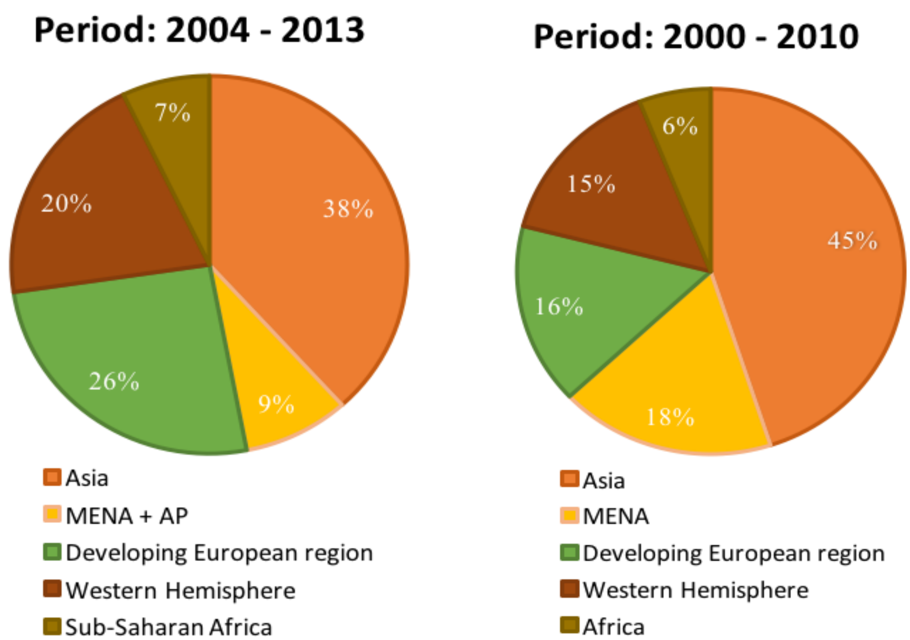
Source: Green (2013)

According to the Global Financial Integrity report by Kar and Spanjers (2015), Asia remains the region with the most significant volume of IFFs across the developing world and it constitutes for about 38 percent of total global IFFs for the 2004 to 2013 period. Although it is not clear in the above figure, Asia is followed by the developing European Developing region which is 25.5

percent and then Western Hemisphere at 20.0 percent. This is followed by Sub-Saharan Africa, the Middle East, North Africa, Afghanistan and Pakistan (MENA+AP) which accounted for 8.6 and 7.1 percent of global IFFs for the 2004 to 2013 period (Kar and Spanjers, 2015).

The abovementioned findings are similar to the statistics published in the Global Financial Integrity report by Kar and Freitas (2012) for the period 2000 to 2010. According to Kar and Freitas (2012) and the statistics published in the report, Asia dominated other regions in terms of IFFs, with a contribution that is almost half of average total illicit outflows at 45 percent from 2000 to 2010. However, Asia is followed by the MENA region during this period with a contribution of 18 percent. The developing European countries come in third place with a share of 16 percent. Thereafter, the Western Hemisphere follows with a significant contribution of 15 percent and Africa contributes the lowest with a share of only 6 percent.

Figure 3.2: Cumulative geographic sharing of illicit financial outflows by region



Source: Kar and Spanjers (2015) Global Financial Integrity Report; Kar and Freitas (2012) Global Financial Integrity Report

According to Kar and Spanjers (2013), between the ten-year period of 2000 to 2010, Asia experienced the highest growth rate of IFFs at an average of 13 percent, this did not change from 2004 to 2013, Asia experienced the fastest growth rate in IFFs again, with an average growth rate of 8.6 percent. Thereafter followed the Developing European region and MENA+AP region with an average annual growth rate of 7 percent respectively. In turn the Western Hemisphere followed at a growth rate of 3.4 percent and Sub-Saharan Africa at 3 percent (Kar and Spanjers, 2015). Although Sub-Saharan Africa contributes the least to total illicit financial outflows, it is important to note that it tops the list when IFFs are scaled as a percentage of GDP. Its illicit financial flows were averaging at 6.1 percent of the region's GDP. This is followed by developing Europe at 5.9 percent of GDP, Asia at 3.8 percent, the Western Hemisphere at 3.6 percent and MENA+ AP region at 2.3 percent

Table 3.1: Country Rankings by Largest Average Illicit Financial Flows for period (2004 -2013) (millions of U.S. Dollars)

Rank	**Country**	**Average IFFs**
1	China, P.R.: Mainland	139,228
2	Russian Federation	104,977
3	Mexico	52 844
4	India	51 029
5	Malaysia	41 854
6	Brazil	22 667
7	South Africa	20 922
8	Thailand	19 177
9	Indonesia	18 071
10	Nigeria	17 804

Source: Kar and Spanjers (2015)
Global Financial Integrity Report

Table 3.1. is adapted from the Global Financial Integrity report on illicit financial flows from developing countries for the period 2004 – 2013, the study included 148 countries, which on average contributed an estimated US$785,389 million to illicit flows for 2004 -2013 (Kar and Spanjers, 2015). The abovementioned countries were the top 10 largest contributors to illicit financial flows for the ten-year period, accounting for 62.2 percent of IFFs from developing countries. Interestingly, all the BRICS countries (Brazil, Russia, India, China and South Africa) appear on the list of the largest contributors to IFFs. They make up for 43.1 percent of IFFs in the study. China was ranked as the largest contributor to IFFs from the developing world from 2004

to 2013 and comprised 17.7 percent of total IFFs, and 28.5 percent of the top ten countries. South Africa was ranked number 7 out of 148 countries and contributed 2.7 percent towards total IFFs, and 4.3 percent of the top 10 listed above.

Table 3.2: IFFs as a percentage of GDP and Total Trade (2005 – 2014)

Country	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**Average**
	As a share of GDP										(2005-2014)
China	2,62%	2,46%	2,23%	1,61%	2,16%	2,08%	0,95%	1,76%	1,49%	1,84%	1,92%
Russia	4,47%	4,16%	3,98%	3,91%	5,71%	5,37%	4,87%	3,40%	3,16%	2,65%	4,17%
Mexico	3,45%	3,51%	3,66%	3,90%	3,53%	5,59%	4,55%	5,44%	5,34%	4,85%	4,38%
India	0,59%	0,76%	0,75%	1,13%	0,40%	0,74%	0,49%	0,42%	0,36%	0,47%	0,61%
Malaysia	17,69%	16,88%	13,39%	12,57%	11,41%	17,12%	10,69%	9,23%	7,77%	7,60%	12,44%
Brazil	0,80%	0,48%	0,69%	0,63%	0,60%	0,52%	0,52%	0,55%	0,41%	0,39%	0,56%
South Africa	0,86%	2,64%	3,98%	4,33%	5,30%	0,56%	1,83%	2,03%	2,11%	2,54%	2,62%
Thailand	3,28%	2,86%	2,23%	3,16%	2,45%	3,23%	1,97%	3,23%	1,93%	2,10%	2,64%
Indonesia	2,88%	2,79%	2,69%	3,17%	2,35%	1,19%	1,27%	1,22%	0,86%	0,96%	1,94%
Nigeria	15,69%	12,48%	10,30%	10,99%	15,56%	4,44%	2,38%	1,08%	5,19%	2,30%	8,04%
	As a share of total trade										
China	4,21%	3,85%	3,65%	2,88%	4,99%	4,27%	1,99%	3,90%	3,44%	4,47%	3,76%
Russia	9,25%	8,80%	8,95%	8,51%	14,11%	12,62%	11,80%	8,70%	8,42%	6,79%	9,80%
Mexico	6,75%	6,59%	6,80%	7,05%	6,71%	9,65%	7,49%	8,59%	8,74%	7,78%	7,62%
India	1,97%	2,32%	2,38%	2,60%	1,25%	2,12%	1,15%	0,97%	0,86%	1,23%	1,68%
Malaysia	9,92%	9,43%	8,04%	8,16%	8,22%	12,02%	7,66%	6,85%	5,78%	5,80%	8,19%
Brazil	3,65%	2,29%	3,37%	2,81%	3,51%	2,91%	2,78%	2,85%	2,06%	2,09%	2,83%
South Africa	1,95%	5,25%	7,52%	6,82%	11,61%	1,11%	3,27%	3,55%	3,48%	4,16%	4,87%
Thailand	2,71%	2,45%	1,99%	2,58%	2,41%	2,93%	1,62%	2,68%	1,69%	1,88%	2,29%
Indonesia	5,39%	5,89%	5,86%	6,45%	6,34%	3,07%	2,98%	2,94%	2,12%	2,42%	4,35%
Nigeria	24,72%	21,30%	16,90%	16,78%	29,10%	12,77%	5,71%	3,02%	16,88%	8,49%	15,57%

Source: GDP and Trade data from World Bank (WDI) (2018); IFF data from Spanjers and Salomon (2017).

However, looking IFFs as a percentage of GDP and total trade reveals a different story to the one in table 3.1. South Africa has, on average, a slightly higher IFF to GDP ratio than China. The difference is about 0.7 percent of GDP per year on average. China's GDP and investment rates averaged at 43 percent in this period as compared to South Africa's 20.1 percent. It is hard to see how 0.7 percent of GDP illicit flows can account for a 22.9 percent difference in investment. This gives evidence of how consistent and sustainable economic growth which is characterised by high levels of investment can counteract issues such as illicit outflows.

A more recent study was conducted on illicit flows from developing world for the period 2006 – 2015. The study found that the top 30 countries ranked by dollar value of illicit flows include resource rich countries such as South Africa and Nigeria which amounted to US$10.2 billion and

US$8.3 billion respectively (Global Financial Integrity, 2018). The top 30 also included European countries such as Turkey which stood at US$8.4 billion, Hungary at US$6.5 billion and Poland at US$3.1 billion. The top ranked Latin American countries included Mexico at US$ 42.9 billion, Brazil at US$12.2 billion, Colombia at US$7.4 billion and Chile US$4.1 billion. In similar fashion to the study conducted for the 2004 to 2013 period, the Asian states in the top 30 countries include Malaysia which amounted to US$33.7 billion and India which stood at US$9.8 billion. The top quintile of countries ranked by illicit outflows did not include China (Global Financial Integrity, 2019)

Both the abovementioned studies prove that trade-related IFFs appear to be both significant and persistent features of developing country trade with advanced economies (Global Financial Integrity, 2019). Furthermore, Global Financial Integrity (2019) found that trade misinvoicing remains an obstacle to achieving sustainable and equitable growth in developing countries However, it is important to note that most of the countries that account for large illicit outflows have weak monetary policies and regulatory systems, which brings us back to the question on whether or not illicit financial flows are symptomatic of weak governance and macroeconomic systems? Another important factor to note in conducting research on illicit financial flows is that there is great deal of difficulty in measuring IFFs and consequently there are a range of estimates. For purposes of this paper the methods that will be used to estimate IFFs are Trade Misinvoicing and abusive transfer pricing

3.2.1 Trade misinvoicing

For purposes of this paper it is important to define and understand the concept of trade misinvoicing because this is how most estimates of trade-based illicit financial flows focus are derived (IFF Main Report, 2016). Additionally, because this paper focuses on tax evasion and tax haven activity, it is important because this is the main method individuals and multinational corporations use to evade taxation. Trade misinvoicing involves the false practice of declaring a false value of goods imported or exported in order to evade custom duties and taxation, circumvent quotas or launder money. This value of goods and services is often understated when it comes to exports is and overstated when comes to the value of imports. Thereafter, the proceeds are illicitly shifted overseas. When imports are overstated it results in lower corporate revenues and therefore less income tax is paid (Global Financial Integrity, 2018). When exports are under-invoiced, the exporter collects less revenue and consequently reports lower income, resulting in less income tax paid (Global Financial Integrity, 2018).

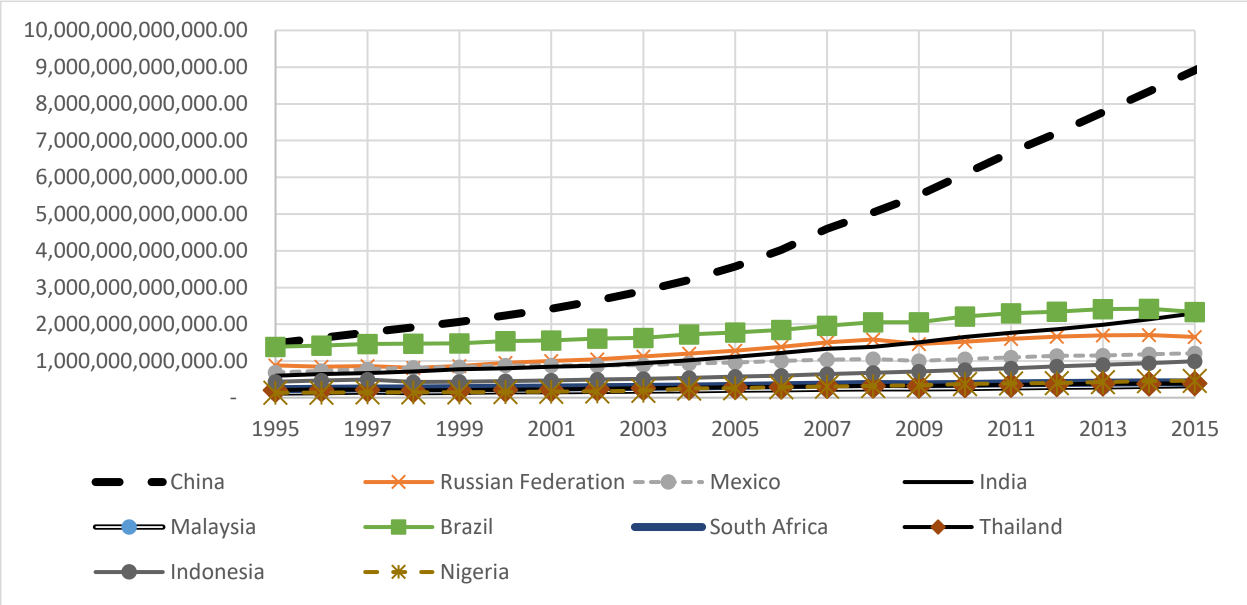
3.2.2 Abusive Transfer Pricing

When multinational corporations take advantage of its multiple structures to shift profits across different jurisdictions, this is known as abusive transfer pricing. It is not wrong for trade to take place between companies that are part of a single group, however these companies have to comply with the "arm's-length principle" for them not to be considered to be engaging in base erosion and profit shifting (IFF Main Report, 2016). Abusive transfer pricing is also another method that multinational corporations use for illicit tax practices.

3.3 Economic overview of developing countries with the largest average illicit outflows

3.3.1 GDP, GDP per capita and GDP per capita growth rate

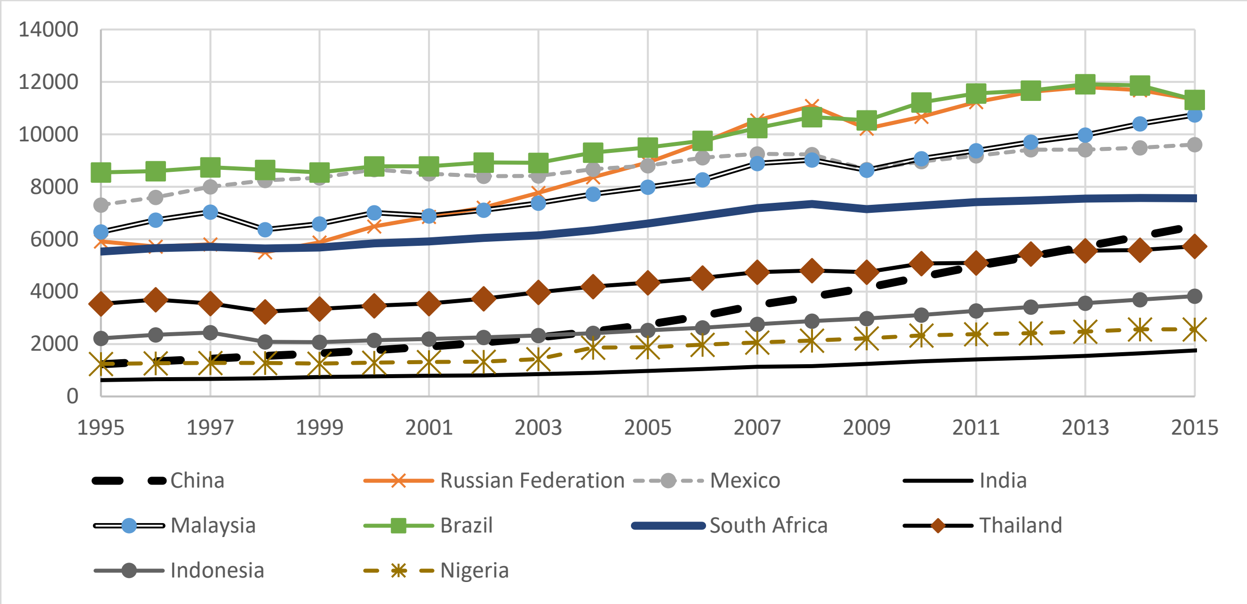
Figure 3.3: GDP (Constant 2010 US$)



Source: The World Bank (WDI) (2018)

In line with prior economic expectations, China had the largest increase in GDP in last 20 years. However, it is important to note that the other countries, apart from India, that have the largest average capital outflows, have had stagnant GDP growth for the 20-year period, so there could be a correlation between stagnant economic growth and high volumes of illicit financial flows.

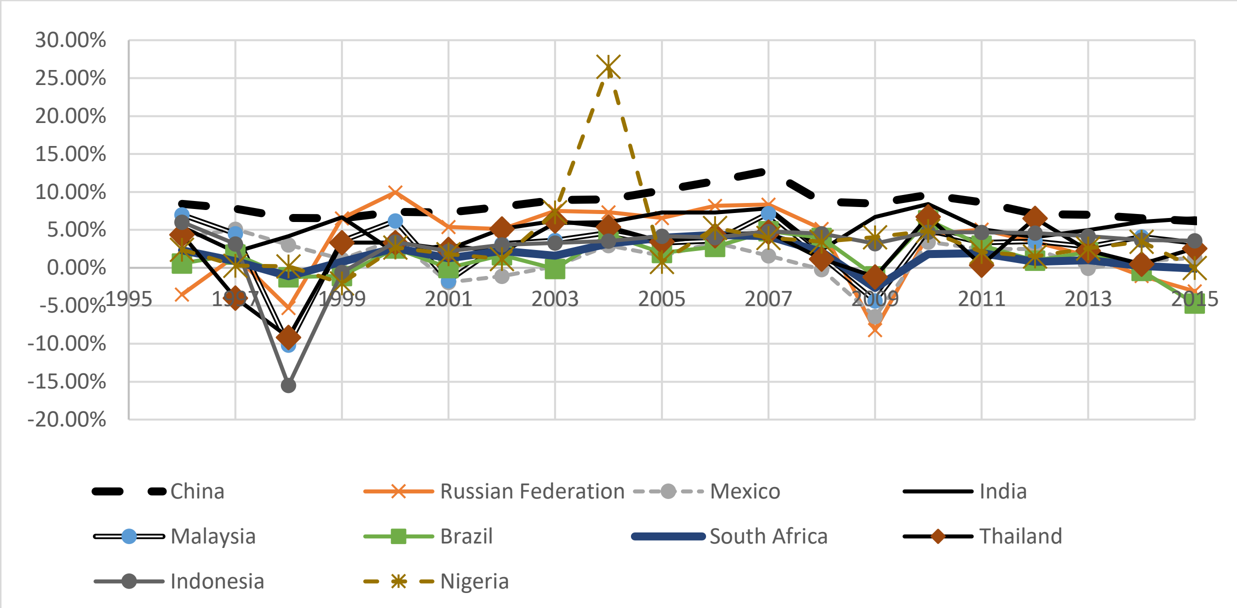
Figure 3.4: GDP per capita (constant 2010 US$)



Source: The World Bank (WDI) (2018)

China has consistently outperformed SA in GDP/capita growth terms, to the extent that China has almost caught up to SA in GDP/capita terms. China GDP per capita rose at a constant rate until about 2005, then it started increase at an increasing rate thereafter, indicating that the standard of living for its citizens dramatically rose after 2005. There was a bit of a slow-down in 2008, and that could have been due to the global financial crisis but thereafter, GDP per capita in China continued to rise at an increasing rate.

Figure 3.5: Growth Rate of GDP per capita (Constant 2010 US$)

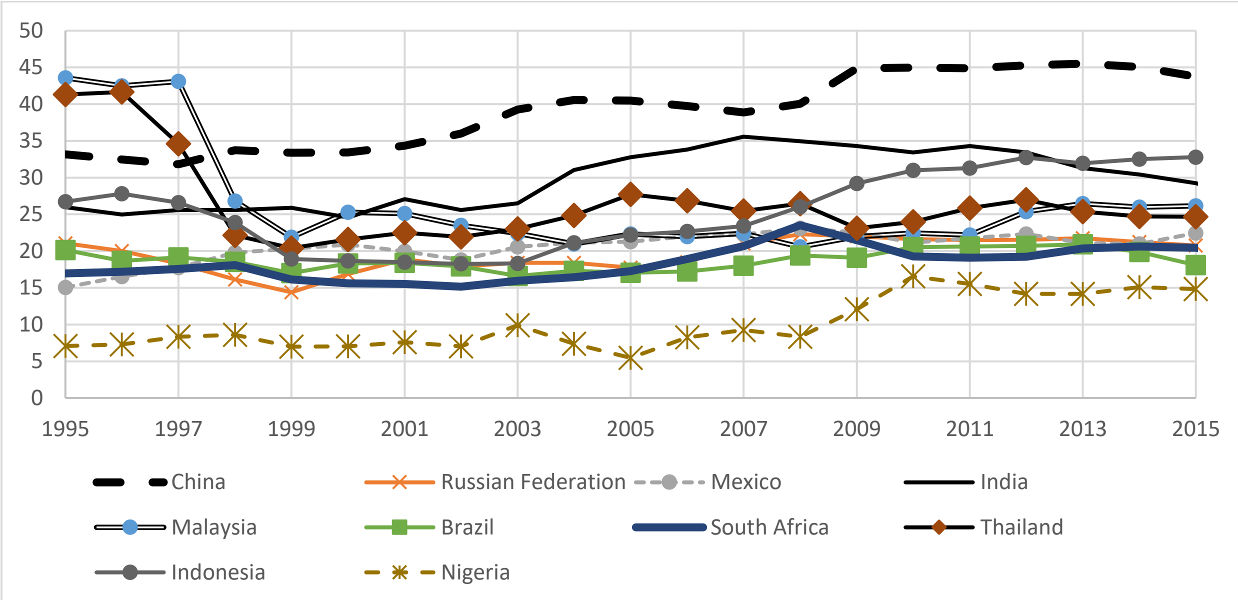


Source: The World Bank (WDI) (2018)

This second figure basically reiterates the findings of the first. Overall China has the highest growth rate of GDP Capita during the period 1995 to 2015. However, interestingly Nigeria has the highest growth rate of GDP per capita between the years 2003 and 2005. The first reason for this could have been because there was strong growth in both private consumption and private investment in Nigeria. The second could have been the introduction of a reform programme called the National Economic Empowerment and Development Strategy (NEEDS), with a simultaneous state level programme, which is known as the State Economic and Development Strategy (SEEDS) (OECD, 2006).

3.3.2 Investment, foreign direct investment, portfolio inflows and savings

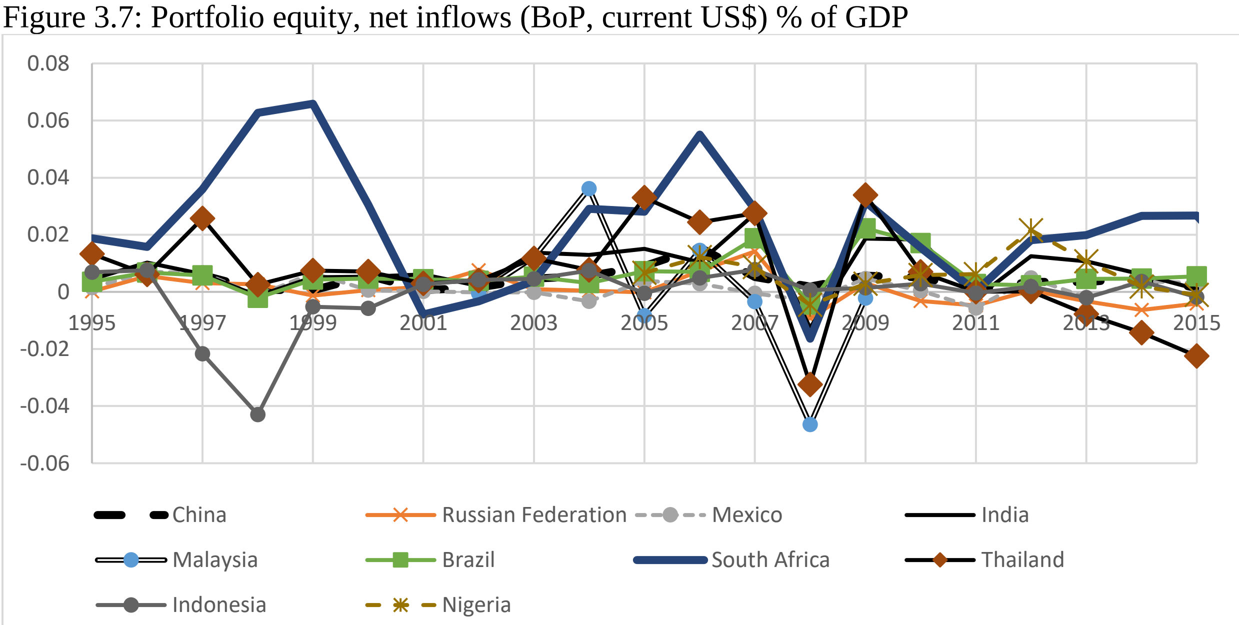
Figure 3.6: Gross Capital formation (% of GDP)



Source: The World Bank (WDI) 2018

In terms of Gross capital formation, and domestic investment China has the highest rate and most constant rate of domestic investment, while South Africa has amongst the lowest rates in domestic investment.

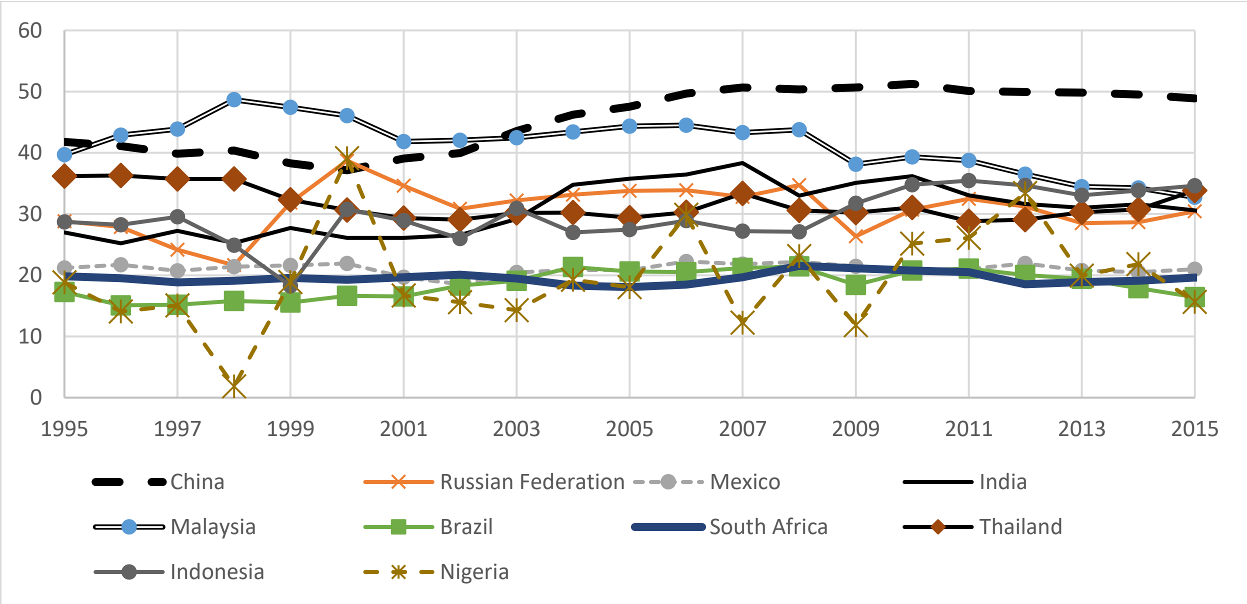
Figure 3.7: Portfolio equity, net inflows (BoP, current US$) % of GDP



Source: The World Bank (WDI) (2018)

According to figure 3.7 and figure 3.8, South Africa interestingly has among the highest levels of FDI and portfolio equity net inflows and China has a very constant level of foreign direct investment and portfolio equity. This could also be because the degree of trade openness is much wider in South Africa than in China. This is an interesting finding because this could make South Africa's economy more susceptible to the adverse effects of IFFs due to its reliance on foreign direct investment (FDI).

Figure: 3.8: Gross Domestic Savings (% of GDP)



Source: The World Bank (WDI) (2018)

In terms of gross domestic savings South Africa has a very low and stagnant rate of domestic savings, which is why the South African economy is reliant on foreign aid or foreign investment. In contrast China has the amongst the highest rate of domestic savings which could enable it to counteract the adverse effects of IFFs, tax evasion and tax haven activity. The following analysis on gross capital formation, foreign investment, portfolio equity and savings in these developing countries somewhat indicates that liberalised financial systems make it easier for capital to be moved to foreign markets with lower risks and higher returns.

3.4 Literature Review: Determinants of Illicit Financial flows

The reasons for illicit financial flows (IFFs), tax evasion and tax haven activity have been extensively explored by economists. The main idea is to understand the push and pull factors that drive IFFs, in order to find suitable solutions to ‘stop the bleeding’. Although the most obvious push factor is the desire to hide wealth, this section will seek to explore other determinants such as macroeconomic factors, structural issues, behavioural issues, monetary policy and most importantly the correlation of tax evasion and certain tax systems

3.4.1 Macroeconomic factors and structural issues

Macroeconomic factors such as structural issues, poor governance and weak regulation, are amongst the most common drivers of IFFs. Owners of illicit capital are more interested and invested in hiding income that maximises rates of return, meaning they are less likely to be concerned with the future taxation that is implied by a rising government deficit (UNDP, 2011). According to Boyce and Ndikudima (2001), countries that are structurally indebted around the world are the ones who suffer the most from illicit outflows. The structural factors that go hand in hand with IFFs are; rising inequality, faster rates of (non-inclusive) economic growth and increasing trade openness without adequate regulatory oversight (UNDP, 2011). Additionally, a poorly regulated business environment may encourage illicit outflows from multi-national corporations because people find it easier to make money through illicit activities than through legitimate business (IFF report, 2016). This can be highly attributable to corruption because it multiplies IFFs by weakening institutions and regulations (IFF report, 2016). According to UNDP (2011), if a country has non-inclusive economic growth it worsens and widens the income gap and the distribution of income. This results in a larger number of individuals with high net worth seeking to evade higher taxes because overall governance does not improve. Mossadak and Lahlou (2013) also identify the proliferation of corruption, political instability and inadequacies in governance as determinants of IFFs. Corruption distorts public policies because resources are allocated to those who are willing and/or able to bribe and pay kickbacks to public officials, instead of resources being allocated based on efficiency or internal interest rates. Therefore, weak governance spawn’s public corruption and encourages corporate malfeasance. Furthermore, weak regulatory structures are an important factor in post conflict African countries (UNDP, 2011; IFF Report, 2016). Political instability and armed conflicts are sources of increased capital outflows, and there is a positive and significant correlation between corruption and IFFs in most developing countries (Hermes and Lensink, 2001; Le and Rishi, 2006). According to the IFF Report (2016), the relative success that developed countries have had in tackling IFFs, as compared to the African experience is evidence that strong legal frameworks and enforcement make it harder for companies to move illicit resources.

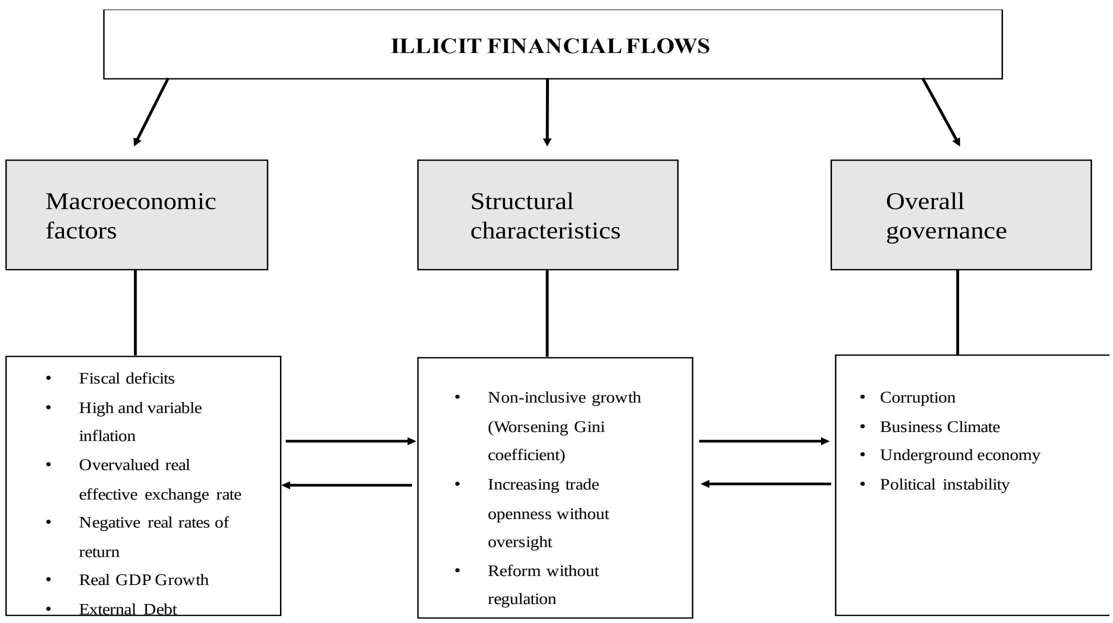
Other macroeconomic factors other than monetary policy that drive illicit outflows include; external debt, risk and return on investment, and exchange rate regimes. According to Mossadak and Lahlou (2013), external debt and the significant contribution of international loans is a determinant that has been cited by most studies done on the drivers of capital outflows. Other studies have identified the external debt that results from illegal capital flows as the reason for the deterioration of the macroeconomic environment in terms of the increase of the debt crisis (Ndikumana and Boyce, 2001). Alternatively, a high level of external debt can be interpreted as an indicator of good economic outlook by investors, because the state can easily borrow on international markets (Mossadak and Lahlou, 2013). In such cases the increase in public debt is expected to reduce illicit capital outflows.

A study conducted by Vos (1992) in the Philippines concluded that the stock of debt has no significant impact on capital flight. However, Collier (2001) conducted a similar study on a panel of 50 countries and found that the correlation between the accumulation of foreign debt and capital outflows is statistically significant.

According to Boyce and Ndikudima (2001), risk aversion and return on investment can be regarded as drivers of IFFs because investors are always looking to maximize their profits by arbitraging between domestic and foreign markets on the basis of risk and returns. Various indicators such as movements in exchange rates and interest rates can be used to test this hypothesis (Mossadak and Lahlou, 2013). Studies focused on African countries found that there is no significance between internal interest rates and the extent of capital flight (Hermes and Lensink, 1992; Murinde *et al*., 1996; Nyoni, 2000). In addition to interest rates, an overvalued exchange rate could lead to the acceleration of capital flight. Expectations about its depreciation could lead investors to change the composition of their portfolio by acquiring more foreign assets (Cuddington, 1986; 1987).

Figure 3.9 represents the interaction between the macroeconomic drivers of IFFs. The figure shows that overvalued exchange rates fuel the growth in underground economic activities, which further worsen corruption and the distribution of income (UNDP, 2011). There are strong interactions between macroeconomic conditions and the overall business climate. Growth promoting economic policies, attractive rates of return, lower fiscal deficits and stable rates of inflation can attract foreign direct investment (FDI). Alternatively, unstable economic policies that result in severe macroeconomic imbalances can discourage FDI (UNDP, 2011). Furthermore, corruption will reduce the country's capacity to attract FDI because it imposes high overhead costs of doing business in a country. (UNDP, 2011). In summary, the figure shows that interactions among these three main categories of macroeconomic drivers can further stimulate illicit flows and in very few instances dampen them.

Figure 3.9: Factors driving illegal financial flows



Source: IFF Main Report (2016)

3.4.2 Financial Development and Monetary Policy

It has been said that financial development reduces capital flight, as long as it provides more opportunities to diversify asset portfolios (Mossadak and Lahlou, 2013). However, it is important to note that the development of the financial system may also encourage or endorse illicit outflows if it facilitates international capital movements. The more liberalised and deregulated a financial system, the higher the probability of domestic capital being moved to foreign markets with lower risks and higher returns (Mossadak and Lahlou, 2013). In many African countries capital outflows are perpetuated by the government, therefore the central bank's attempt to influence private investment through interest rates will be ineffective. This means that illicit financial flows can weaken the way in which monetary policy transmission mechanism affects real economic activity (Fofack and Ndikumana, 2014). Resources from the domestic banking sector is another way in which Illicit financial flows can be financed. An example of this occurrence, is the large amount of capital outflows that took place in South Africa towards the end of the apartheid regime as the owners of capital shipped all their capital overseas for safekeeping due to the 'uncertain' future of the South African economy. However, this capital came from the domestic financial system. This is more evidence that monetary policy is weakened when domestic capital leaks out of the country (Fofack and Ndikumana, 2014).

Fofack and Ndikumana (2014) conducted research on illicit outflows in African countries, and the objective of the study was to analyse the relationship between monetary policy and illicit financial flows in Africa. A further purpose was to investigate the extent and gravity to which IFFs may change the course of monetary policy outcomes by changing the course of monetary transmission mechanism. This study tested two empirical propositions the first, was that capital flight may be affected by monetary policy and the second was monetary policy may in turn affect capital flight through its impact on the liquidity in the financial sector, domestic credit and the exchange rate (Fofack and Ndikumana, 2014). The findings of this study were that high interest rates reflecting high returns to saving in Africa do not deter capital flight, and that the monetary policy stance has not been a direct driver of capital flight either through interest rate regime or monetary policy targets. Fofack and Ndikumana, (2014) also found that financial development appears to have no effect on capital flight in regressions with annual data. However, pooled cross-section data shows that financial development is negatively related to capital flight. Medium term foreign reserves may also contribute to accelerating capital outflows. According to Fofack and Ndikumana (2014), most African countries are facing "capital flight trap". What this means is that high capital outflows lead to higher capital outflows, which indicates underlying structural and institutional factors that drive illicit capital outflows as stated in the previous section. This result is evidence that specific targeted and explicit policies are needed in most African countries in order to break the capital flight trap (Fofack and Ndikumana, 2014).

According to Fofack and Ndikumana (2014), the results also confirm the "revolving door" theory, which is supported by the strong positive correlation between external borrowing and illicit capital outflows. The results of the pooled data used in this study over a 5-year period, suggest that half or more of each dollar borrowed seeps out of the continent in the form of capital flight in the same period. These results call into question whether African nations are responsible for repaying foreign loans by challenging the legitimacy of international or external debts that fuel capital flight, which means that these debts could essentially be odious. (Fofack and Ndikumana, 2014).

3.4.3 Tax regimes and policies

According to the IFF report (2016) double taxation agreements, tax incentives and then existence of financial secrecy jurisdictions/havens are drivers of illicit financial flows in terms of tax evasion and tax avoidance. Double taxation agreements (DTAs) can enable capital flight, stifle economic activity and deteriorate FDI and it is very difficult to determine the extent to which these agreements positively contribute towards economic growth (IFF report, 2016). The benefits of DTAs depend on their provisions, and a well negotiated DTA will not deter foreign direct investment and should not contain provisions that encourage capital flight (IFF report, 2016). However, because most countries in Africa are dependent on foreign aid and foreign direct investments, most taxation agreements include provisions that endorse IFFs to the detriment of development finance.

Tax incentives have bad effects when abused but are usually granted in order to encourage inward investment and/or expansion of economic activity in general or in specific sectors of the economy (IFF report, 2016). The exploitation of rules relating to change ownership as well as base erosion enables abuse of incentives such as tax holidays which then result in illicit capital outflows (IFF report, 2016). Furthermore, financial secrecy and tax haven also accelerate IFFs and although these two sound familiar, they are not. Financial secrecy jurisdiction has an elaborate framework and was put in place to attract and draw financial resources irrespective of their location, therefore tax havens are deliberately put in place exploit the differences in tax rates across different jurisdictions (IFF report, 2016).

3.5 China: A Brief History

China has experienced decades of high speed growth. In contrast to South Africa, China has managed to transform itself from one of the poorest countries in world to being the second largest economy in the world that accounts for one third of global growth (IMF World Economic Outlook, 2018). Through four decades of reform and economic growth that is driven by capital accumulation

and savings, the Chinese government has managed to lift 800 million people out of poverty and achieve sustainable economic growth (IMF World Economic Outlook, 2018; OECD, 2017).
Around the late 1970s China started the process of transforming its economy from a closed economy to an open market system (Harris, 2009). In 1996, China informed the IMF of its full current account convertibility but emphasised that important capital controls remain (Harris, 2009). According to the IMF World Economic Outlook (2018), since then the economy sustained rapid growth. This was achieved through strategic restructuring and an improvement of the quality and benefits of economic activity by laying foundations and putting state owned enterprises on a modern enterprise footing. This allowed for greater participation in international cooperation and competition. During the 2000 to 2005 period, the average GDP growth stood at 9.53 percent. Thereafter China achieved a growth rate of 12.7 percent in 2006, followed by a 14.2 percent growth rate in 2007. In addition to achieving relatively high growth rates, the debt to GDP ratio in 2007 stood at 34 percent and exports constituted about 38 percent of GDP (Yang and Huizenga, 2010). Since then China has become the second largest exporter of goods and services in the world.

After the 2008/09 global financial crisis the Chinese economy experienced a slowdown, however because the financial sector had limited openness, the impact of the crisis was not as harsh. The reported loss of financial assets was much smaller than the total share of assets that their banks possessed (BRICS Report, 2012). So because China only kept a small percentage of mortgage-backed securities (MBS), the losses incurred by the main banks in china amounted to US$20 billion, which is much smaller compared to the US$ 41 trillion lost by other international financial institutions (Yongding, 2010; Yang and Huizenga, 2010).

Thereafter, due to the economic slowdown caused by the 2008/09 crisis the government in China decided to implement a fiscal stimulus package estimated at US$ 586 billion, which amounted to about 1.8 percent of GDP, for 2009 and 2010 (Yang and Huizenga, 2010). The objectives of this stimulus package were to increase domestic demand and the role it plays in growth, promote innovation, improve infrastructure and industrial development in order to ensure intensive economic development (BRICS Report, 2012). A quarter of this stimulus package was funded by the central government which resulted in public debt to rise by 4 percentage points to 36 percent. The rest of the stimulus package was planned to be financed from local governments who are explicitly prohibited from resorting to market borrowing (Lu and Sun, 2013). This monetary type policy prescription is a very important point because it is a key insight of modern monetary theory, which advocates for a consolidated state that does not rely on external borrowing in order to fund developmentalism. MMT states the government should always use its capacity to achieve full employment and price stability. In order to have social infrastructure the government must be willing to deal with a fair amount of debt. So by virtue of the consolidation state hypothesis the government should be able to create money by spending money into existence in order to propel economic development. This is exactly what the government in China did by implementing this fiscal stimulus package after 2008, which is in contrast to the austerity measures the South African government used in order to deal with negative impacts of the 2008 financial crisis.

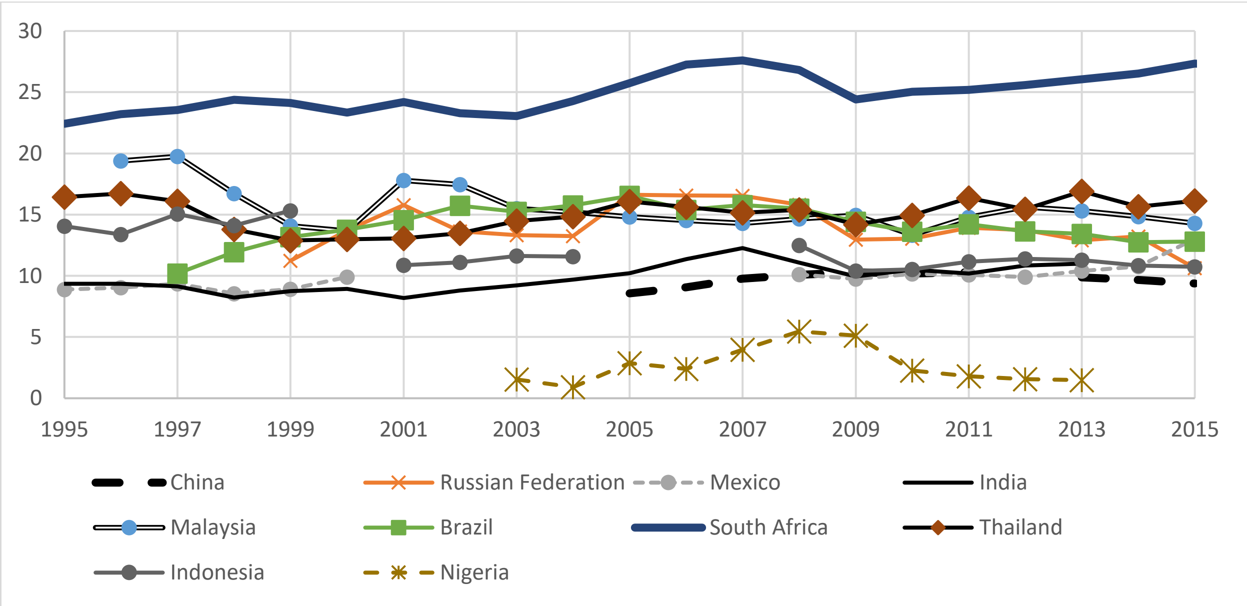
Even with China's impressive rise to the second largest economy in the world, it is important to note that it is not perfect. China has structural issues such as non-inclusive economic growth because there are a larger number of high net worth individuals who choose to shelter their wealth overseas (Ker and Freitas, 2012). Other structural issues include the degree of trade openness, weak regulatory systems and corruption which is evidenced by the expanding underground economy relative to GDP (Kar and Freitas, 2012). Increasing income inequality is also a soft underbelly of the decades of high-speed growth that China has achieved, and it poses a threat for maintaining social and political stability (Kar and Freitas, 2012). Since the late 1970s, China's distribution of income has become increasingly skewed with the Gini coefficient rising from 0.31 in 1981 to 0.47 in 2008. This has a negative impact of household consumption, which decreased by over 10 percentage points of GDP since the early 1980s (Kar and Freitas, 2012). As of 2015, China has managed to keep public debt levels relatively lower than debt levels of other emerging markets, however because fiscal stimulus is not funded by external capital, there is a local government debt crisis.

As much as China has managed to achieve sustainable economic growth, taxation is still a problem. The collection of taxation is, and continues to be a persistent challenge in China. Although taxation the revenue of China has improved from 13.8 percent of GDP in 2000 to 22.3 percent of GDP in 2011, it is still lower than that of the G-7 group of major advanced economies which stands at an average of 36.6 percent. Furthermore, China lags behind the emerging and developing markets average revenue collection of 26.6 percent of GDP (Kar and Freitas, 2012). The IMF notes that it will likely require more resources in the medium term in order to broaden the tax base for sustainability despite the fact that China has made significant progress in strengthening social safety nets. Given its ambitious spending promises and expenditures which only account for 5.7 percent of GDP on social safety net account, the Chinese government cannot afford to fail to collect sufficient tax revenues (Kar and Freitas, 2012)

3.6 Case Studies: IFFs in South Africa vs IFFs in China

3.6.1 Taxation Revenue

Figure 3.10: Taxation Revenue (% of GDP)



Source: The World Bank (WDI) 2018

The following figure introduces this section with an interesting narrative, because it seems like South Africa collects the highest levels of taxation revenue as a percentage of GDP, and China is amongst the countries that collect the least in taxation revenue. South Africa has a strong tax system and prides itself on this. While having a good tax system is important, it does suggest that South Africa has emphasised austerity: balancing the budget, which is part of a broader orthodox monetary policy package. Indeed, the orthodox account might argue that high tax in SA weakens the economy and is a reason for IFFs (tax avoidance). However, the MMT story (i.e. the critique of loanable funds) would also fit this picture.

3.6.2 Illicit Financial Flows and Tax Evasion: South Africa

Global Financial Integrity (2018) research identifies three main types of drivers of cross-border transfers of illicit capital; weak macroeconomic systems, structural issues, and poor governance. The main drivers of illicit financial flows in South Africa include weak macroeconomic and monetary policies, growing budget deficit which forces South Africa to seek external capital, rising inflation because the owners of capital do not want the real value of their assets to decline over time, weak regulatory systems, stagnant economic growth and the degree of trade openness (Global Financial Integrity, 2012).

According to the IFF main report (2016) there is evidence of aggressive tax avoidance by multinational corporations being curtailed in South Africa. A multinational corporation was found to have avoided taxation amounting to a whopping US$2 billion. The company did this by claiming that a big part of its business was conducted in the UK and Switzerland because these regions had lower taxation rates at the time. After the South African authorities (SARS) investigated the case, they found that these UK and Switzerland branches did not handle any of the commodities that the company traded and only had handful of low-paid employees. Furthermore, the company managed to create a paper trail, through creative accounting, that would route each transaction through the UK or Swiss offices to create the illusion that these branches were critical in running the business whilst most of the company's customers were in South Africa, Thereafter, South African Revenue Services (SARS), was able to reclaim the taxation that was avoided on the basis that the core of the corporation's activities is conducted in South Africa (IFF Main Report, 2016).

Table 3.3: Trade Misinvoicing and Potential Revenue losses in South Africa (millions of U.S. dollars average 2010 – 2014)

	USD, Millions
Average Import Value Analysed	**92,052**
Import Under-Invoicing	16,308
Average VAT lost revenue	2,110
Average customs duty lost revenue	596
Import Over-Invoicing	9,833
Average company income tax lost revenue	2,134
Average Export Value Analysed	**88,145**
Export Under-Invoicing	11,598
Average company income tax lost revenue	2,517
Average royalties, lost revenue	116
Export Over-Invoicing	8,584
Potential Revenue Losses	7,473

Sources: Global Financial Integrity (2018)

The analysis of trade-misinvoicing in South Africa revealed that the potential loss of revenue to government is US$7.4 billion annually and US$37 million for the period 2010-2014. The average portion of revenue loss attributable to import misinvoicing amounts to US$1.85 billion each year (Global Financial Integrity, 2018). The mentioned amount can then be broken into different components; uncollected VAT amounting to US$2.1 billion, customs duties of US$596 million and corporate income tax amounting to US$2.1 billion. The revenue lost due to export misinvoicing was US$2.6 billion on average each year (Global Financial Integrity, 2018).

The study conducted by the Global Financial Integrity (2018) also analysed data from SARS in order to gain extensive insight on import under-invoicing in South Africa. This analysis included 7.4 million trade transactions which compromised of 8,200 commodity types for the period 2000-2015. The key finding was that predominant goods categories which are under-invoiced are associated with higher effective tax rates than other classes of imports (Global Financial Integrity, 2018)

The figures in Table 3.2 represent the estimated value of the gap between what was reported by SARS and its trading partners. Misinvoicing gaps related to imports comprised of US$16.3 million in under-invoicing and US$ 9.8 million in over-invoicing (Global Financial Integrity, 2018). The misinvoicing gaps of exports were US$11.6 million for under-invoicing and US$8.6 million for over-invoicing. (Global Financial Integrity, 2018).

According to Global Financial Integrity (2018), the practice of trade misinvoicing has become normalised in many categories of international trade in the world economy. Trade misinvoicing is a major contributor to government revenue loss, which in turn means it is a contributing factor when it comes to poverty, inequality and insecurity in developing economies in emerging markets. Trade misinvoicing undermines sustainable growth in living standards and exacerbates critical issues such as inequities and social divisions in South Africa today (Global Financial Integrity, 2018). However, South Africa has yet to achieve sustainable economic growth because its policies do not focus on developmentalism, in other words, it is impossible to undermine sustainable growth as it is not a reality in the South African economy.

In South Africa there is a similar narrative about IFFs undermining the capacity of the economy. However, in this case IFFs are linked to, and seen as a major cause for low investment and yet South Africa has very large rate foreign investment. SA's IFFs are not particularly out of line with other emerging markets, and are not dramatically higher than China (as a share of GDP). SA's performance measured in GDP/capita growth is dramatically poor, especially recently. IFF's don't really stand out and what really stands out is SA's low I/GDP and low S/GDP

"Finance has been the fastest growing sector in the economy … While the orthodox account of finance assigns it the role of mobilising and allocating funds for investment the South African economy has suffered from miserably low levels of domestic investment. The South African economy does fail to achieve adequate levels of investment because of an inadequately generated surplus from the domestic economy. High proportions of that surplus are simply taken out of the country, much of it illegally. Calculations of such exports of capital reveal that it peaked at well over 20 percent of GDP in 2007. So capital flight is on par with levels of domestic investment which could therefore be doubled in its absence" (Ashman *et al*., 2017: 68 -9)

Even if IFFs are much bigger as in Ashman *et al*., (2017) claim, the question remains: are they causing SA's low investment rates? Or are they a consequence of SA's choice of 'orthodox' policies? The indicator of the latter is that SA has a relatively strong fiscal system with high tax revenue/GDP and very open financial systems (portfolio flows). Therefore, SA has gambled on 'austerity' (i.e. cutting back on debt) and integration into the global trade and financial system and it would appear that this has not produced the desired results. During the period of austerity up to 2008, with the Debt/GDP ratio going down, SA's investment, growth and economic growth remained stubbornly low. So, a case can be made that we need to explore 'endogeneity': the argument that signs of financial weakness (corruption, weak savings, IFF, etc.) are a consequence rather than a cause of the overall poor performance. And that this poor performance was driven by SA's orthodox policies, i.e. it taking the role of a 'cost-cutting' rather than a development engine.

There are a couple of nuances that could be drawn from the abovementioned statement. The first is that this does differ from the orthodox perspective, which sees IFFs as being caused by high taxation, corruption etc. Here, Ashman *et al.* (2017) see IFFs as being caused by financialisation. Secondly this perspective sees IFFs, and capital flight more generally, as a major issue and as a cause of low investment. Meaning money that could have been invested in the economy is now being taken out of the country. However, this could be because South Africa, has a high degree of foreign private investment, and as seen from figure 3.11 it collects the largest amount of taxation revenue as a percentage of GDP so where is the disconnect? The answer could be to acknowledge the MMT point that 'funds' are endogenous. Meaning that South Africa's low savings, weak revenue and IFFs resulting from tax evasion are to a large degree driven by the hole that South Africa has gotten into by choosing to adhere to new monetary policy prescriptions such as austerity.

3.6.3 Illicit Financial Flows and Tax evasion: China

In the Chinese case there are a number of drivers of illicit outflows. According to Kar and Freitas (2012), these drivers, including growing current account surpluses, lead to large capital outflows, some of which may be "licit" capital. Another contributor to illegal capital flight is high rates of inflation, because the owners of capital do want to see the value of their assets decrease over time. Another reason for IFFs in China is the perception that the Yuan is under-valued. This is because trade surpluses may feed into the expectation of exchange rate revaluation in the future which could lead to speculative inflows and round tripped capital (Kar and Freitas, 2012). Similar to the South African case, structural issues are also a driver of IFFs in China. These structural problems include non-inclusive economic growth, which results in a large number of high net individuals who choose to shelter their burgeoning wealth abroad (Kar and Freitas, 2012). Another structural factor is the increase in trade openness, which then provides more opportunities for trade misinvoicing as the customs administration does not have the capacity to keep up with rising trade volumes (Kar and Freitas, 2012). Furthermore, Kar and Freitas (2012) state that the underground economy in China is both a driver and is driven by IFFs.

It is also important to note that illicit financial flows from China, tend to vary by a much wider margin than they do for most countries (Kar and Freitas, 2012). This is because another important driver of IFFs in China is the fact that Hong-Kong is a tax haven. According to Global Financial integrity (2014) and Baazka (2017), after the Bank of China's money laundering schemes were discovered and it revealed that China's elite had invested large sums of money, billions of US dollars in international property and foreign assets, and large banks such as Bank of China and China Citi Bank, they aided wealthy Chinese individuals in moving illicit funds abroad. The way in which this happened is that China's currency controls were hindering the Chinese elite from making large foreign investments and in order to alleviate this 'roadblock', Chinese banks began manipulating currency controls in China (Baazka, 2017). Additionally, Chinese banks also furnished wealthy clients underground banking services to facilitate the cross-border movement of funds (Baazka, 2017). Although a lot of the exported wealth was legitimately obtained, some of the funds were acquired unlawfully and the intended use of those exported funds was unclear (Baazka, 2017). According to Kar and Freitas (2012), the intra China and Hong-Kong trade poses difficulties in identifying the original source of exports and destination of imports that are recorded by their partner countries. For example, if China's exports to other countries that pass through Hong-Kong are recorded by those countries as originating from China, while China records those exports as originating from the Mainland which is Hong-Kong, then the total Chinese mainland exports to the world would be overstated relative to world imports from Mainland China, this implies another important factor which is that China could be receiving illicit inflows due to export over-invoicing (Kar and Freitas, 2012).

Table 3.4: Trade Misinvoicing and Potential Revenue losses in China
(billions of U.S. dollars, 2000 – 2011)

Year	Export Under-Invoicing USD Billions	Import Over-Invoicing USD Billions	World Trade Misinvoicing USD Billions	Share of World Trade Misinvoicing %
2000	73.9	54.3	128.2	74.3
2001	74.8	62.7	137.5	75
2002	86.9	66.9	153.8	95
2003	98.9	84.6	183.5	95.8
2004	129.3	121.7	251.1	100
2005	153.4	130.1	283.5	96.9
2006	149.9	146.2	296.1	77.3
2007	154.9	171.8	326.7	80
2008	138.6	209.9	348.4	84.8
2009	132.1	162.6	294.7	100
2010	129.8	237.6	367.4	84.3
2011	119.2	310.8	430	71.3
Total	**1441.7**	**1759.2**	**3200.9**	
Average	**120.14**	**146.6**	**266.74**	**86.23**

Source: Kar and Freitas (2012) Global Financial Integrity

Table 3.5: Illicit Financial Flows and Trade Misinvoicing as % of GDP (2000-2011)

Year	**GDP USD Billions**	**Nominal IFFs Outflow USD Billions**	**Total IFFs as % of GDP %**	**Total Trade Misinvoicing as % of GDP %**
2000	1198.5	172.6	14.4	10.7
2001	1324.8	183.2	13.8	10.4
2002	1453.8	161.9	11.1	10.6
2003	1641	191.6	11.7	11.2
2004	1931.6	229.7	13	13
2005	2256.9	292.7	13	12.6
2006	2712.9	383.1	14.1	10.9
2007	3494.2	408.6	11.7	9.3
2008	4520	411	9.1	7.7
2009	4990.5	277.2	5.9	5.9
2010	5930.4	435.6	7.3	6.2
2011	7298.1	602.9	8.3	5.9
Total	**38752.7**	**3750.1**		
Average	**3229.39**	**312.5**	**11.12**	**9.53**

Source: Kar and Freitas (2012)

The purposeful misinvoicing of exports and import is largest channel for the transfer of illicit outflows from China (Kar and Freitas, 2012). Table 3.3 and Table 3.4. show that the average share of trade misinvoicing in total IFFs for the 2000-2011 is 85.3 percent, and according to Kar and Freitas (2012) this ratio has tended to fluctuate over the 11-year period. Before the 2008/2009 crisis (2000 - 2007) the average stood at 87 percent of total outflows and thereafter decreased to 85 percent of total outflows. Studies on China have shown when the firm's round tripping FDI is larger than the export subsidies forgone as a result of under-invoicing happens when corporations seek to reduce export under-invoicing when tax rebates are high. (Kar and Freitas, 2012). The way in which this happens is that and the firm's round tripping FDI is used to launder the illicit assets in order to take advantage of tax breaks and incentives on top of the already 'ill-gotten' wealth, the same way under-invoicing is used to shift illicit capital overseas to places such as Hong Kong and the British Virgin Islands, (Kar and Freitas, 2012).

This means that Chinese firms "systematically underreport exports to Hong Kong, even though the export rebates do offset some incentives to do so" (Fung *et al*., 2010). Other studies also show that trade misinvoicing occurs in order to avoid high tax rates and to take advantage of certain incentives (Kar and Freitas, 2012). Fisman and Wei (2004) gave an example of this practice by quantifying the impact of import tariffs and customs duties on tax evasion using trade data between China and Hong Kong. They found that one percentage point increase in the sum of custom duties and VAT on imports led to a 2-3 percent increase in tax evasion, which means that the correlation between higher taxation rates and tax evasion is very strong (Kar and Freitas, 2012).

Table 3.3 and Table 3.4 also show that gross illicit outflows have increased by an estimated US$430.3 billion over the 2000-2011 period. According to the Global Financial Integrity report by Kar and Freitas (2012), IFFs grew at an average of 7.2 percent per annum for the abovementioned period, which is slightly below the 10.2 percent average annual economic growth rate. The above tables also illustrate that total illicit outflows exceed 10 percent of GDP, which is worrisome because China is the world's second largest economy (Kar and Freitas, 2012). It is also possible to note that illicit outflows have declined by an average of 6.1 percent from 2000-2001, but the rate of outflows have accelerated from 10.4 percent pre-crisis to 13.9 percent post crisis (Kar and Freitas, 2012). Overall China suffered net illicit outflows of US$3.75 trillion over the 2000 - 2011 period and one of the worst effects of illicit flows from China is that the distribution of income is becoming more skewed. According to Kar and Freitas (2012) in the Chinese economy tax evasion is a mechanism by which the rich use to get richer and do this through using the world's shadow system to shelter and multiply their illicit wealth. If outflows continue to rise in China, adverse repercussions on social and political stability cannot be ruled out and illicit financial outflows whether estimated on net or gross basis, are massive (Kar and Freitas, 2012). Therefore, such outflows adversely impact the collection of government revenues and worsen the distribution of income (Kar and Freitas, 2012). According to the Kar and Freitas, (2012) China needs more effective collection of taxes in order to fund its social infrastructure commitments. However, because the government funds most of the fiscal stimulus this non effective tax collection system could result in a domestic financial crisis.

Kar and Freitas (2012) complain that China suffered an estimated US$3.75 trillion loss over the 2011 period. However, this argument is quite interesting because they also talk about money laundering and round tripping in China, which is essentially allowing Chinese nationals to get around paying tax, and to invest in China taking advantage of favourable foreign direct investment (FDI) legislation. However, it is important to note that in the same period China experienced extremely high rates of investment and growth. Consequently, this means that if a lot of money is being round-tripped into FDI into China, it is not lost to China. This is presumably different to the situation in resource rich countries like Nigeria, where the outflows are unlikely to flow back and support investment. Or in South Africa where money is flowing out and the country gets inflows into the financial system but does not translate into investment.

What this suggests is that a country like China, which has financial repression and a developmental state, is unable to perfectly control capital flows. A lot of money does leak illicitly, and licitly by means of taking advantage of loopholes. However, this is not the reason to suggest we should throw out the baby with bath water and abandon the developmental model. Although IFFs are certainly caused by financial repression and high tax rates and favourable treatment of FDI, IFFs can be regarded as a side effect, a fairly nasty one, but the medicine does still seem to be working.

3.7. Conclusion

Despite the growing attention and extensive research that has been done on the topic of illicit financial flows, the primacy of these outflows has yet to be identified. In as much as capital flight remains as the hallmark of underdevelopment in Africa, greater attention needs to be paid to the reasons why this issue has a bigger impact on the economies of African countries. The economic vulnerability of these economies to negative terms of trade shocks may exacerbate contraction in international reserves (Fofack and Ndikumana, 2014). However, the pertinent question is that have resource enriched developing countries in Africa ever had positive terms of trade? One thing that is very clear is that economic systems in Africa were never tailor made for sustainability, development and betterment of its citizens. Rather it has been a vessel for the perpetuation of exploitation.

According to the latest estimates illicit outflows from South Africa have amounted to US$10.2 billion from 2006 – 2015, and this largely exceeds the amount of external debt owed to foreign creditors. Furthermore, because illicit outflows result in a leakage of aggregate money supply it weakens the transmission of monetary policy especially because the structure of monetary policy is weak in South Africa. It is paradoxical that the most capital-scarce region of the developing world has emerged as a 'net creditor' to the rest of the world (Fofack and Ndikumana, 2014). According to Kar and Spanjers (2015), Sub-Saharan Africa tops the list when IFFs are scaled as percentage of GDP. Which means that economies such as South Africa are not achieving sustainable economic growth, and which is why IFFs have a greater impact on the economy

China is ranked as one of the countries with largest volume of illicit outflows. in fact, for the period 2004 -2013 it was ranked number 1. The major contributing factor to this is that Hong Kong in itself is a tax haven, however China has managed to achieve sustainable economic growth curtailing it into the second largest economy in the world despite the weak regulation and poor tax collection administration. Therefore, the next point of inquiry should be what is the difference between the workings of the South African economy and the Chinese economy?

The point is that the government in South Africa needs to focus on developmentalism in order to reduce the impact IFFs have on the economy. According to UNDP (2011) fiscal measures to fund a social safety, combined with investment in health, education and infrastructure need to be implemented so that economic growth benefits all income groups and not just the few privileged. The UNDP (2011) report states that it is fair to say that tax reform needs to focus on reducing tax evasion by widening the tax base and improving compliance. However, it is not fair to say that tax reform alone will succeed in curbing tax evasion. If the quality of government services and systems is not improved in terms of providing social infrastructure, IFFs will continue to have harsh effects on African developing countries. (UNDP, 2011). Which brings us back to the question whether or not IFFs, or their effects, are symptomatic of the kind economic mechanisms in African countries.

CHAPTER 4
CONCLUSION

The issue of exploring IFFs is a very complex one, and although extensive research has been done on this subject matter, IFFs are often seen as the cause for the lack of developmentalism in developing countries. This paper sought to question that hypothesis by viewing IFFs as symptomatic to the kind of development path most developing countries have adopted. Over the last 50 years Africa is estimated to have lost approximately $1 trillion to IFFs (Kar and Cartwright-Smith, 2010; Kar and Leblanc ,2013; IFF Main Report, 2016). According to the IFF main report (2016), the level of IFFs estimated for the abovementioned 50-year period exceeds the official development assistance needed in the African region which stood at $46 billion in 2012. Additionally, Global Financial Integrity (2015) states that IFFs and offshore tax haven activity are a big driver of inequality in developing countries, this is because IFFs and tax havens undermine state capacity and the funds needed for developmental finance. Therefore, there is a consensus among economists that curtailing IFFs would improve the effectiveness of macroeconomic policies and improve social infrastructure in developing countries. (Global Financial Integrity, 2015).

By looking at the orthodox and heterodox-MMT debate on developmental finance there are two key issues that emerge. The orthodox approach puts emphasis on the need to reduce public debt and views IFFs as an exogenous factor that contributes to increasing debt. Meaning by curtailing tax evasion and tax haven activity there would be more funds to investment in economic development. Austerity measures such as increasing taxes and reducing government spending are used to tackle the restraint of finance this system. Ironically, higher taxes incentivises the owners of private capital to evade taxes or engage in tax haven activity. The heterodox approach also views IFFs as exogenous. According to this approach, in order to combat the adverse effects IFFs have on developmental finance, wealth taxes should be raised. But the participants of illicit tax practices are not poor, so by increasing wealth taxes the government also further incentivises the wealthy to partake in illicit behaviour. The problem is that both approaches do not seem to be focused developmentalism. Tax evasion practices and tax havens are widespread and engrained in the financial system meaning, IFFs are not a cause of the demise of the financial system but a symptom of an unsound and weak financial system. In other words, tightening tax laws and tax reform will help the problem but cannot fix it inevitably

On the other hand, MMT views money, investment savings and by extension IFFs as endogenous variables. So according to this approach IFFs could be seen as a symptom of system that does not create its own money, or invest in its own economy. Developmentalism through endogenous state money creation is the core principle of this approach, which takes away this reliance on private investment, and takes away the economies vulnerability to illicit practices. Yes, this will create debt but debt is necessary for economic development and in any case most countries in the global economy have very high levels of public debt. So what MMT is saying is; an economy that has high levels of debt but is characterised by high levels of development and provides social infrastructure for all its citizens, has low levels of employment, good healthcare and education etc., is better than an economy with high debt levels characterised by inequality, poverty and unemployment. In other words, when it comes to developmental finance debt is inevitable however, it is up to governments and policy makers to choose the right 'kind' of debt, and not the type that makes them susceptible to exploitation and illicit financial flows.

Upon conducting analysis on the primacy of illicit financial flows in developing countries there was difficulty in measuring IFFs. The reason for this is because IFFs have a range of estimates so it was very difficult to produce precise and accurate results. However, there seems to be a positive correlation between large volumes of illicit financial outflows and high dependency on external debt. This means it seems that weak economies, that are highly dependent on external debt and have large amounts of this debt, seem to have the largest volumes illicit financial outflows. Weak regulation, high levels of debt and liberalised trade markets seem to be contributing factors to the degree to which companies evade taxes and partake in tax haven activity in these regions. Another interesting finding was that countries such Nigeria, and South Africa with high levels of private investment had a lower degree of illicit outflows than countries such as China in 2015. However, the central theme captured by the numerical analysis is that countries with low savings, high foreign investment, stagnant GDP growth seem to be affected most by illicit outflows.

The case study on China and South Africa yielded interesting results as well. In the case of China round tripping and money laundering is allowing Chinese nationals to get around paying taxation, and to invest in China taking advantage of favourable FDI legislation. However, in the same period in which the IFF study in China was conducted, China experienced extremely high rates of investment and growth. It is important to note that if a lot of money is being round-tripped into FDI into China but, it is not lost to China. This presumably different to the situation in resource rich countries like Nigeria, where the outflows are unlikely to flow back and support investment. Or in South Africa where money is flowing out and the country gets inflows into the financial system but does not translate into investment.

In South Africa there is a similar narrative about IFFs undermining the country. However, in this case IFFs are linked to, and seen as a major cause for low investment and yet South Africa has very large rate foreign investment. There are two nuances here the first is the orthodox perspective, which sees IFFs as being caused by high taxation, corruption etc. Secondly this perspective sees IFFs, and capital flight more generally, as a major issue and as a cause of low investment. Meaning money that could have been invested in the economy is now take out of the country. However, this could be because South Africa, has a high degree of foreign private investment. Furthermore, as seen from figure 3.11 South Africa collects the largest amount of taxation revenue as a percentage of GDP so where is the disconnect? The answer could be to acknowledge the MMT point that 'funds' are endogenous. Meaning that South Africa's low savings, weak revenue and IFFs resulting from tax evasion are to a large degree driven by the hole that South Africa has gotten into by choosing to adhere to new monetary policy prescriptions such as austerity.

A country like China, which has financial repression and a developmental state, is unable to perfectly control capital flows. A lot of money does leak illicitly, and licitly by means of taking advantage of loopholes. However, this is not the reason to suggest we should throw out the baby with bath water and abandon the developmental model. Although IFFs are certainly caused by financial repression and high tax rates and favourable treatment of FDI, IFFs can be regarded as a side effect, a fairly nasty one, but the medicine does still seem to be working.

The shortcomings of this study was the availability of data. The years in which the conducted studies on IFFs in South Africa and China do not match, which made it difficult to directly compare the two countries on the strict basis of IFFs. Further research can or should be done on the impact Hong Kong has on the degree of illicit financial outflows in China, as it is a tax haven. More research needs to be conducted on the relationship between monetary policy and illicit financial flows, and a comprehensive numerical study can be done on the causational relationship between IFFs and saving and investment.

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