Illicit Trade and Illicit Financial Flows

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Kathy Nicolaou-Manias
Independent Consultant (UNECA on SDG 16.4b) and IFF Technical Advisor

The views expressed are those of the author and do not necessarily reflect the views of UNCTAD
Overview of the Presentation

1. Introduction – the Relationship between Illicit Trade and IFFs
2. Illicit Trade – A South African Perspective
3. Cross-border Difficulties
4. Curbing and Measurement
5. Policy Actions to Curb Different Types of IFFs
Introduction and Background

The Relationship between Illicit Trade and Illicit Financial Flows (IFFs)

Dev Kar, lead economist at **Global Financial Integrity (GFI)**, defines IFF or illicit money as “money that is illegally earned, transferred, or utilised. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit.”

**UNDP**, definition: “include, but are not limited to, cross-border transfers of the proceeds of tax evasion, corruption, trade in contraband goods, and criminal activities such as drug trafficking and counterfeiting.”

The bulk of the IFF problem is fundamentally a TRADE problem.
**Introduction and Background**

**New Approach to Defining/Categorising IFFs for SDG Indicator 16.4.1**

**Illicit Trade Components**

<table>
<thead>
<tr>
<th>Tax and Commercial Practices</th>
<th>Illegal Markets</th>
<th>Theft-type and Terrorism</th>
<th>Corruption</th>
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<tbody>
<tr>
<td>Includes both <strong>illegal practices</strong> such as tariff, duty and revenue offences, tax evasion, corporate offences and market manipulation, but also practices that are <strong>legal but may be considered illicit</strong>.</td>
<td>Domestic &amp; international trade in <strong>illicit goods &amp; services</strong>; often involve a degree of criminal organization and are aimed at <strong>creating profit</strong>. They include any type of trafficking in goods such as drugs, firearms, or services such as smuggling of migrants</td>
<td><strong>Forced, involuntary and illicit transfer</strong> of economic resources between 2 actors (e.g. theft, embezzlement, fraud). <strong>Terrorism financing</strong>, and all other financial flows of either licit/illicit origin used to fund illegal activities – are <strong>illicit, voluntary transfers</strong> of funds between 2 actors.</td>
<td><strong>Misuse of a public or private position for direct or indirect personal gain.</strong> UNCAC provides a list of acts considered as corruption including bribery, embezzlement, trading in influence, etc.</td>
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</tbody>
</table>
Illicit Trade is on the real side of the economy and the IFF on the monetary side.

**Introduction and Background**

**Shadow Goods and Services Economy**
- Comprising the Informal Sector

- **Illicit Economy**
  - Production & trade of goods & services through Criminal Activities including:
    - Drugs
    - Human trafficking & organs
    - Illegal arms trade & Terror Financing
    - Smuggling (agricultural, mineral, animal etc. . .)
    - Racketeering
    - Counterfeit goods & currency

- **Bribery and Corruption Commercial Activities**
  - Mispricing
  - Abusive transfer pricing
  - Fake transactions
  - . . .

- I illicit proceeds
  - Tax evasion

- **Illicit Financial Flows:**
  - Money Laundering (commercial purchases & real estate)
  - Tax avoidance & Tax Evasion (including mispricing of goods & services; unreported, unrecorded & unobserved activities)
  - Illicit Cross-border Flows (tax evasion through tax havens, trade mispricing etc . . .)

**Licit Economy**
- Production & trade of goods and services in the formal commercial & non-commercial sectors including:
  - Private/individual
  - Small, medium and large scale enterprises
  - Public organisations and entities
  - NGOs, CBOs
  - . . .

**Real sector of the economy**
- represents the goods & services sector or the productive economy

**Monetary Sector**
- represents the financial sector of the economy, which is the proceeds of financial flows stemming from the production & trade of goods and services
Illicit Trade and IFFs are often two sides of the same coin/transaction

**Introduction and Background**

Illegal

- Illegally produced good that is seized by the authorities, i.e. diamonds, ivory/rhino horn, smuggled tobacco
- Commercial tax malpractice (tax evasion through mis-invoicing); also referred to as TBML
- Only ONE side of the transaction can be seen
- Cash seized at the airport

Legal

- Legally produced good that is over- or under-invoiced or there is VAT fraud (carousel fraud)
- Likely that BOTH sides of this transaction can be seen

**Productive/Real Economy** (Economic Activity i.e. Goods and Services)

**Monetary Economy** (Financial Flow)

**NOTE:** We know that about 50% to 60% of illicit narcotics are seized by only 1% of the financial flows
Introduction and Background

Some ideas where

Illicit Financial Flows
- Economic (Financial/FDI)
- Theory on Capital Flight
- Legal (ito Excon)
- Immoral/Illicit
- Illegal

Transfer Pricing
- Accounting and Tax
- Accounting
- Payments / Transactions between related entities
- Legal
- Abusive form (mispricing) = Illegal

Trade Pricing
- Economic (Trade)
- Direction of Trade Statistics
- General Agreements on Trade
- Legal
- Trade mispricing – illicit/illegal

Trade Based Money Laundering
- Law Enforcement (Financial crimes)
- Organised Crime
- Trans-national Crime
- Bootlegging
- Illegal
Illicit Trade – A South African Perspective

Illicit Trade in South Africa – Prevalent Sectors (1)

**Illicit Drugs**

**Anti-piracy using the blockchain**

Custos combines patented blockchain technology with forensic watermarking to keep media files secure and unshared both online and offline, and to detect content leaks when they happen.

- Robust Watermarking
- Global Tracking
- Unique to Each Recipient
- Leak Alerts
- Embedded Bounties
- Pinpoint Leak Source

- Brussels bombings funded through Counterfeits

- SA calamari being hauled illegally as Falkland calamari
Illicit Trade – A South African Perspective

Illicit Trade in South Africa – Prevalent Sectors (2)

Forestry
- Illegal logging is an issue for the Department of Agriculture with hotspots identified.
- Not quantified.

Pharmaceuticals
- TM Est. $61,2m outflow (2013).
  FIC and SARS adjusted estimate

Pesticides
- TM Est. $300m (2013)
  FIC and SARS adjusted estimated

Petroleum
- TM Est. $7,7bn outflow (2013)
- SARS focus area
  FIC and SARS adjusted estimate

Precious metals and gems
- TM Est. $5,2bn outflow (2013).
  FIC and SARS adjusted estimate
Illicit Trade in South Africa – Prevalent Sectors

Trafficking in Persons

- Not estimated.
- Seen as low risk...
- Clothing manufacturing – ILO SCORE study identified forced labourers being trafficked to work in Chinese sweat-shops

Wildlife

- Illicit rhino horn est. at $785m (2013).
- Or $795m including environmental lost opportunity cost

Tobacco

- TM Est. $760m inflow (2013).
  FIC and SARS adjusted estimate
- Seizures est. at $190m (2019)

Miscellaneous (commodities not specified elsewhere)

- TM Est. $33bn outflow (2013) or 75% of Trade Mis-invoicing
  FIC and SARS adjusted estimate
- Non-monetised gold to China via Hong Kong
Illicit Trade – A South African Perspective

Illicit Trade in South Africa – Measuring the Illicit Economy, Illicit Trade and IFFs

- **Total Economy** = IE + Formal Economy
  - Conservative CDA estimate of the illegal economy
  - MIMIC estimate includes illegal and informal

- **Illicit Economy**:  
  - CDA (conservative: illegal)
  - MIMIC (includes illegal and informal). *The WB Columbian Money and Asset Laundering Model estimates the shadow economy*

- **Hot Money (Capital Flight)** = Licit + Illicit  
  - Capital outflow using the Balance of Payments data

- **Illicit Financial Flows**:  
  - The GFI approach includes Hot Money plus Trade Mispricing

- **Trade Mispricing**:  
  - GFI focuses on 35 developed countries plus estimate for ROW trade mispricing
  - FIC estimates trade mispricing for all countries due to large role for China. Add Attractiveness weights to explain direction of trade between developing countries (Trade Based Money Laundering)

- **Money Laundering (Gravity Model)** estimates the proceeds of crime and the ML destinations (Threat and risk model). Updated the model with narcotics and trade.
  - *Columbian Money Asset Laundering Model (WB)*

- **Criminal Activity**: Narcotics, wildlife crime, illicit mining...
Cross-border Challenges, Measurement and Curbing Illicit Trade and IFFs

Only as good as the weakest link, your neighbouring country

Mangazi protesters demand action over cross border crime at Kozi Bay (South Africa and Mozambique border)
Measurement and Curbing Illicit Trade and IFFs

Criteria to measure commercial tax malpractices – UNECA approach

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<th>Data Availability</th>
<th>Data Source/Type</th>
<th>Model Type</th>
<th>IFF Indicator Accuracy</th>
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<td>SNA MACRO DATA</td>
<td>Estimate – TOP DOWN</td>
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<td>Aggregate Country</td>
<td>IMF DOTs method</td>
<td>Consistently accurate estimate by countries across the continent</td>
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<td>Hot Money Model</td>
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<td>GFI (IMF Dots)</td>
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<td>GFI UNCOMTRADE</td>
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<td>Nicolaou &amp; Wu (C)</td>
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<td>MACRO DATA</td>
<td>UNCECA COMTRADE (P)</td>
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<td>Statistical</td>
<td>Nicolaou &amp; Wu (COMTRADE) (P)</td>
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<td>Cobham &amp; Jansky</td>
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<td>Torslov, Wier &amp; Zucman</td>
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<td>MESO DATA</td>
<td>Zdanowicz &amp; Pak</td>
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<td>Commodity/Sectoral</td>
<td>Artificial Intelligence/Machine</td>
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<td>Analytical</td>
<td>Learning Models (Whol &amp; Kennedy, Wu)</td>
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<td>Measurement – BOTTOM UP</td>
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<td>Accurate measurement, inconsistent indicator by countries across the continent</td>
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Measurement and Curbing Illicit Trade and IFFs

Measuring a hidden phenomenon (UNECA): current capabilities in Africa

**SDG Indicator 16.4.1**

**Top-Down Estimate**

**Indicator A**

- **MACRO Estimate**
  - **Capital:** Narrow Hot Money Model
  - **Current:** Trade Mis-invoicing (IMF) or Updated v2
  - **Data Source:**
    - SNA MACRO (IMF)
    - IMF DOTS

**Indicator B**

- **MESO Estimate**
  - **Capital:** Narrow Hot Money Model
  - **Current:** Trade Mis-invoicing (UNECA) with variations
  - **Data Source:**
    - SNA MACRO (IMF)
    - UNCOMTRADE

**Indicator C**

- **MICRO Measure**
  - **Profit Shifting by MNCs** (Cobham & Janský)
  - **Undeclared Offshore Assets** (Cobham & Janský)
  - **Current:** Trade Mis-invoicing (Zdanowicz & Pak)
  - **Data Source:**
    - OECD CRS
    - Transactional

- **AI-ML PILOT:** Whol & Kennedy and Wu
  - Use supervised and unsupervised learning and clustering techniques
  - **Data Source:**
    - CBN/NFIU - cross border
    - NCS - Customs
Measurement and Curbing Illicit Trade and IFFs

Data anomalies and data challenges

- **Mapping**: Linking standardised (or harmonised) national I-O tables to international bilateral trade matrices is problematic, resulting in classification anomalies.
- **Coverage** of data is not complete in all countries, some developing countries do not report and mirror data is used. Quarterly data updates result in analysis inconsistencies.
- **Reporting**: Exporters and importers may report the same trade differently due to various factors e.g. (import cost, insurance and freight), timing, FOB, inclusion and exclusion of some commodities, etc...
- **UNCOMTRADE reporting standards**: creates variances in reporting as some countries use General method, other use Special, some apply strict rules others not.
- **UNCOMTRADE AND IMF DOTS Source and destinations countries**: Reported trade is affected by transit destinations and reporting anomalies of source and destination countries. This results in incorrect statements of the variances (Up/down).
- **Services**: Missing traded services hence the need to include the Hot Money analysis.
- **Clandestine Activities**: Measuring illicit financial flows/TBML is difficult at the macro level since proxies need to be used to estimate clandestine activities not reported.
Policy Actions to Curb IFFs

Multi-disciplinary approach is the key

• Addressing the data is the first critical step... large variations in the results are problematic

• Enforcing WCO’s Unique Consignment Reference is CRITICAL

• Introducing a Benchmark pricing tool (e.g. GFTrade) to be incorporated into customs risk engine to red flag suspicious

• Enforce bilateral exchange of customs information and introduce similar oversight and reporting structures as in the tax arena

• Social Network Analysis and black-listing of perpetrating enablers (from actual cases) – shipping companies, logistics companies, bankers, lawyers, accountants, auditors, etc.

• Cooperation and coordination between (domestic and international) authorities
  ✓ Tax authorities
  ✓ Customs authorities
  ✓ Central banks
  ✓ FIU’s
  ✓ LEAs and Judiciary
Policy Actions to Curb IFFs

Multi-disciplinary approach is the key

- Risk assessments critical and typology studies to flag risky perpetrators.
- Fundamental for **FIUs to analyse trade data** (at customs/granular level) for TBML
- Training and capacity building on IFFs, illicit trade, tax and commercial malpractices and TBML
- Standard ML transparency toolkit applies (KYC, ECDD, CbC reporting, Beneficial ownership,...)
- **Big data analysis and the use of artificial intelligence and machine learning is critical**
- **Identify enablers/perpetrators** (REGISTRY) and redline all their activities.
# Policy Actions to Curb IFFs

Multi-disciplinary approach is the key

## Comparison between Abusive Transfer Pricing and Trade Mispricing

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<tr>
<th>Policy Tools – General and Specific</th>
<th>Abusive Transfer Pricing</th>
<th>Trade Mispricing/Mis-invoicing/TBML</th>
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<tbody>
<tr>
<td></td>
<td>• Automatic Exchange of Tax Information</td>
<td>• Automatic exchange of customs information;</td>
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<td>• DTAs</td>
<td>• GATT</td>
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<td>• Beneficial Ownership</td>
<td>• Beneficial Ownership</td>
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<td></td>
<td>• Demand Resource Mobilisation;</td>
<td>• Improved vetting and controls at customs authorities;</td>
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<tr>
<td></td>
<td>• Base Erosion and Profit Shifting (including Country-by-Country Reporting); and</td>
<td>• Benchmark pricing tools in customs risk engine (i.e. the GFI TM online-real-time tool); and</td>
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<tr>
<td></td>
<td></td>
<td>• Enforcement of Unique Consignment Reference to track consignments</td>
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