Session 2: Illicit Financial Flows from Developing Countries

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FIRST INTERGOVERNMENTAL GROUP OF EXPERTS ON FINANCING FOR DEVELOPMENT:
Domestic Public Resources and International Development Cooperation
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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD.

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Target 16.4

By 2030, significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organized crime.
Overview (with Petr Janský)

- Types of illicit financial flows
- Definitional questions
- Magnitudes and impact
- Core policy issues
1. Types of IFF
Types of illicit financial flows

1. Market/regulatory abuse
2. Tax abuse
3. Abuse of power, including theft of state funds and assets
4. Proceeds of crime

Each can be situated in terms of
- capital legality; and
- transaction licitness
IFF by capital and transaction type
### Table 1: A typology of illicit financial flows and immediate impacts

<table>
<thead>
<tr>
<th>Flow</th>
<th>Manipulation</th>
<th>Illicit motivation</th>
<th>IFF type</th>
<th>Impact on state funds</th>
<th>Impact on state effectiveness</th>
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</thead>
<tbody>
<tr>
<td><strong>Exports</strong></td>
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<td>Under-pricing</td>
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<td><strong>Public lending</strong></td>
<td>(If no expectation of repayment, or if under-priced)</td>
<td>Public asset theft (illegitimate allocation of state funds)</td>
<td>3</td>
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<tr>
<td><strong>Public borrowing</strong></td>
<td>(If state illegitimate, or if over-priced)</td>
<td>Public asset theft (illegitimate creation of state liabilities)</td>
<td>3</td>
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<td><strong>Related party lending</strong></td>
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<td><strong>Public asset sales</strong></td>
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<td>Public asset theft</td>
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<td><strong>Public contracts</strong></td>
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<td>Public asset theft</td>
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<td><strong>Offshore ownership transfer</strong></td>
<td>Anonymity</td>
<td>Corrupt payments</td>
<td>3</td>
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Source: Cobham (2014). 'IFF type’ is defined as follows: 1 – market/regulated abuse, 2 - tax abuse, 3 – abuse of power, including theft of state funds, 4 – proceeds of crime.
2. Definitional questions
Definitional questions: two views

- Illicit = illegal
  - “Illicit financial flows (IFFs) are illegal movements of money or capital from one country to another. GFI classifies this movement as an illicit flow when the funds are illegally earned, transferred, and/or utilized.”

- Illicit ≠ illegal
  - Illicit: “forbidden by law, rules or custom” (OED)
  - Illicit > illegal (e.g. tax); illicit < illegal (e.g. Blankenburg & Khan)
  - But in all cases, for legal or social reasons, illicit = HIDDEN
IFF by capital and transaction type

Figure 2.1
Origins of illicit financial flows

Old ‘corruption’ view – emphasis here

The fight for 16.4: to ensure multinationals’ abuses remain in scope
Three reasons to retain MNE avoidance

- Sustained effort retrospectively to exclude multinationals from scope
- Excluding two of three areas?
  - Illegal evasion vs Unlawful avoidance vs Lawful avoidance
- But:
  1. Substance: inclusion is what was agreed in SDGs
  2. Definition: illicit ≠ illegal
  3. Scale and robustness of estimates
3. Magnitudes and impact
Leading estimates of IFF

- Trade mispricing (GFI, Boyce & Ndikumana, UNECA, Pak…)
- Capital account measures (Dooley et al, GFI, Boyce & Ndikumana)
- Undeclared wealth (Henry/TJN, Zucman)
  - Revenue losses: c.$200 billion annually
- Shifted profits (TJN, OECD, UNCTAD, IMF)
  - Revenue losses: c.$500-600 billion annually
The 4 Rs of tax

- Revenue
- Redistribution
- Re-pricing
- Representation

=> Importance of *direct* taxation in particular: for how revenues are raised and for how well they’re used
IFF impacts

Financial opacity gives rise to IFF

- Laundering criminal proceeds
  - Drug trafficking
  - Human trafficking

- Corruption
  - Bribery of officials
  - Theft of state assets

- Tax abuse
  - Corporate
  - Individual

- Market abuse
  - Conflicts of interest
  - Regulatory abuse

'Illegal capital' IFF
Most urgent threats:
- conflict
- state illegitimacy
- rent-seeking

'Legal capital' IFF
Most urgent threats:
- basic service provision
- inequality
- effective political representation
- rent-seeking

Risk to negative security

Risk to positive security
4. Core policy issues
Progressive policies (national and global):

The ABC of tax transparency

- Since IFF are – centrally – hidden, key responses include transparency
  - Automatic exchange of financial information
    - OECD CRS: opportunity but failure of multilateral inclusion
    - Indicator: % of world pop, GDP with which information exchanged
  - Beneficial ownership (public registers for companies, trusts & foundations)
    - Emerging international standard: SDGs could confirm
    - Indicator: % of entities for which BO information public
  - Country-by-country reporting (public) by multinationals
    - OECD BEPS: single aim (reduce profit misalignment) + accountability mechanism (CBCR)
    - Indicator: % profit misalignment (profit share vs activity share)
Defensive policies (national): Managing IFF risk

Vulnerability

\[ V_i = \frac{\sum F_{i,j} \cdot SS_j}{F_i} \]

Intensity

\[ I_i = \frac{F_i}{Y_i} \]

Exposure

\[ E_i = \frac{\sum F_{i,j} \cdot SS_j}{Y_i} \]

- \( i: \{1, ..., I\} \) Country of interest
- \( j: \{1, ..., J\} \) 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.
Defensive policies (national):

Managing IFF risk
Progressive policies (national/regional): Taxing multinationals differently

In order of political ease:

- Use country-by-country reporting to target most egregious companies
- Require publication of country-by-country reporting for accountability
- Establish formulary alternative minimum corporate tax (FAMICT)
- Drop OECD rules, \(\Rightarrow\) unitary taxation with formulary apportionment
Progressive policies (international): New global architecture

In order of ease/impact?
- Upgrade UN tax committee (now use it!)

- Establish UN tax *commission*, reporting to ECOSOC

and/or
- *(UN?)* Convention on minimum standards of international financial transparency
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Distribution of impact: tax avoidance

Estimated Tax Loss ($bn)

- United States: 188.8
- China: 66.8
- Japan: 46.8
- India: 41.2
- Argentina: 21.4
- France: 19.8
- Germany: 15.0
- Pakistan: 10.4
- Indonesia: 6.5
- Philippines: 6.4
Distribution of impact: tax avoidance

Estimated Tax Loss (percent Total Tax)
Who wins? (US multinationals)

Effective tax rate

Share of declared profit 'misaligned' from elsewhere

- Switzerland
- Netherlands
- Ireland
- Luxembourg
- Bermuda