ACE
Anti-Corruption Evidence
Making Anti-Corruption Real

Corruption and Illicit Financial Flows

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Mushtaq Khan and Antonio Andreoni
Department of Economics SOAS
SOAS-ACE

SOAS
University of London
100 Years

Illicit flows and corruption

- Corrupt transactions are usually defined as breaking or violating a formal / legal rule (without necessarily crossing borders), illicit flows are cross-border flows that are in some sense socially damaging (eg tax avoidance or profit shifting) (without necessarily being entirely illegal)

- There is a powerful argument (for instance Maya Forstater) that 'illicit' should only refer to illegal cross-border transfers or we risk undermining respect for a rule of law – She argues that if we are concerned with tax we should look at transfer pricing problems under SDG 17.1 (domestic resource mobilization) and not SDG 16.4 (illicit flows)

- There are arguments on the other side (for instance Blankenburg and Khan) that defining IFFs as illegal cross-border transactions does not work either because rule-violating transactions are not all equally damaging: many rule violations may be driven by inappropriate or contradictory formal rules, or low capabilities of firms in developing countries. So illicit is not usefully defined as illegal

- The relationships between corruption, financial flows (both licit and illicit) and crime are complex and so finding policy-relevant ways of measuring IFFs are challenging: our collective experience in measuring and attacking corruption can inform how we arrive at practical measures of illicit flows

Measurement challenges

- 1) What we measure and how we describe what we have measured has a direct effect on policy

- 2) To prevent the exercise being shot down by those who are opposed to such measurements, it is important in the early stages to ensure that our measures throw up few false positives (illicit flows that on closer inspection turn out to be false). False negatives are easier to deal with over time

- 3) Since the SDG goal is to *reduce* illicit flows, illicit flows must be a 'bad thing'. Hence, we need to be sure that societies will be better off if what we are measuring is reduced.

- 4) The history of how corruption has been measured and informed anti-corruption is therefore useful: the ACE programme

Lessons from corruption analysis

- Aggregate measures of corruption in a developing country 'add up' many different types of corruption which have different causes and effects

- This is one reason why aggregate measures of corruption have not been very useful in anti-corruption work

- Anti-corruption strategies that target these measures either do not work (there are too many different things being targeted) or

- Inadvertently have negative effects like shrinking the economy (because some types of corruption cannot be feasibly reduced without significant structural changes that take a long time to achieve)

- For instance, some forms of informality in firm behaviour is technically corruption but can reflect low firm capabilities, or some forms of political corruption may reflect the dearth of formal sources of revenue for organizing political activity

- Feasible anti-corruption requires identifying the corruption that can be actually reduced and that has positive effects on welfare, to support these strategies we need to provide evidence of these relationships *and measures of corruption that are fine-grained enough to track the success of specific policies*
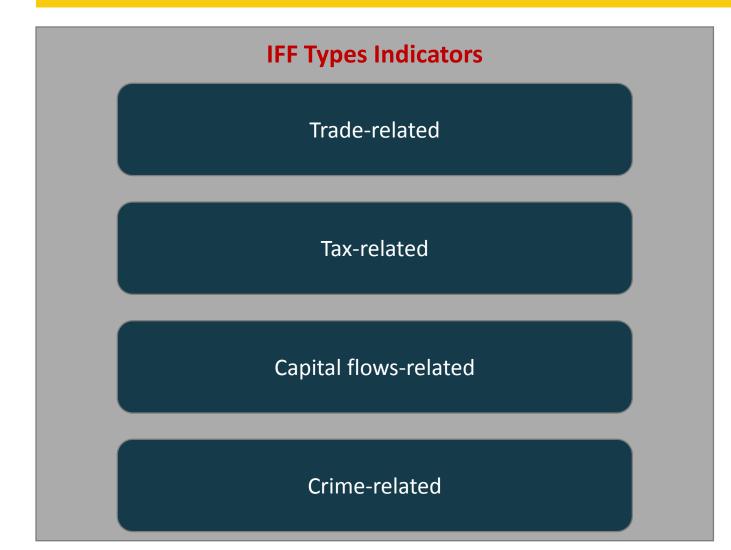
Lessons from corruption analysis

- Our experience in anti-corruption tells us that some measures of anti-corruption are not useful for policy (even if they make sense on their own), AND inappropriate measures can sometimes have unintended consequences

- If the measure is too broad and measures flows that have many different drivers, the measure is not useful for policy (because even effective policies appear to have no effect on the corruption measure)

- When policy does target a broad measure, the results can also be adverse (because the target includes flows that may have benign or structural drivers that cannot be changed in the short to medium term without harming the economy or social welfare)

- Consider a measure of IFFs focusing on capital flight or profit-shifting that does not discriminate between flows that are the result of illegal tax evasion, criminal activity, poor rule of law conditions, or high political expropriation risk. These may turn out to be bad measures of illicit flows from a policy perspective because policies targeting these measures could make *some societies* worse off

Lessons from corruption analysis

- One strategy would be to test different measures of IFFs of different types (for instance illicit capital outflows or trade-related outflows) and select measures or combinations of measures that fulfil minimum conditions

- The statistical challenge may be how to aggregate a number of different measures of each type of IFF problem (capital outflows affecting domestic investment, profit shifting that reduces tax collection, flows associated with drugs, trafficking or terrorism) into an aggregate measure that is still useful

- Corruption is not an additively separable IFF that can be added to tax evasion, crime and other IFFs to get a consolidated IFF figure: it is not *always* a distinct illicit flow but can sometimes be, for instance if politicians use *specific* mechanisms to export their bribes to foreign jurisdictions

- More typically, corruption *indirectly affects the magnitude and effects of* IFFs, for instance corruption can affect negotiations on tax rates with MNCs or the assessment of tax. Corruption may also facilitate transfers of the proceeds of crime if police and customs are paid off

- Our work on corruption shows that corruption operates very differently across sectors and countries, and this insight means that IFFs will also work differently in countries with different types of corruption: the immediate challenge is to field-test measures of IFFs so that (at least) our measures are not misleading or damaging and (ideally) also useful for monitoring the progress of anti-IFF policies

Taking stock: challenges

IFF Types Indicators

Trade-related

Tax-related

Capital flows-related

Crime-related

- **Definitional issues (and risk of tautologies…)**
- **Data (and the impossibility of direct data)**
- **Proxies / indicators**
- **Benchmarks (prices, unit values, related/unrelated act.)**
- **Fund / flows**
- **Level of aggregation/s**
- **Activities or Impact**
- **Statistical rigour / policy relevance tensions**
- **…**

Beyond a single indicator, towards a multi-level indicator system for IFF

1. Responding to the SDG measurement mandate (composite IFF indexes for global benchmarking)

2. Modularity of the index designed around key IFF types (and data), avoiding compensability in aggregation

3. Indicators capturing different IFF types and allow to distinguish the dominant IFF in different country (e.g. trade related, tax related, capital flow related)

4. Complementing the indicators with benchmarks (e.g. price / unit values / profit-activity levels) but also manuals to interpret the patterns

5. Politically actionable indicators, from macro to micro level indicators (e.g. indicators allowing for targeting anti-IFFs strategies)

SECTORAL – level
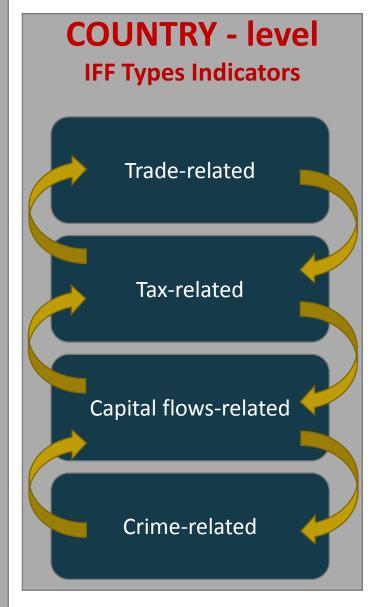## IFF benchmarking

By products (6 digits)

By transactions

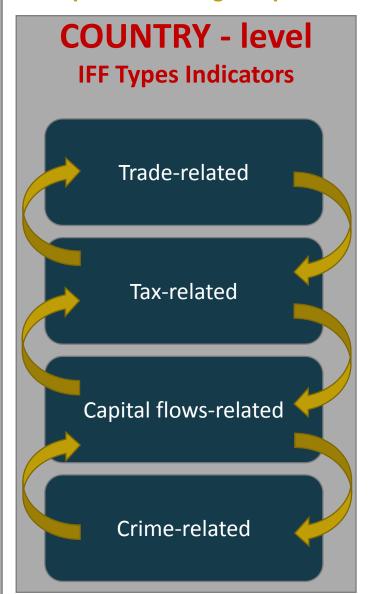By sectors / VCs
(e.g. different opportunities
for profit shifting)

By disaggregated analysis of
capital account
discrepancies

By supply chains
…

COUNTRY - level
IFF Types Indicators

Trade-related

Tax-related

Capital flows-related

Crime-related

GLOBAL – level

SDG Global Benchmarking
Indexes

(IFF types composite)

Corruption as orthogonal process

CASE STUDY – level

Context-specific case study based analysis

(specific **incentive structures,** agents, VCs, processes, regulation etc.)

SECTORAL – level
IFF benchmarking

By products (6 digits)

By transactions

By sectors / VCs
(e.g. different opportunities for profit shifting)

By disaggregated analysis of capital account discrepancies

By supply chain
…

Corruption as orthogonal process

COUNTRY - level
IFF Types Indicators

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GLOBAL – level

SDG Global Benchmarking Indexes

(IFF types composite)

ACE research on smuggling

Corruption as orthogonal process
Multi-methods ACE analysis: Tanzania / EAC

Companies (domestic and multinational): Domestic company/conglomerate case

Mirror statistics (product level):

- reveals consistent gaps, cyclicality connected to political elections and various forms of custom manipulation (price/quantity discrepancies)
- misses product group heterogeneity (domestic/industrial sugar) against different import duty regimes, product collusion cases (when prices and corrupted deals were pre-arranged), transit trade and cross-regional trade

Transactions based data (data for Tanzania):

- reveals custom/product code manipulation, concentration among importers, import licencing violations, main IFF channels
- misses the ways in which corruption and trade-related IFF are impacting the development of the sector in the country

Value chain, supply chain and rents analysis (for VCs in EAC):

- reveals the corruption-related rents capture activities AND how the rents have been accumulated and "re-invested" in other related activities which allows for profit-shifting in the region/international