

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

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Abstract

The paper focuses on illicit financial flows in the mining sector in South Africa as a threat to industrialisation - by draining the economy of a potentially rich resource, domestic investment, which is required to promote industrial development in the country. Arguably, it could be that the capital that illicitly exits South Africa as far as the mining sector is concerned could well be reinvested for further beneficiation /processing of raw materials into intermediate and finished products and in the development of productive capacities in manufacturing or firm expansion. Even though the problem of illicit financial flows is not unique to South Africa, still it is those countries that highly dependent on natural resources are most severely impacted by illicit financial flows. It was found that trade mis-invoicing, likely motivated by a desire for tax evasion, is the biggest contributor to illicit financial flows in the mining sector in South Africa. The paper therefore concludes that it is essential that strategic mechanisms and programmes aimed at curbing illicit trading, with a particular focus on export trade under-reporting, are strengthened to ensure that the surplus generated from the South African mining sector is reinvested back into the economy. Furthermore an examination of how illicit trading impacts on South Africa's trade policy prescriptions or evaluations is also critical - especially because trade policy is widely used as an instrument to promote industrial development

1. Introduction

South Africa, similar to many other African countries, has renewed its commitment to industrialization. The objective is to place the country in a manufacturing-led growth path, which will enable the creation of employment opportunities, reduce inequalities and eliminate poverty in order for the South African economy to develop further. Ramdoo (2015) states for those economies highly dependent on natural resources, industrialisation is no longer a choice - it is a timely imperative, in particular, in the aftermath of the triple shock of the sharp rise in food prices, in energy prices (until 2014) and due to the 2008/09 global financial and economic crisis that the world economy is yet to overcome. Moreover, the recent collapse in commodity prices have placed a majority of economies (whose production and exports have continued to be highly dependent on primary commodities) in significant vulnerability.

Malan, Steenkamp, Rossouw and Viviers, (2014: 6) indicate that industrialisation as a process that is enabled by structural change that is seen to follow three stages. In the first stage the production of primary goods is the dominant economic activity. It is then in the second stage that industrialisation takes centre stage by ensuring that manufacturing becomes a source of value to an economy. Then in the third stage the developed economy emerges. Schneider (2000: 413) reiterates that the development of the manufacturing sector is essential, this is because as a viable manufacturing sector is key to self-sustaining development of any economy. Roberts (2014: 184) adds that at the core of industrialisation is the development of productive capabilities in manufacturing that would result in increased productivity, quality and design of products. According to Roberts (2014: 189) these production capabilities are not simply about acquiring technology or skills, but are to do with the internal know-how of the firm, including routines and working practices, and the linkages within clusters and supply chains.

The South African government has set out its approach to industrial development in the country in the National Industrial Policy Framework (NIPF), and the Industrial Policy Action Plan (IPAP) as the implementing mechanism. However, according to Ashman, Fine, Padayachee and Sender (2014: 68), South Africa suffers low levels of domestic investment that is required for there to be any prospect for development policy to be successfully implemented. This is of critical concern given that the expansion of firms, as does the entry of new firms requires

investment, and even a movement towards a more labour-intensive production technology may require additional capital (see, Rankin 2014: 197). Ashman, et.al, (2014: 69) goes further to highlight that the reason South Africa fails achieve adequate levels of investment is not because of an inadequately generated level of surplus from the domestic economy, it is simply due to the high levels of surplus taken out of the country, much of it illegally. For instance, in the 2015 Global Financial Integrity Report, South Africa was ranked 7th place globally among the top ten source economies for illicit financial flows. Illicit financial flows are defined as the money that is illegally earned, transferred or utilised (Kar and Spanjers, 2015). It could therefore be said that illicit financial flows are a threat to industrialisation in South Africa. Arguably, it could be that, the capital that illicitly exits South Africa could well be used to promote industrial development in the country. For instance, it could be reinvested for beneficiation/processing of raw materials into intermediate and finished products and in the improvement of productive capacities in manufacturing and/or firm expansion.

The paper thus focuses illicit financial flows in the mining sector in South Africa as a threat to industrialisation. The paper is structured as follows. First, an overview of South African manufacturing sector trends post-1994 is presented. The aim of this section is to highlight industrial developments in South Africa post-1994. Then the linkages between industrialisation and the mining sector in South Africa are reviewed. The aim of this section is to highlight the opportunities for resource-based industrialisation in the country. This is followed by a discussion on illicit financial flows in the mining sector in South Africa. The aim of this section is to problematize illicit financial flows deliberating on the main drivers and channels of these flows in the mining sector in South Africa. Concluding remarks are provided towards the end of the paper.

2. An overview of South African manufacturing sector trends post 1994

2.1 Economic performance

The economic performance of the manufacturing sector has significantly deteriorated post-1994. Table 1 show that the share of manufacturing in South African GDP declined from 21.4% in 1995 to 13% in 2015. Notably, in the same period the share of finance in GDP soared from 15.3% in 1995 to 20.9% in 2015. The shift in the performance of the manufacturing sector is also an indication of the structural changes in the South African economy that have taken place post 1994.¹

Table 1: Sectoral share in GDP at basic prices (at current prices)

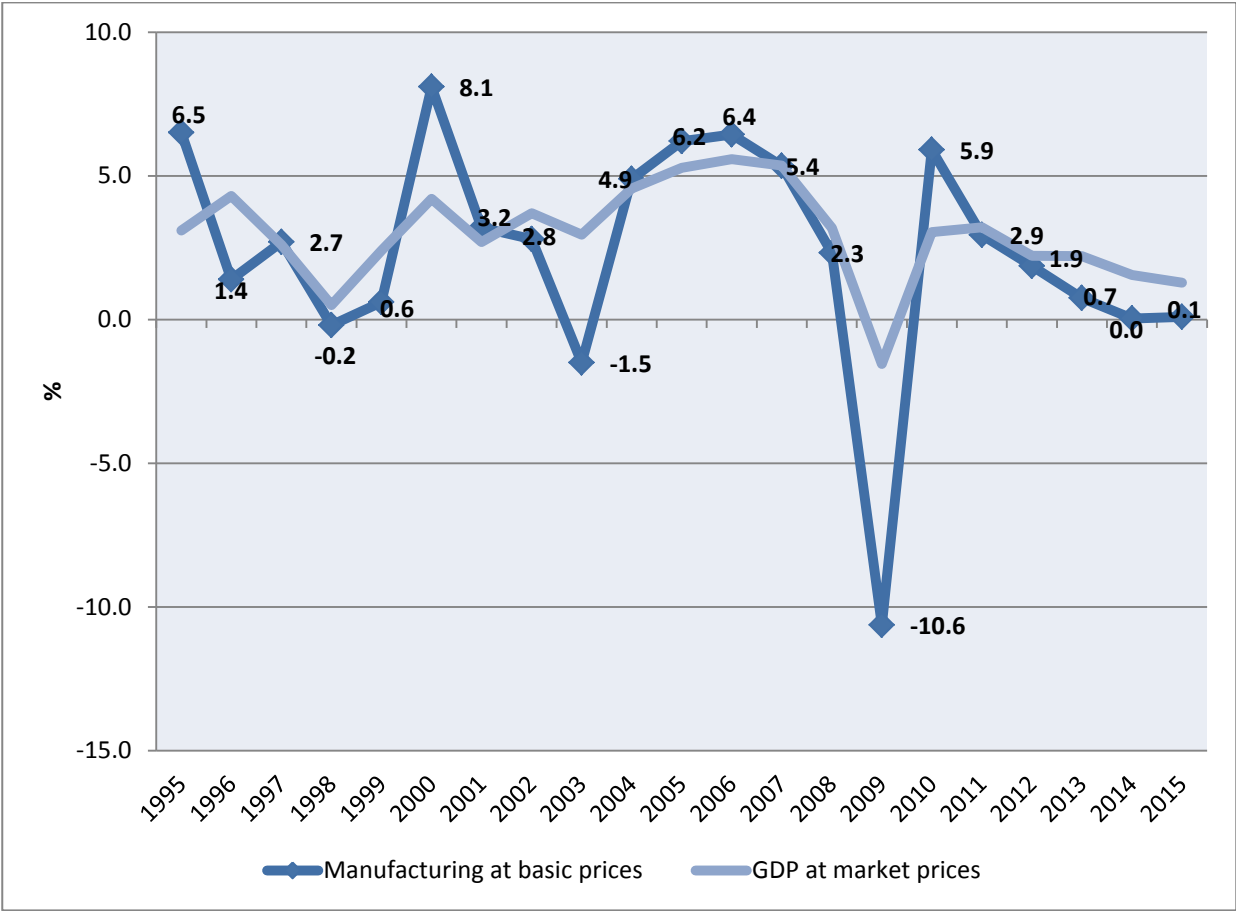
Sectors	1995	2005	2015
Agriculture, forestry and fishing	3.9	2.7	2.3
Mining and quarrying	6.8	7.3	8.0
Manufacturing	21.4	18.1	13.0
Electricity, gas and water	3.3	1.9	3.6
Construction	3.4	2.9	4.0
Wholesale, retail, motor trade and accommodation	14.4	14.2	15.0
Transport, storage and communication	9.3	10.9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

Source: Stats SA data

¹ Also highlighted by Borat, Hirsch, Kanbur, and Ncube (2014: 2), are the key set of structural shifts that the South African economy has undergone in the post-1994 period are manifest in four key outcomes: the decline of the share of mining in GDP; the stagnation of the manufacturing sector; the rise of the share of finance in GDP; and the subtle increase in the share of transport and telecommunications sector in GDP.

During the 2008/09 global financial and economic crisis the manufacturing sector experienced a severe contraction that saw the annual real growth rate decline by 10.6% in 2009. The recovery to pre- crisis growth rates has been very slow. Figure 2.1 shows that in the period 1995 to 2007, the average annual real growth rate in the manufacturing sector was 3.6% and just only 1.9% in the period 2010 to 201. Also when looking at the quarterly GDP statistics (*not included in the graph*), it reveals that by definition the manufacturing sector went into a recession in the period 2008Q3 to 2009Q2.

Figure 2.1: Annual Real Growth Rates (constant 2010 prices)

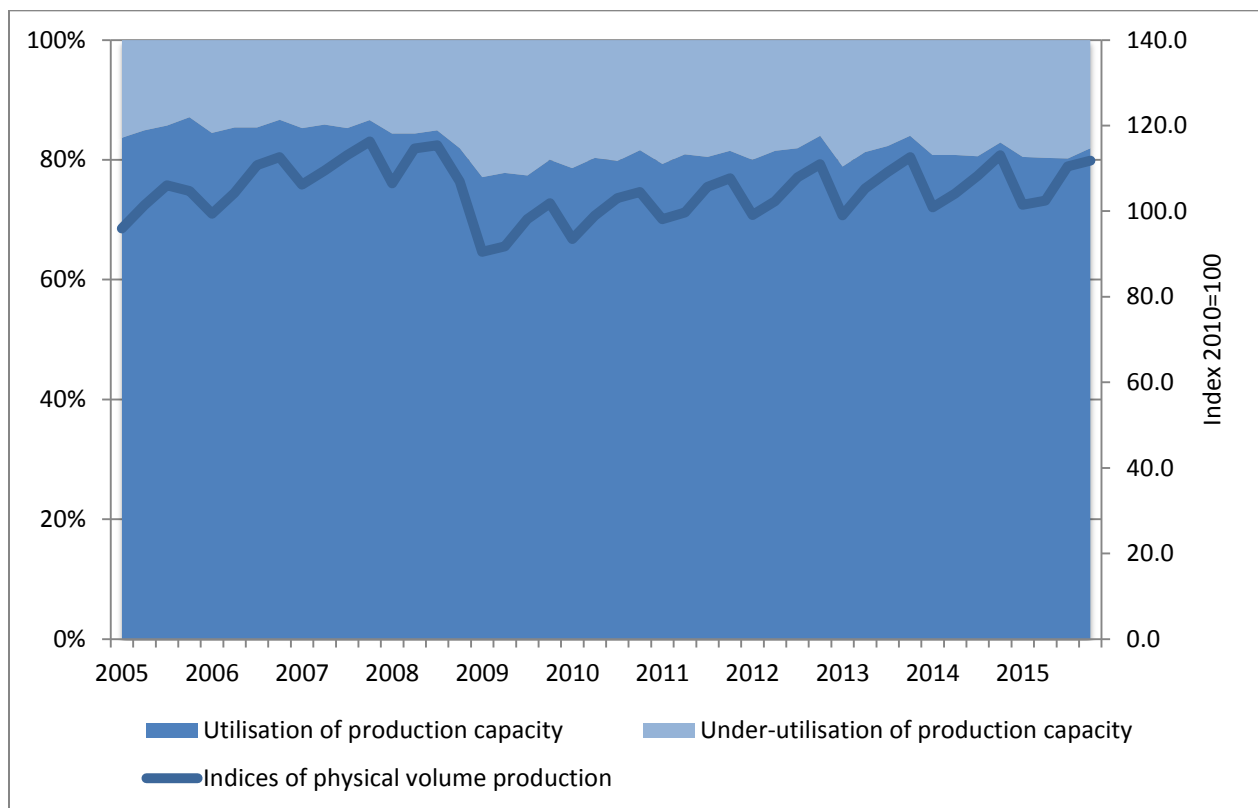


Source: Stats SA data

2.2 Capacity utilisation

Increased productive capacity over time leads to increased levels of output. Therefore the degree of capacity constraint experienced in the manufacturing industry has a direct impact on production volumes. Figure 2.2 shows that in the period 2005Q1 to 2015Q4 on average production capacity utilisation was around 82% with under-utilisation averaging 18%. The reasons for under-utilisation include raw materials, labour, insufficient demand and other. According to Stats SA , over the years large manufacturers reported insufficient demand as having a major impact on the capacity constraint experienced in the manufacturing industry, with labour having the least effect.

Figure 2.2: Utilisation of production capacity and index of volume production

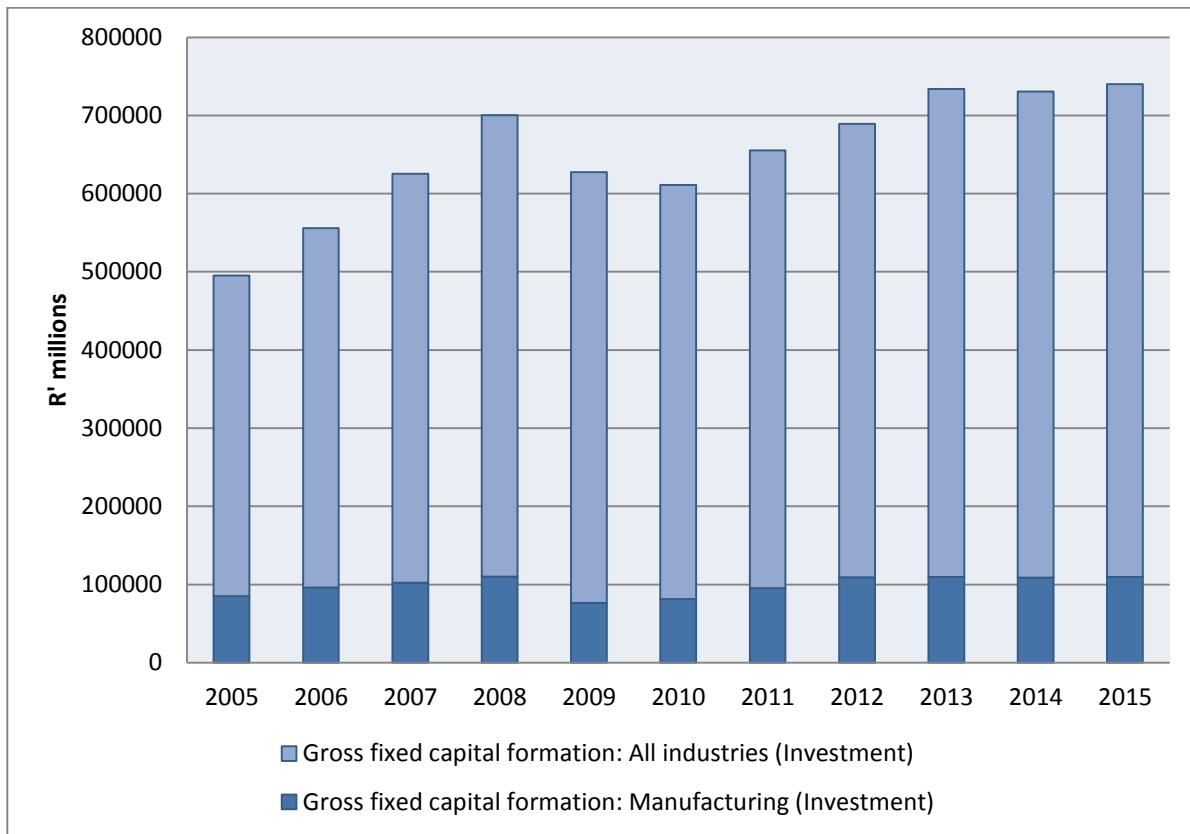


Source: Stats SA data

2.3 Investment

Investment is needed in any industry to improve productivity and increase competitiveness. Investment in the manufacturing sector has remained at very low over the years. Figure 2.3 shows that the Gross Fixed Capital Formation (GFCF) for the period 2005 to 2015, on average only accounted for only 19.9% of total GFCF.

Figure 2.3: Gross Fixed Capital Formation (Investment)

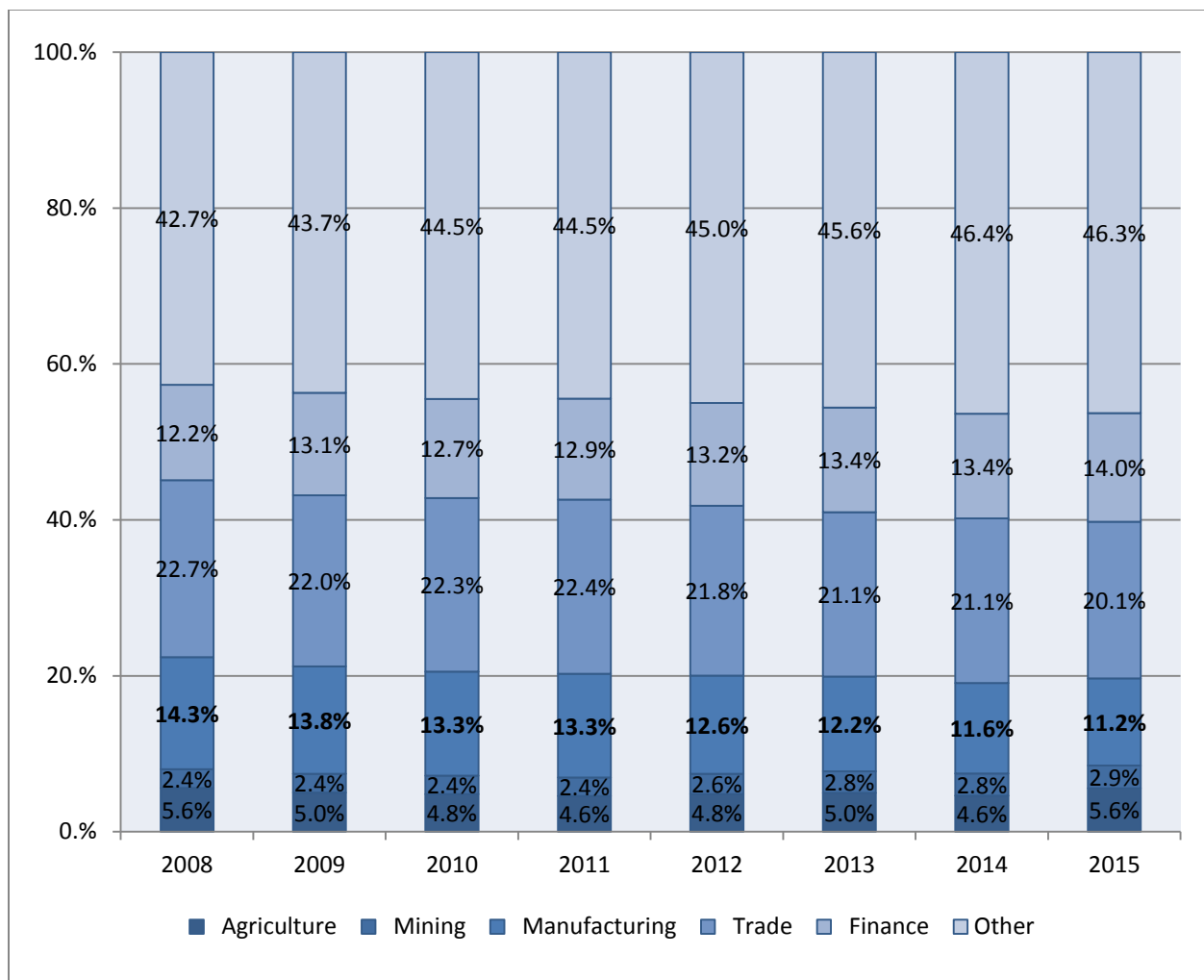


Source: SARB data

2.4 Employment

Employment in the manufacturing sector was also severely affected by the 2008/09 global financial and economic crisis. Figure 2.4 shows that the percentage shares of manufacturing in total employment to have declined from 14.3% in 2008 to 11.2% in 2015. The manufacturing sector has lost over 131 500 (thousand) jobs over the 2008 to 2015 period. The sector has struggled to recover its pre-crisis employment figures.

Figure 2.4: Sectoral composition of employment in South Africa in 2015 Employment



Source: Stats SA data

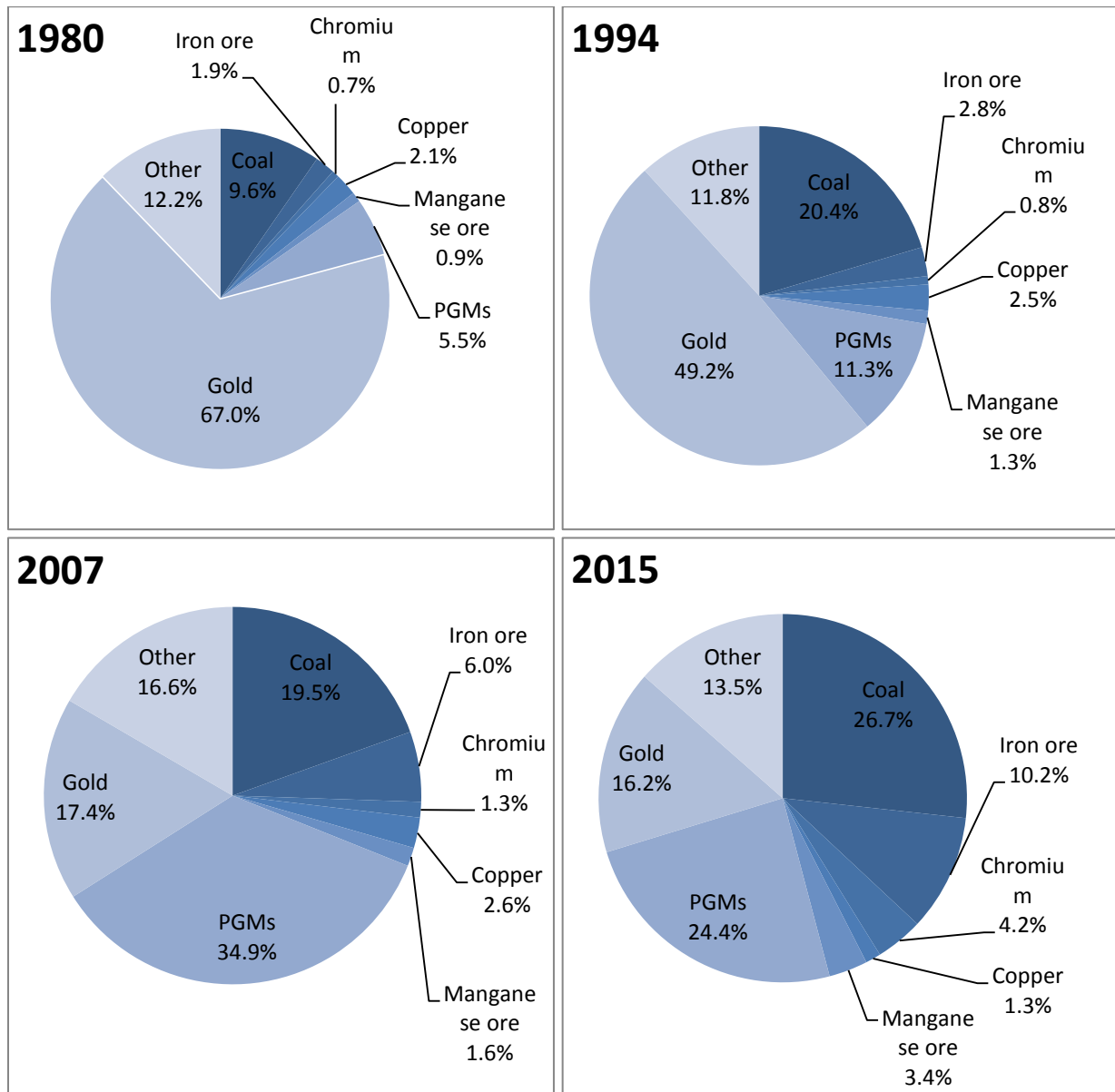
3. Industrialisation and the Mining Economy in South Africa

Historically, the minerals revolution of the 19th century laid the foundation for the emergence of the modern South African industrial state (see, for instance; De Kock 1924, Lumby 1983, Jones and Müller 1992). Even post-1994, South Africa's industrial developments still remained to be dominated by what Fine and Rustonjee (1996) termed the 'minerals-energy complex'. According to Fine and Rustonjee (1996:71) the minerals-energy complex includes the mining and energy sectors and a number of associated sub-sectors of manufacturing, which have constituted and continue to constitute the core site of accumulation in the South African economy. Roberts (2007: 14) states that the minerals-energy complex has ensured that rapid expansion of productive capacity occurs mostly in those sectors closely related to minerals beneficiation. Consequently, those sectors which have been identified to have weak linkages to the minerals-energy complex are inadequately developed (Mohamed 2007: 82). Ashman, Fine and Newman (2011: 11) add that the 'minerals-energy complex' that has dominated South Africa's industrial developments had embraced the processes of financialisation in which the export of domestic capital has played a leading role.²

South Africa remains one of the most geologically blessed regions in the world (Malhere, 2000). Malhere (2000: 5) highlights that South Africa has more than half of the world's reserves of manganese, chromium and platinum group metals. It has 40 per cent or more of the world's vanadium, gold and vermiculite reserves. According to Malhere (2000: 5) the country's mineral legacy is reflected in robust production statistics, a full roster of new mining investments, a dynamic mining supplies and services sector, and globally prominent firms. Also, over the years the structure of South African mining economy has become noticeably more and more diversified. Figure 3.1 below depicts how the structure of the mining sector has changed in the period 1980 to 2015. Notably, gold had declined its share in mining industry from 67% in 1980 to 16% in 2015. Whereas PGMs increased their share in mining industry from 5% in 1980 to 24% in 2015; coal has also increased its share its share in mining industry from 9.6% in 1980 to 27% in 2015.

² According to Stockhammer (2010), financialisation is the term used to summarise a broad set of changes in the relation between the 'financial' and 'real' sectors which give greater weight than heretofore to financial actors or motives. Chen (2015) adds that due to the gradually expanded gaps between financial and manufacture investments, financialisation is suggested to work against industrialization.

Figure 3.1: Structure of the mining sector (sales at current prices)



Source: Own calculations, using Stats SA data

South Africa's natural resources and its diversified mining economy continue to present real opportunities for resource-based industrialisation in the country. Ramdoo (2015: 18) highlights three linkages in the extractive sector that when fully explored would benefit industrialisation of resource rich countries. These are fiscal, production and consumption linkages.

1. Fiscal linkages

Fiscal linkages relate to the resource rents, collected by governments from the commodities sectors in the form of corporate and income taxes and royalties. According to Ramdoo (2015:18) even though these fiscal revenues have been used for budgetary purposes, they can potentially serve to promote industrial development in the other sectors of the economy. Therefore, illicit financial flows occurring in the mining sector drain the economy of a potentially rich resource that could be used to promote industrial development in the country.

2. Production linkages

Production linkages include forward or upstream (processing and transforming extractive produce into manufactured products) and backward or downstream (producing inputs that will be utilised in commodity production). Ramdoo (2015:18) says that production linkages are more likely to stimulate the development of a more diversified economy. According to Industrial Development Corporation (IDC, 2013) in the period of 1992 and 2012 the share of manufactured goods as intermediate inputs for the mining sector was 50% and 31% respectively. Whereas the share of demand for mining products by local manufacturing sector for further beneficiation/processing was 86% in 2002 and 77% in 2012. The linkages between South Africa's mining and manufacturing sectors remain strong. Thus focusing the attention to the linkages between the mining sector and other sectors in the economy, for example agriculture and services sector, would avail prospects to diversify and develop other industries.

3. Consumption linkages.

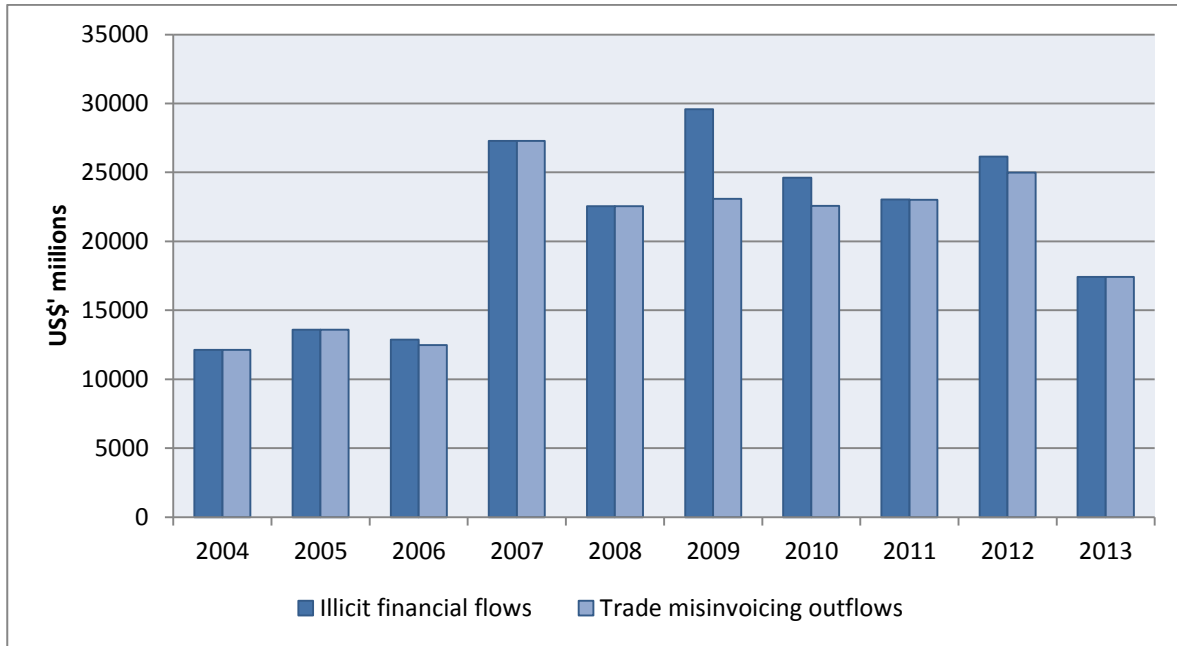
Consumption linkages are associated with the demand for outputs produced by other economic sectors resulting from the expenditures incurred by the extractive sector. According to Ramdoo (2015:18) in countries with a weak industrial sector, the domestic economy would be unable to respond and therefore the country would need to resort to imports to meet the demand. It is imperative that South Africa recognises the significance of renewed commitment to industrialization; so as to develop its industrial base.

4. Illicit Financial Flows in the Mining Sector in South Africa

For developing economies illicit financial flows pose intricate development challenges. The Report of the High Level Panel on Illicit Financial Flows from Africa, highlights the challenges posed by illicit financial outflows to include; draining scarce foreign exchange resources, reducing government tax revenues, deepening corruption, aggravating foreign debt problems and impeding private sector development (see also the World Bank publication *Draining Development? Controlling Flows of Illicit Funds from Developing Countries*, edited by Peter Reuter, 2012). The countries most severely affected by the problem of illicit financial flows are those that are highly dependent on natural resources and this is mainly due to specific factors that make extractive sectors prone to illicit financial flows. As highlighted by Le Billon (2001:3-4) these include; high-level discretionary political control under which extractive sectors tend to come; blurring of public, shareholder, and personal interests with regard to extractive sectors; limited competition; complex technical and financial processes that require a high degree of expertise; and the high degree of integration into the global economy through resource exports and imports of food and manufacturing goods. As a result, in the case of resource rich countries the three main sources of illicit financial flows are corruption, illegal exploitation and tax evasion.

The 2015 Global Financial Integrity Report, ranked South Africa 7th place globally among the top ten source economies for illicit financial flows. During 2004-2013, South Africa's cumulative illicit financial flows amounted to US\$ 209,220 million. Trade misinvoicing is reported as dominating South Africa's measurable illicit financial flows. Figures 4.1 below shows that in the period 2004 to 2013 trade misinvoicing accounted for about 95% of the illicit financial flows from South Africa. Sub-Saharan Africa accounted for 8.6% of cumulative illicit financial flows from the developing world during 2004-2013. A significant majority of illicit financial flows from Sub-Saharan Africa 71.5 % are due to trade mis-invoicing.

Figure 4.1: Illicit Financial Flows from South Africa



Source: Global Financial Integrity data

Trade mis-invoicing is the movement of capital abroad by mis-reporting the value of international trade. Table 2 gives an indication of the motives for mispricing in international trade. The focus of this discussion is however not on trade mis-invoicing inflows (over-invoicing of exports and under-invoicing of imports), rather on trade-mis-invoicing outflows (under-invoicing of exports and over-invoicing of imports).

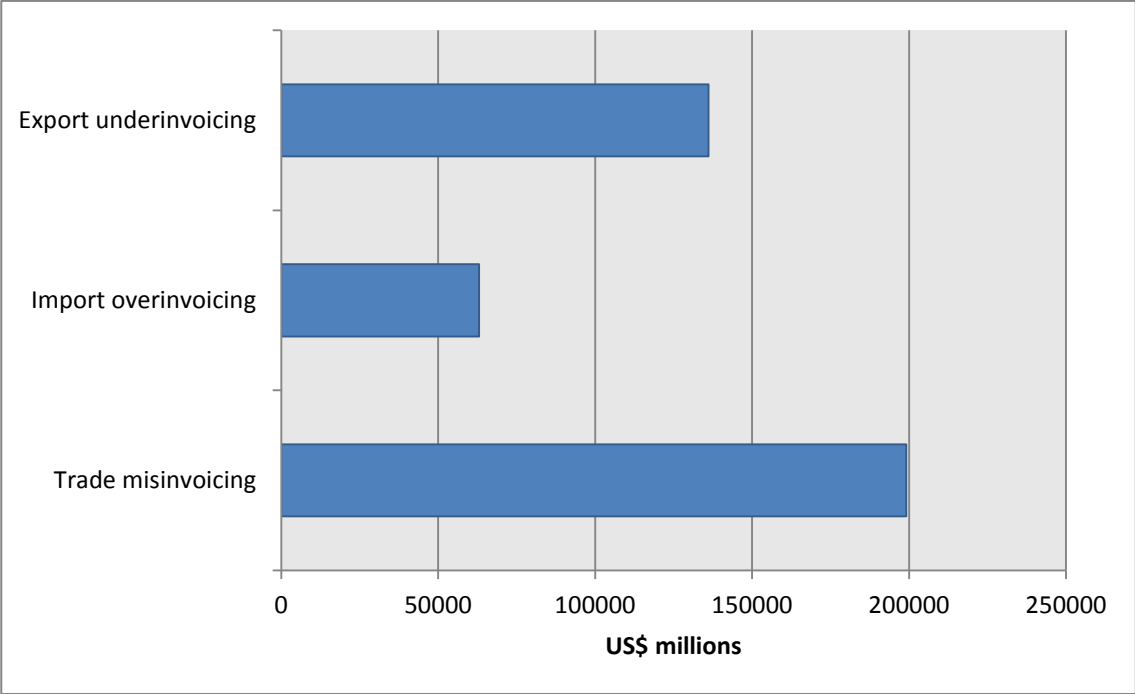
Table2: Motives for Mispricing in International Trade

Trade	Over invoicing	Under invoicing
Exports	Capturing export subsidies	Capital flight, avoiding export taxes
Imports	Capital flight, lowering domestic profits	Evading import duties

Source: Nitsch (2012)

Nitsch (2012: 314) explains that, when exporters understate the export revenue on their invoices (under-invoicing), and importers overstate import expenditures (over-invoicing), this facilitates the movement of capital abroad without any official record of this having taken place. Nitsch (2012) argues that under-invoicing of exports, rather than over-invoicing of imports, is more often used as a vehicle of capital flight, this is because export controls are less restrictive. The components of trade misinvoicing outflows from South Africa as shown below in figure 4.2). According to Nitsch (2012: 314) the under-reporting of exports allows firms to acquire foreign exchange that is not disclosed to national authorities; the foreign currency can then be freely used by exporters without complying with controls and regulations (for example, a potential option may be the sale of foreign currency in the parallel exchange rate market). Furthermore, because authorities may use information on the export activities of firms to infer the production of these firms. As a result, firms that seek to hide output (to evade domestic taxes) will automatically also seek to hide exports (Nitsch 2012: 314).

Figure 4.2: Trade misinvoicing outflows, 2004-2013



Source: Global Financial Integrity data

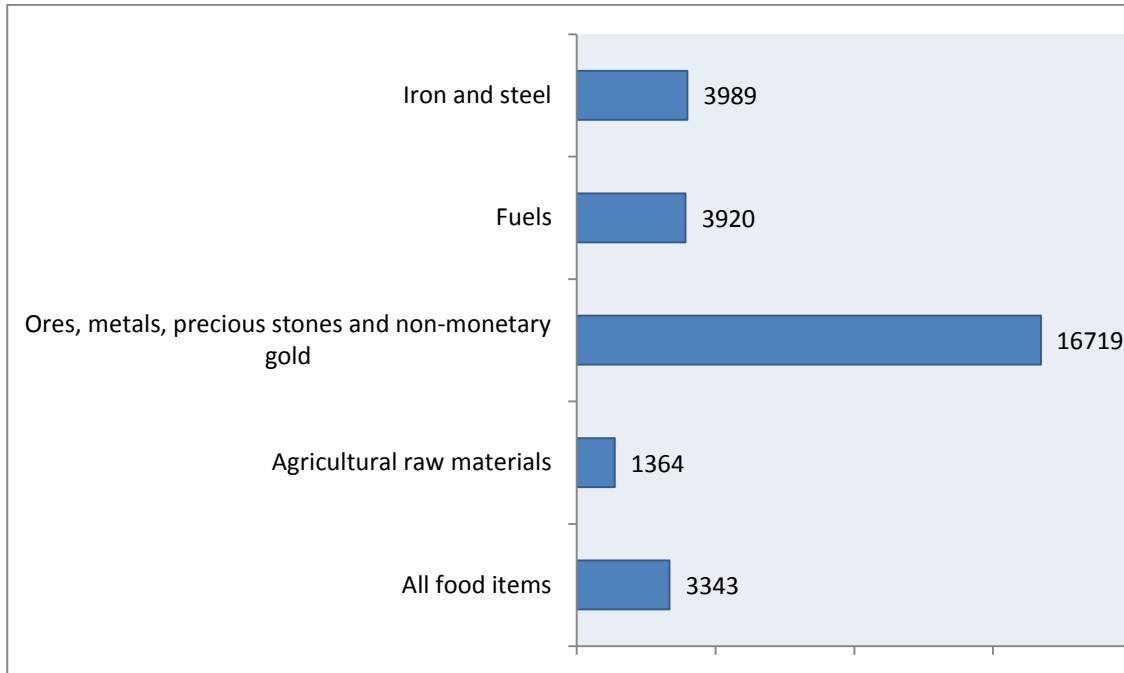
The vast majority of trade misinvoicing outflows from South Africa occur in and around the mining sector. Table 3 and figure 4.3 shows trade misinvoicing outflows by sector during 1995-2006. The mining sectors cumulative trade misinvoicing outflows during 2004-2013 amounted to about US\$167.6 million, and peaked at as much as US\$31.7 million in the year 2006.

Table 3: Trade misinvoicing outflows by sector (US\$ millions)

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

Source: Ashman et al., (2011)

Figure 4.3: Trade misinvoicing outflows by sector (US\$ millions)



Source: Ashman et al., (2011)

The fact that in South Africa, export under invoicing rather than over-invoicing of imports, is more often used as a vehicle to facilitate capital flight, and that the vast majority of these trade misinvoicing outflows occur in and around the mining sector should not be that surprising. As asserted by Jill Nattrass, in 1986 “mining appears to provide an almost perfect means of transferring the investible surpluses that are generated within the economy supplying the mineral... until these surpluses can be re-directed for use within the region itself, little economic development is likely to take place”. For South Africa and equally for much of Africa, this has particular significance.

5. Conclusions

Post-1994 South Africa has experienced a negative industrial development trajectory which can be viewed as leading to de-industrialisation. The manufacturing sector has been impacted by both the structural changes in the South African economy that have taken place post 1994 as well as the 2008/2009 to the global financial crisis that the world economy is yet to overcome. This is evident in the decline in the economic performance of manufacturing, slow growth rates, low levels of investment in the sector, the rise levels of under-utilisation and the loss of jobs in the sector. Therefore, to change the course of industrial development in the country requires a robust and pragmatic approach to industrial policy focused on the following: strengthening of production capacity in the manufacturing sector so as to increase the levels of output; guaranteeing that the sector a share in local markets so as to improve demand; and ensuring a conducive ‘investment climate’ so as to influence the decisions of corporates to invest in the sector.

South Africa’s mineral endowment and its diversified mining economy continue to present real opportunities for resource-based industrialisation in the country. By optimising the fiscal, production and consumption linkages within and outside the extractive sectors, South Africa, can successfully develop its industrial base. In the main, the paper focused on illicit financial flows in the mining sector in South Africa as a threat to industrialisation - by draining the economy of a potentially rich resource, domestic investment, which is required to promote industrial development in the country. The paper therefore concludes that it is essential that strategic mechanisms and programmes aimed at curbing illicit trading, with a particular focus on export trade under-reporting, are strengthened to ensure that the surplus generated from the South African mining sector is reinvested back into the economy. Furthermore an examination of how illicit trading impacts on South Africa’s trade policy prescriptions or evaluations is also critical - especially because trade policy is widely used as an instrument to promote industrial development

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