



# **Illicit Capital Flows and Money Laundering in Botswana: An Institutional Economic Analysis**

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## **Abstract**

Despite the success story of Botswana's economy, the country is among other southern African countries that are highly prone to money laundering and illicit financial flows. Botswana has been regarded as one of the global conduits for illicit economic activities. Approximately US\$ 1.1 billion and US\$ 1.2 billion illicit financial flows were recorded in 2004 and 2013 respectively. However, there is a dearth of literature on the illicit financial flows in Botswana that takes into account the peculiar institutions, transactions and markets in Botswana. This study therefore aims to contribute to the body of literature by using document analysis and an institutional approach to analyse illicit financial flows in Botswana. The results show that over the years, tremendous efforts have been made to respond to money laundering and related offences. However, some deficiencies still remain. It is essential for financial institutions to carry out remedial exercises in their customer due diligence data in order for them to have useful profiles for risk management purposes. Furthermore, inter-agency co-operation and co-ordination should be enhanced and promoted in order to combat illicit capital flows and money laundering.

## **Résumé**

Malgré la réussite économique du Botswana, il compte parmi les pays d'Afrique australe très affectés par le blanchiment d'argent et les flux financiers illicites. Le Botswana a été considéré comme un conduit mondial des activités économiques illicites. Des flux financiers illicites d'environ 1,1 et 1,2 milliard de dollars américains ont respectivement été enregistrés en 2004

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et 2013. Cependant, la littérature sur les flux financiers illicites au Botswana, qui prenne en compte les institutions, transactions et marchés singuliers au Botswana est rare. Cet article contribue donc à cette littérature en utilisant l'analyse de documents et une approche institutionnelle de l'étude des flux financiers au Botswana. Les résultats montrent qu'au fil des années, des efforts considérables ont été déployés pour lutter contre le blanchiment d'argent et les délits connexes. Cependant, certaines lacunes subsistent. Il est essentiel que les institutions financières procèdent à des exercices de correction dans leurs données-client afin d'avoir des profils utiles à leurs besoins de gestion des risques. En outre, la coopération et la coordination entre institutions devraient être renforcées et encouragées dans la lutte contre les flux de capitaux illicites et le blanchiment d'argent.

## **Introduction**

It is estimated that Africa has lost over US\$ 1 trillion in illicit financial flows since just over half a century ago (Kar and Leblanc 2013). According to the High Level Panel on Illicit Financial Flows (HLP) report (2016), the estimated amount of money lost by the continent due to illicit financial flows is over US\$ 50 billion annually. However, it is argued that the estimates fall way below the real amounts because they do not include such forms of illicit financial flows as bribery and trafficking (HLP 2016). The opportunity costs of illicit financial flows include economic growth and improved well-being for the citizenry.

Africa has high levels of poverty in both absolute and relative terms. According to the United Nations (UN 2013), the number of people living below the poverty datum line is estimated to have increased by a staggering 43 per cent between 1990 and 2010. The estimated amount of money lost by Africa to illicit financial flows between 1970 and 2008 is almost equal to all of the official development assistance received by the continent within the same period (OECD 2012). The substantial illicit financial flows in Africa are largely attributed to global shadow financial systems that include, though are not limited to, disguised corporations, trade mispricing, tax havens and money laundering (Salomon and Spanjers 2017). Risks likely to be experienced by shadow banks, such as large and unexpected sales of assets that may have a direct effect on financial assets prices, may be transmitted to the traditional banking system, leading to instability in the financial system (FSB 2012; Madigele 2014). Highly unregulated shadow banks can be easily used as a gateway to avoid supervision designed for regular banks. This sets a potential risk for the financial system if left unchecked (Madigele 2014). Essentially, institutions can propagate illegal economic activities.

Institutional deficiencies and weaknesses impede the adequate enforcement of illicit financial flows strategies and laws. Thoumi and Anzola (2012) show how institutions, formal and informal, can shape extralegal economies that are immune to conventional mechanisms for combating illegal economic activities. However, there is a dearth of academic research analysing the role of institutions in combating or promoting illicit financial flows. There is a need, therefore, to understand the institutions and institutional arrangements that shape and/or govern economic activity.

## **Background and Theoretical Framework**

Economic theorists and other scholars of various disciplines have, over the years, given increasing attention not only to understanding the position of institutions in the economic systems' web, but also to developing paradigms necessary for evaluating problems of resource mismanagement, misallocation and scarcity from an institutional perspective (see, for example, works by: Drobak and Nye 1997; Saleth and Dinar 2004; Rossiaud and Locatelli 2010). This interest has been encouraged by, among other factors, the fact that economists have come to appreciate that the discipline does not fully define and describe how various factors relate to one another in a complex interconnected system. Hence, it has failed to satisfy the effectiveness in policy implementation (Furubotn and Richter 1991; Saleth and Dinar 2004; Evensky 2004).

This argument finds support in Matthews' (1986:903) work, wherein Marshall was quoted as follows, 'The chief fault in English economists at the beginning of the [nineteenth] century was... that they did not see how liable to change are the habits and institutions of industry'. In his article titled 'The new institutional economics: taking stock, looking ahead', Williamson made the following reflection:

I open my discussion of the new institutional economics with a confession, an assertion, and a recommendation. The confession is that we are still very ignorant about institutions. The assertion is that the past quarter century has witnessed enormous progress in the study of institutions. The recommendation is that, awaiting a unified theory, we should be accepting of pluralism. (Williamson 2000:595)

A wide variety of literature has since emerged, with its primary interest being establishing how factors such as property rights, community participation and transaction costs affect economic development, human behaviour and incentives in any given economy (Furubotn and Richter 1991; Macher and Richman 2006). The literature has found the influence of institutional economics in other fields of economics such as environmental, natural resource, ecological and financial economics to be more apparent over the years.

It has been observed that institutional economics has become one of the most interesting and liveliest areas in economics (Matthews 1986; Chang 2010), and this is because this field of economics has turned on two propositions: first, 'institutions do matter'; and second, 'the determinants of institutions are susceptible to analysis by the tools of economic theory' (Matthews 1986:903). Institutional economics seeks to demonstrate how institutions influence public choice and human behaviour. According to North (2003:1), 'institutions are incentive systems that structure human interaction'.

Institutional economics is hence the field of economics that uses a wide range of literature from other fields of study such as law, sociology, ecology, socio-biology and many others in an effort to establish the role played by institutions in defining the direction of economic development and behaviour (Brousseau and Glachant 2008). This field of economics seeks to demonstrate how formal and informal institutions such as contracts, property rights, firms and other social arrangements may lead to positive economic growth and a reduction in transaction costs (Williamson 1998).

There is much interesting scholarly literature about the 'old' and 'new' institutional economics (Rutherford 1994 and 1995; Nee 2003; Rossiaud and Locatelli 2010). The point of intersection of these two approaches is that they both relax some of the assumptions adopted in neo-classical economics analysis. Some of the proposed assumptions used in the neo-classical economics approach are the availability of perfect information for all economic agents, zero transaction costs, rationality in human behaviour and markets being viewed as the only mechanism of allocation, and hence ignoring the role of institutions in the economic system (van de Poel et al. 2005).

New institutional economists argue that factors such as the opportunistic behaviour of agents, transaction costs that are greater than zero, information asymmetry and property rights should be infused into the economic analysis as they could affect the conclusions of the study (Rossiaud and Locatelli 2010). These economists view institutions as key structures necessary for moulding the behaviour of economic agents in the real world of imperfect information (Ferrari-Filho and Conceição 2005).

The main emphasis of the new institutional economics is to illustrate the role played by transaction costs and information in influencing human and economic behaviour (Williamson 1998). The core distinction between the 'Old Institutional Economics' (OIE) and the 'New Institutional Economics' (NIE) is that the old fails to embrace the concept of self-interest, thereby earning itself a label of 'anti-theoretical' (Castle 1999:297). Rationality and the self-interest hypothesis from the neo-classical economics framework

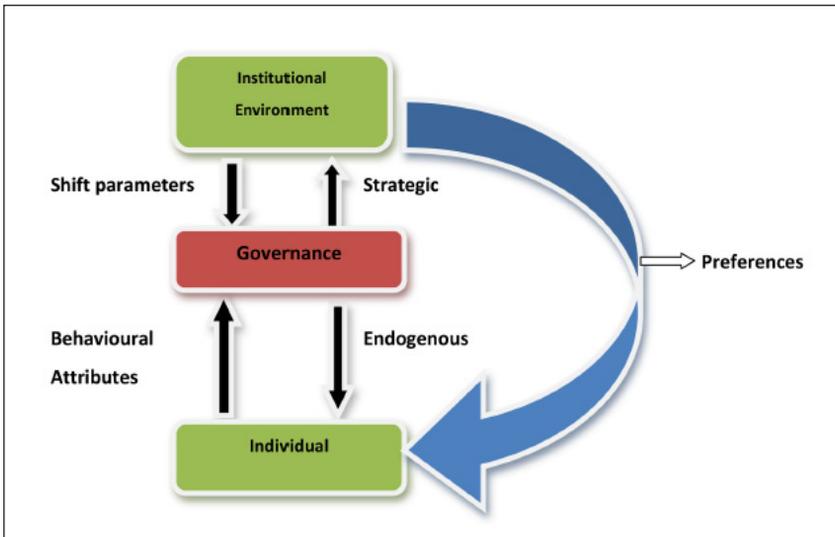
are applied in the public choice field as well as in NIE, while the OIE tends to reject the majority of the propositions of neo-classical economics including that of rational economic actors (Castle 1999; North 1990, 1991; Rutherford 1995, 2001).

Rutherford (1995, 2001) argues that while OIE abandoned the assumption of unbounded rationality of economic actors, NIE scholars, on the other hand, instead extended and modified the assumption. This shortcoming ultimately led to the failure of OIE in its bid to shape the direction of modern economics (Nee 2003). According to Coase (1984:230), OIE produced a 'mass of descriptive material waiting for a theory, or a fire.' In line with this argument, Williamson quotes Kenneth Arrow as follows:

Why did the older institutionalist school fail so miserably, though it contained such able analysts as Thorstein Veblen, J. R. Commons, and W. C. Mitchell? I now think that... [one of the answers is in the] important specific analyses... of the New Institutional Economics movement. But it does not consist of giving new answers to the traditional questions of economics-resource allocation and the degree of utilization. Rather, it consists of answering new questions, why economic institutions emerged the way they did and not otherwise; it merges into economic history, but brings sharper [micro-analytic]... reasoning to bear than had been customary. (Williamson 2000:596)

Figure 1 below shows a causal model hypothesised by NIE adapted from Williamson (1995:213) and Nee (2003:4). According to the model, the main drivers of the institutional environment are the rules of the game (North 1991; Williamson 1995; Nee 2003). 'Institutional environment' in Figure 1 refers to a set of core principles that govern the production, exchange and distribution processes in the economy (Davis and North 1971; Williamson 1995). The shift parameters of the institutional environment include conventions, contract laws, property rights, norms and customs (Williamson 1995; Nee 2003; Menard and Saleth 2011).

Changes in governance structures are prompted by changes in parameters of the institutional environment, represented by the downward arrow in Figure 1. These changes are a result of the interaction processes of a number of factors that are both exogenous and endogenous to, for example, the financial sector. For instance, if there are changes in social norms, legal directives and property rights, relative prices for firms will change and this will likely lead to changes in the governance structures of the firms (Nee 2003; Menard and Saleth 2011). In summary, 'the model includes a purposive actor whose behavioural attributes' – self-interest seeking with guile – 'lie behind many of the transaction costs governance structures are designed to address' (Nee 2003:5).



**Figure 1:** A causal model hypothesised by the new institutional economics  
*Source:* Williamson 1995; Nee 2003

In the absence of effective institutions, the illicit financial flows and other forms of illegal economic activity are likely to be propagated, leading to undesirable outcomes such as negative economic growth, heightened criminal activities and poverty.

### **Problem Statement**

In Africa, as in other continents, the illicit flow of financial resources contributes to the reduced levels of resources available to finance and promote African countries' development goals. Estimates have shown that without illicit financial flows from Africa, the continent's GDP would have been at least 16 per cent higher (UNECA 2013). The illicit flow of financial resources in resource-rich countries in Africa reduces revenues and other fiscal benefits from the mining sector (UNECA 2015). Several case studies in Africa indicate that the natural resource sector is prone to illicit financial flows (see generally UNECA 2015; HLP 2016). This is in part due to the high degree of discretionary power and political influence inherent in countries reliant on extractive industries export earnings (HLP 2016).

Prior to the discovery of diamonds and other minerals in Botswana, the country was one of the poorest countries in the world (Taylor 2006). Subsequent to the discovery of minerals, Botswana's economy made significant and remarkable growth to an 'upper-middle- income country'

(Martin 2008). Botswana's economy is heavily dependent on the exploitation of minerals and the use of revenues derived from mineral production for investment in economic and social infrastructure. The country is the world's largest producer of gem diamonds.

Despite the success story of Botswana's economy, the country is among southern African countries that are highly prone to illicit financial flows (Kar and Spanjers 2017). Botswana has been regarded as one of the global conduits for illicit economic activities. About US\$ 1.1 billion and US\$ 1.2 billion illicit financial flows were recorded in 2004 and 2013 respectively (Kar and Spanjers 2017). According to a report prepared by Kar and Spanjers (2017), the illicit financial inflows in Botswana are primarily due to organised syndicates that produce goods and service and/or attract both legally and illegally from the country. Furthermore, trade misinvoicing outflows are prevalent in Botswana, with over US\$ 12.3 billion cumulatively recorded in 2003 and 2013 (Kar and Spanjers 2017). The catalyst factors for illicit financial flows in Botswana include weak enforcement institutions, corruption and existence of tax havens (Kar and Spanjers 2017).

Despite the alarming statistics, there is a dearth of academic research on the illegal financial flows in Botswana that takes into account the peculiar institutions, transactions and markets in Botswana. Therefore, this study aims to contribute to the body of literature through an institutional approach to analysing illicit financial flows in Botswana. The specific objectives of this study are to: analyse the influence of institutions in combating illegal economic activities in Botswana; evaluate the role played by institutions in propagating illegal economic activities in Botswana; and determine challenges faced by institutions in combating illegal economic activities in Botswana.

## Methods

A narrative approach using literature and document analysis was used to provide an insight into the institutional arrangements and structures shaping the flow of financial resources in Botswana's economy. Available literature sources were systematically identified in electronic databases such as Google Scholar, EBSCO Discovery Service and African Journal Index using keywords such as financial institutions, money laundering, illicit financial flows, illegal financial flows, and financial integrity institutions among others. The systematic reviewing technique entailed employing a rigorous and transparent approach to the identification, quality appraisal and synthesis of studies (Best, Manktelow and Taylor 2014). According to MacDonald (2003:3), a systematic review is 'designed to provide a reliable picture of "current best evidence" relevant to a particular question'.

In addition to the systematic review technique, this study also relied on a purposive selection of documents for review and analysis. The documents included such institutions as Botswana's Corruption and Economic Crimes Act, Proceeds of Serious Crimes Act and Financial Intelligence (Amendment) Act among others.

## **Results and Discussions**

### ***The Formal Regulatory Framework for Combating Illegal Economic Activities in Botswana***

Botswana is one of the countries that responded late to the criminalisation of illicit financial flows and other illegal economic activities, notwithstanding its flourishing economy and growing financial industry since the 1980s. Nonetheless, the country has criminalised illicit financial flows and other financial crimes in various pieces of legislation. These legislative enactments empower various regulatory bodies and law enforcement agencies to combat illegal economic activities.

The origin of the criminalisation of illicit financial flows and other illegal economic activities in Botswana is traceable to the promulgation of the Corruption and Economic Crimes Act (CECA) in 1994. The CECA played a key role in the anti-money money laundering institutional framework for quite some time. Section 3 of CECA establishes the Directorate on Corruption and Economic Crimes (DCEC) with a mandate to investigate any alleged or suspected contravention of any of the provisions of the fiscal and revenue laws of the country (Republic of Botswana 1994). It is interesting to note that none of the forty-six sections of the CECA makes any specific reference to the offence of money laundering. It appears that the legislature has not made much thought of the ultimate act of money laundering as a necessity to clean the proceeds of corruptions. Furthermore, the CECA was not promulgated as a domestication of the United Nations Convention Against Corruption (UNCAC).

Botswana acceded to the UNCAC on 27 June 2011. The UNCAC was adopted ten years after the passing of CECA. This has resulted in a legislative gap between the two. The said lacuna is a compelling basis for the amendment of the CECA to make a clear link between corruption and illicit financial flows such as money laundering. It is thus recommended that the legislature should embark on reviewing and amending this important piece of legislation. This is important in ensuring that Botswana continues being viewed as one of the least corrupt countries in Africa and to prepare the country to efficiently deal with new threats, specifically the money laundering risk.

The mandate to investigate suspected illicit financial flows and money laundering activities was specifically given to DCEC in 2000 through the amendment of the Proceeds of Serious Crimes Act (POSCA). Following the amendment of POSCA, a specialised unit within DCEC called the Financial Intelligence Unit (FIU) was established. The Unit was tasked with the responsibility to receive Suspicious Transaction Reports (STRs) and Cash Transaction Reports (CTRs) and to consider, investigate and prepare dockets to the Directorate of Public Prosecution if they were of the view that a *prima facie* case of illicit financial flows exists (Republic of Botswana 2007). It was observed that the DCEC was incapacitated to execute the functions of an FIU envisaged by Financial Action Task Force (FATF) (Republic of Botswana 2007).

The role of the DCEC as an FIU fell away following the enactment of the Financial Intelligence Act, which established a dedicated FIU known as the Financial Intelligence Agency (FIA) (Republic of Botswana 2009). Although the DCEC has been relieved of the duties to act as an FIU, it cannot be totally divorced from playing a role in the combating money laundering in Botswana.

In addition to the aforementioned institutions, Banking (Anti-Money Laundering) Regulations as subsidiary legislation to the Banking Act were enacted in 2003. These regulations were intended to operationalise Section 14 of the now repealed POSCA. Following that, the Financial Intelligence Act (FI Act) was enacted and passed in 2009. The purpose of the FI Act is to establish a National Coordinating Committee on Financial Intelligence. This institution also intends to provide a framework for the reporting of suspicious transactions. It also introduces a concept of mutual assistance with respect to other FIUs pertaining to financial information and related issues. Most importantly, the long title of the FI Act states that it establishes the Financial Intelligence Agency (FIA). The FIA is mandated to transmit to the supervisory authorities, investigatory authorities or comparable bodies related information relating to suspicious transactions, any financial information required to counter financial crimes, and such information concerning the financing of terrorism (Republic of Botswana 2009). In order to fulfil the functions detailed in Section 4(1), the FIA shall collect, process, analyse and interpret all the information before it obtained in terms of the FI Act from specified parties obliged to submit information (Republic of Botswana 2009). The legislation establishing FIA provides for a two-way flow of information between it and the specified parties.

Most of the legislative enactments referred to above were passed following the first in-country mutual evaluation, which was conducted by the Eastern

and Southern African Anti-Money Laundering Group (ESAAMLG) in 2007. The 2007 report, which was produced out of this process, concluded that the Botswana criminalisation of such illegal economic activities as money laundering in Botswana was generally in line with international standards and its material elements are consistent with the Vienna and Palermo Conventions. Critically, it was concluded that there was no effective implementation and systematic enforcement of the POSCA and several predicate offences were not covered under Botswana law.

In enacting the now repealed POSCA, the parliament of Botswana recognised the extra-territorial nature of illicit financial flows and money laundering, and consciously defined them as such. This was quite necessary to comply with the principle confirmed in the case of *State v Jacobs* (Republic of Botswana 1974). In *casu*, the accused was charged with the offence of rape, which was instigated in Botswana but during the assault the accused had chased the complainant through the border fence into South Africa where he had sexual intercourse without the complainant's consent. Upon hearing an appeal from the magistrate court, the High Court held that in order for the courts to exercise jurisdiction over the criminal offence committed outside Botswana, Parliament should confer such jurisdiction in clear and express terms.

The penalties for engaging in money laundering and related economic crimes in terms of the repealed law were imprisonment *not* exceeding three years or to a fine or both. If an offender is a corporate entity or business association, those holding positions of director, manager or partner of such entity became criminally liable for a fine (Republic of Botswana 2007). These sanctions were quite inconsequential by any standards for white-collar crimes that provide more incentives to engage on. It is important for legislators to ensure that the laws passed with the intention of combating organised crimes have hefty and deterrent sanctions that take out profits from crime.

The criminalisation of illegal economic activities such as money laundering in this statute was couched in similar language with that used in the Zambian Prohibition and Prevention of Money Laundering Act No.14 of 2001. The similarities existed in the sense that the two statutes recognised and created different categories of economic crimes. In the case of the Zambian statute referred to above, five offences are created, the first one being the actual money laundering as defined under section 2 of the Prohibition and Prevention of Money Laundering Act (Okogbule 2000). That offence is the same one that was provided for under section 14(2) of POSCA. The second category of the money laundering offence created under the repealed statute is the conspiracy

to commit, conceal or abet the commission of money laundering, or dispose, covert or transfer proceeds of crime.

As stated above, the main criticism made against POSCA was its non-detering sanctions for the commission of the organised and specialised crime of money laundering. The financial sanctions available for those convicted of committing money laundering offence were low by all standards. This rendered the legislation ineffective and had the potential to incentivise those involved in money laundering to consider Botswana as a safe haven.

### ***Some Challenges faced by Institutions in Combating Illegal Economic Activities in Botswana***

One of the main weaknesses of the institutional framework for combating illicit financial flows and money laundering in Botswana as at the time of carrying the first in-country assessment and the release of the Mutual Evaluation Report in 2007 was the lack of co-ordination between different agencies and institutions with anti-money laundering responsibilities. In practice, the duties of monitoring and investigating suspected illicit financial flows and related offences was shared between the DCEC with various investigative agencies such as the Botswana Police Service, Botswana Unified Revenue Service (BURS) with little or no inter-agency co-ordination.

Inter-agency co-operation and co-ordination is an important element in the combating of money laundering and many other organised crimes. It allows for the effective leveraging of human and technical resources across agencies. Further, it allows for specialisation or division of technical expertise by agencies which naturally allows each one of them to excel in their narrow area of operational focus. It is important to note that inter-agency rivalry or competition in law enforcement is not necessary as it inhibits the attaining of the bigger goal of fighting crime.

The ESAAMLG, in its Botswana's Mutual Evaluation Report, recognised that section 10(2) of the FI Act required specified parties to carry customer accounts remediation in respect of those accounts established before the enactment of the FI Act and further prohibits any transactions within such business relationships unless verification has taken place. However, it was further observed that there was no statutory provision to conduct the remediation process on the basis of materiality and risk and that there are for adequate customer due diligence requirements (ESAAMLG 2007). Thus, it was concluded by ESAAMLG (2007) that Criterion 10.17 of the FATF Mutual Evaluation Methodology has not been met by Botswana because the legislative framework does not require financial institutions to apply

enhanced due diligence where money laundering and terrorist financing are higher.

As a direct response to the above concerns and weaknesses of the formal institutions discussed, an amendment to section 9 has been introduced to provide for framework pertaining to the conducting of the ongoing due diligence with respect to existing business relationships which are subject to know-your-customer (KYC) requirements. These relate to the maintaining of current information through a review of accounts and maintaining of records relating to the customer and beneficial owners concerned particularly for high-risk categories of customers. Further, the Financial Intelligence (Amendment) Act of 2018 has introduced the monitoring and reporting of complex and unusual transactions including an unusual pattern of transactions. These transactions can be identified for having no apparent economic or visible purpose and business relations and transactions, including legal persons and arrangements, from or in non-complaint or insufficiently complaint jurisdictions.

## **Conclusions and Recommendations**

The general rationale behind domestic institutions for combating illicit financial flows in every jurisdiction is to make the country compliant with the international standards and to provide an effective framework of combating illegal economic activities. Because illegal economic activities are an ever-moving target, there have to be regular legislative amendments in order for the laws to be relevant. It is also necessary to create working inter-agency co-ordination and sharing of intelligence.

Illicit financial flows have a negative impact on the continent's aspirations for structural transformation because they discourage value creation. This contributes to economic problems such as unemployment, poverty and economic inequalities experienced by various countries within Africa. In addition to development consequences, illicit financial flows contribute to governance consequences. The illegal economic activities thrive from and contribute to constrained institutions. The success of combating the illegal economic activities is arguably dependent on a clearer understanding of regulatory formal financial institutions as well as the informal institutions shaping and/or promoting illicit financial flows. This study, therefore, contributes to a deeper and better understanding of the economic consequences of distorted and fragmented financial institutions.

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