Measurement of Illicit Financial Flows

Alex Cobham and Petr Janský (for UNECA)

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UNODC-UNCTAD Expert Consultation
on SDG Indicator on Illicit financial flows

Legal category	Origin of assets	Behaviour type	Result when transferred abroad
Legal	Legally generated profits, capital gains and income	Tax compliance	*Licit*
		Lawful tax avoidance	*illicit*
Unlawful		Unlawful tax avoidance	illicit
		Market/regulatory abuse	illicit
Criminal		Illicitly transferred, and/or transferred for illicit purposes	illicit
		Tax evasion	illicit
	Proceeds of corruption	Bribery; Grand corruption; Illicit enrichment; Embezzlement	illicit
	Proceeds of theft /related crime	Theft; Extortion; Kidnapping; Fraud; Bankruptcy	illicit
	Proceeds of illegal markets	Drug trafficking; Counterfeiting; […]	illicit

Afternoon session overview

I. Some initial country experience (Kathy Nicolaou: South Africa)

II. Critical evaluation of existing IFF estimates, by type
   - Trade
   - Capital account and offshore wealth
   - Profit shifting

III. Proposed indicators; risk measures; & national pilot opportunities

III. Overview

- **Proposed indicators: SDG 16.4.1a and SDG 16.4.1b**
    - Global process: Updates and next steps
    - National pilots: Immediate opportunities
    - National pilots: Work-around measures
- **Risk measures (vulnerability to IFF)**
    - Global/regional analysis
    - National pilots: assessment; scope for improved data; applications
- **Additional opportunities for national pilots**
    - Transaction-level trade data, including intra-group
    - Multinational tax return analysis

Profit shifting indicator: SDG 16.4.1a

- An indicator of misaligned profits, based on OECD country-by-country reporting data:

   The value of profits reported by multinationals in countries,

   for which there is no proportionate economic activity

- Key advantage: specific measure (as vs estimate)

- Disadvantage: Profit misalignment > illicit

Criminal	Unlawful	Profit shifting	Profit misalignment
Evasion	Evasion	Evasion	Evasion
	Unlawful avoidance	Unlawful avoidance	Unlawful avoidance
		Lawful avoidance	Lawful avoidance
			'Natural' (i.e. not tax-related) misalignment

Profit shifting indicator: SDG 16.4.1a

Defined for each jurisdiction, can be summed across some or all.

For each jurisdiction i we define the misaligned profit as:

$$\chi_i = \omega_i \Pi - \pi_i \qquad \qquad ...(1)$$

where:

- ω_i is the share of all multinationals' economic activity in jurisdiction i;
- Π is the global, gross profits of all multinationals; and
- π_i is the share of all multinationals' gross profits declared in i.

Profit shifting indicator: SDG 16.4.1a

Economic activity captured as simple average of indicators of production (share of FTE employees in jurisdiction, ι_i) and consumption (final sales in jurisdiction, γ_i). We define, for all *i:*

$$\omega_i = \frac{1}{2}(\iota_i + \gamma_i)$$

We also use the label Ω for the global total of multinationals' economic activity, and define:

$$\Omega = \sum_{i=1}^{n} \omega_i; \text{ and}$$

$$\Pi = \sum_{i=1}^{n} \pi_i$$

It follows that the global sum of misaligned profits, X, is equal to zero:

$$X = \sum_{i=1}^{n} \chi_i = 0$$

Profit shifting indicator: SDG 16.4.1a

We propose that the profit misalignment indicator for use in SDG target 16.4 is the global sum of *positively misaligned* profits – that is, the total excess profits declared in jurisdictions with a greater share of profits than would be aligned with their share of economic activity.

Equivalently, this can be calculated as half the sum of the absolute values of misaligned profit:

$$SDG_{16.4.1a} = \frac{1}{2}\sum_{i=1}^{n}|\chi_i| \qquad \qquad ...(2)$$

Underlying jurisdiction-level misalignment measures => accountability

Profit shifting indicator: SDG 16.4.1a

Global process: Updates and next steps
- OECD country-by-country reporting: major obstacles to information exchange
- OECD aggregate data: some availability from end-2019?
- Alternatives? Global Reporting Initiative… Nothing from IASB.
- *UNCTAD; GEISAR*?

National pilots: Immediate opportunities
- Assess current CBCR availability; pursue more (exchange + *direct reporting*)
- Where possible, evaluate company components of 16.4.1a

National pilots: Work-around measures
- MNEs' tax returns in country
  - Combine with global consolidated accounts to perform rudimentary formulary apportionment exercise, as rough benchmark
  - Habu-type (HMRC) analysis of declared profitability, implied revenue losses

Undeclared offshore assets indicator: SDG 16.4.1b

The undeclared offshore assets indicator is defined as the excess of the value of citizens' assets declared by participating jurisdictions under the OECD Common Reporting Standard (CRS), over the value declared by citizens themselves for tax purposes to their tax authorities.

- Key advantages:
  - Specific measure (as vs estimate)
  - Breadth: evaluates a key outcome of most illicit outflows

- Disadvantages:
  - Does not allow breakdown of IFF by channel
  - CRS imperfect (limited by asset type; loopholes)

Undeclared offshore assets indicator: SDG 16.4.1b

For each jurisdiction *i* we define the undeclared assets as:

$$\phi_i = \sum_{j=1}^{n} \beta_{j,i} - \alpha_i \qquad \ldots(3)$$

where:

α_i is the sum of assets declared by citizens of jurisdiction *i* as being held in jurisdictions *j =1,...,n* where *j ≠ i*; and

$\beta_{j,i}$ is the sum of assets of citizens of jurisdiction *i* reported as being held in jurisdiction *j*.

Undeclared offshore assets indicator: SDG 16.4.1b

We propose that the undeclared offshore assets indicator for use in SDG target 16.4 is the global sum of jurisdiction-level undeclared assets:

$$SDG_{16.4.1b} = \sum_{i=1}^{n} \phi_i \qquad \ldots(4)$$

Again, the underlying jurisdiction-level measures will allow monitoring and accountability in a number of ways.

Undeclared offshore assets indicator: SDG 16.4.1b

Global process: Updates and next steps
- OECD Common Reporting Standard: major obstacles to information exchange
- OECD aggregate data: little movement so far
- Alternatives: *UN agencies; national measures?*

National pilots: Immediate opportunity
- Assess current CRS availability; pursue more (exchange + push for aggregate data)
- Analyse tax declarations: obtain jurisdiction-level aggregates (assets and income)
- Where possible, combine to evaluate jurisdiction components of 16.4.1b

National pilots: Work-around measures
- BIS locational bank reporting as proxy for CRS aggregate data
  - Combine with tax declaration data => approximate evaluation of 16.4.1b by jurisdiction
  - Where possible, compare BIS and CRS aggregates for insights into data quality + coverage

Risk measures (vulnerability to IFF)

Global/regional analysis
- Measures of exposure to the risk of IFFs, combining opacity of partner jurisdictions with scale measures of bilateral economic/financial relationships
- Pilot study for African Union/Economic Commission for Africa's High Level Panel on Illicit Flows out of Africa (Cobham & Lépissier, 2015)
- Opacity from secrecy indicators of Financial Secrecy Index (TJN, 2018; Cobham, Janský, & Meinzer, 2015)
- Bilateral scale from various:
  - commodity trade, services trade
  - portfolio investment, direct investment (FDI income; royalties; dividends; interest? *BPM6*)
  - Banking (BIS; also explore SWIFT?)

Risk measures (vulnerability to IFF)

<div style="text-align: center;">Vulnerability   Intensity   Exposure</div>

$$V_i = \frac{\sum F_{i,j} \cdot SS_j}{F_i} \qquad I_i = \frac{F_i}{Y_i} \qquad E_i = \frac{\sum F_{i,j} \cdot SS_j}{Y_i}$$

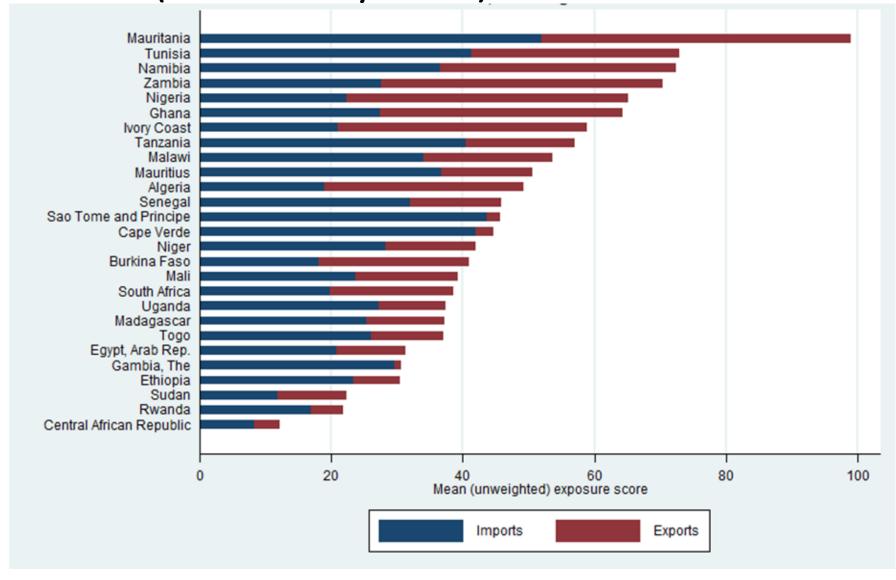|	
$i: \{1, \dots, I\}$	Country of interest
$j: \{1, \dots, J\}$	Partner country
$F_{i,j}$	Flow between reporter i and partner j
Y_i	GDP of country of interest
SS_j	Secrecy Score of partner country. Ordinal scale, 0-100.

Risk measures (vulnerability to IFF)

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National pilots

- Assessment of approach

- Scope for improved data (national sources vs international data series)

- Possible applications
  - Identification of vulnerabilities
  - Focused investigations
  - Basis for policy change
  - Basis for bilateral policy discussions (e.g. prioritisation of CRS relationships etc)

Additional opportunities for national pilots

Transaction-level trade data

- Pilot range of mispricing approaches (Pak & Zdanowicz, etc) to develop indicators of IFF scale
- Compare vs ECA, GFI etc commodity- and country-level findings – robustness?
- Compare estimated IFF scale vs vulnerability measures: which secrecy indicators of bilateral partners (if any), are associated with higher IFF?
- Use data on related/unrelated party trade to evaluate relative pricing patterns and comparative scale of losses (Vicard, 2015 etc)

Summary

- The inherent difficulties of estimating IFFs mean that even the stronger estimates may not rise to the level necessary for a global policy framework such as the SDGs

- We propose two measures using newly available data that allow precise measurement of particular aspects of illicit flows:
  - Annual flow of profit misalignment achieved by multinationals (16.4.1a)
  - Annually recorded stock of undeclared offshore assets (16.4.1b)

Summary

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