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*

Palais des Nations, Geneva

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

8 November, 2017

SUSTAINABLE DEVELOPMENT GOALS

17 GOALS TO TRANSFORM OUR WORLD

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

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Overview (with Petr Janský)

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

1. Types of IFF

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Types of illicit financial flows

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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

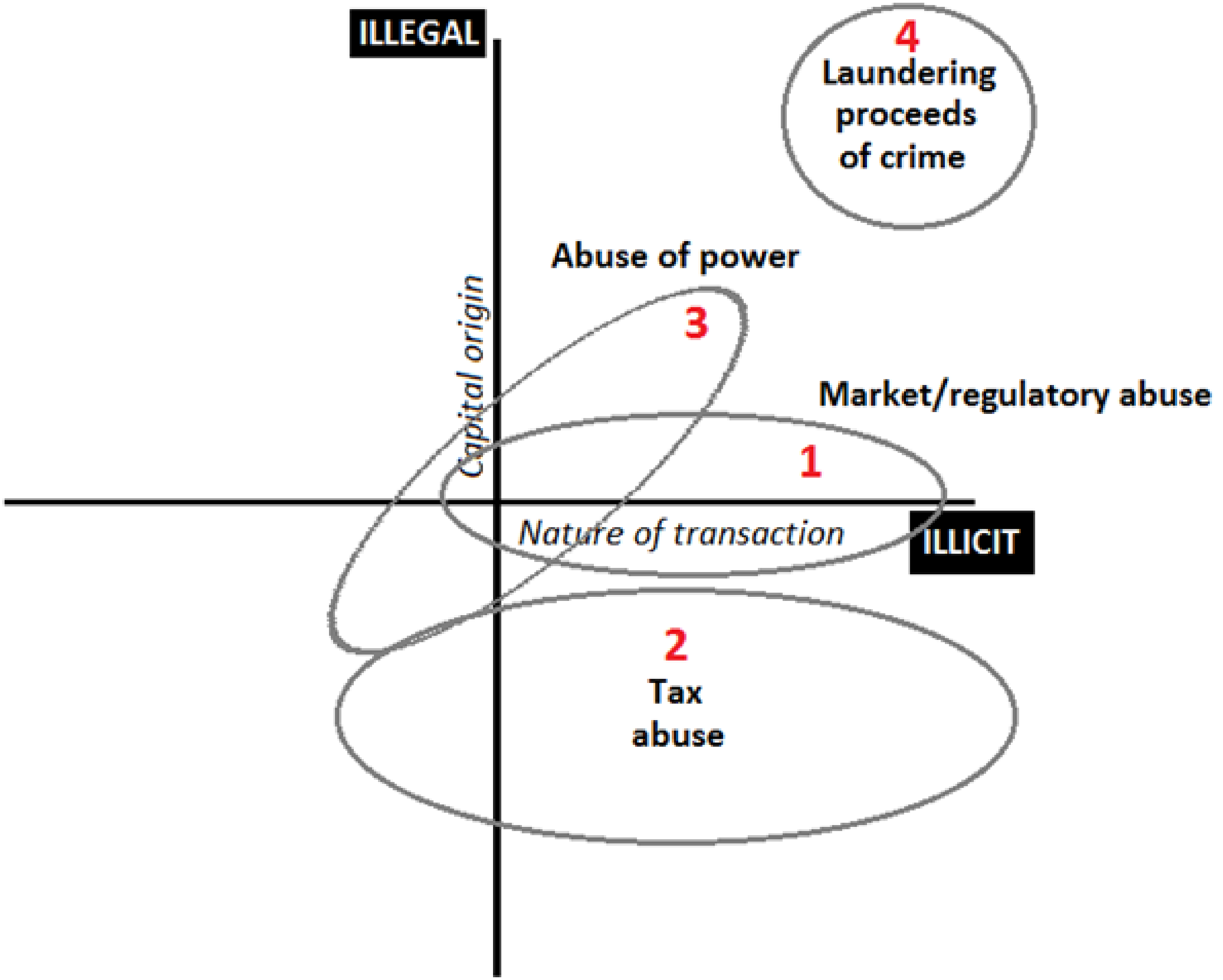

Table 1: A typology of illicit financial flows and immediate impacts

Flow	Manipulation	Illicit motivation	IFF type	Impact on state funds	Impact on state effectiveness
Exports	Over-pricing	Exploit subsidy regime	2	↓	↓
		(Re)patriate undeclared capital	1	↓	↓
	Under-pricing	Shift undeclared (licit) income/profit	2	↓	↓
		Shift criminal proceeds out	4	↓	↓
		Evade capital controls (including on profit repatriation)	1		↓
Imports	Under-pricing	Evade tariffs	2	↓	↓
		(Re)patriate undeclared capital	1	?	↓
	Over-pricing	Shift undeclared (licit) income/profit	2	↓	↓
		Shift criminal proceeds out	4	?	↓
		Evade capital controls (including on profit repatriation)	1	↓	↓
		Shift undeclared (licit) income/profit	2	↓	↓
Inward investment	Under-pricing	Shift undeclared (licit) income/profit	2	↓	↓
		Shift criminal proceeds out	4	?	↓
		Evade capital controls (including on profit repatriation)	1	↓	↓
	Over-pricing	(Re)patriate undeclared capital	1	?	↓
	Anonymity	Hide market dominance	1		↓
	Anonymity	Hide political involvement	3		↓
Outward investment	Under-pricing	Evade capital controls (including on profit repatriation)	1		↓
	Over-pricing	Shift undeclared (licit) income/profit	2	?	↓
		Shift criminal proceeds out	4	↓	↓
	Anonymity	Hide political involvement	3		↓
Public lending	(If no expectation of repayment, or if under-priced)	Public asset theft (illegitimate allocation of state funds)	3	↓	
Public borrowing	(If state illegitimate, or if over-priced)	Public asset theft (illegitimate creation of state liabilities)	3	↓	
Related party lending	Under-priced	Shift undeclared (licit) income/profit	2	↓	
Related party borrowing	Over-priced	Shift undeclared (licit) income/profit	2	↓	
Public asset sales	Under-pricing	Public asset theft	3	↓	
	Anonymity	Hide market dominance	1		↓
	Anonymity	Hide political involvement	3		↓
Public contracts	Over-pricing	Public asset theft	3	↓	
	Anonymity	Hide market dominance	1		↓
	Anonymity	Hide political involvement	3		↓
Offshore ownership transfer	Anonymity	Corrupt payments	3	↓	↓

Source: Cobham (2014). 'IFF type' is defined as follows: 1 – market/regulatory abuse, 2 - tax abuse, 3 – abuse of power, including theft of state funds, 4 – proceeds of crime.

2. Definitional questions

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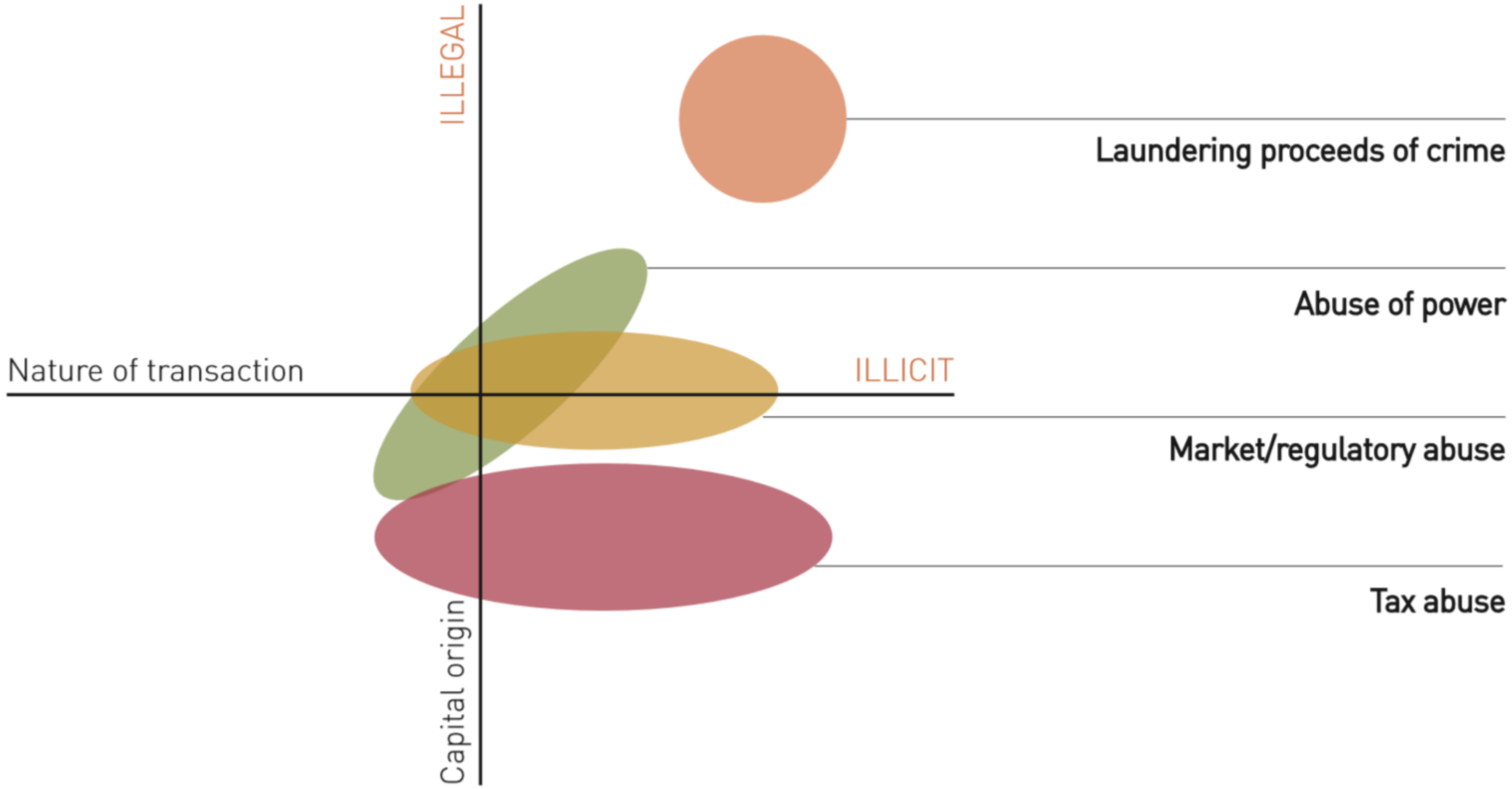
Definitional questions: two views

- 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

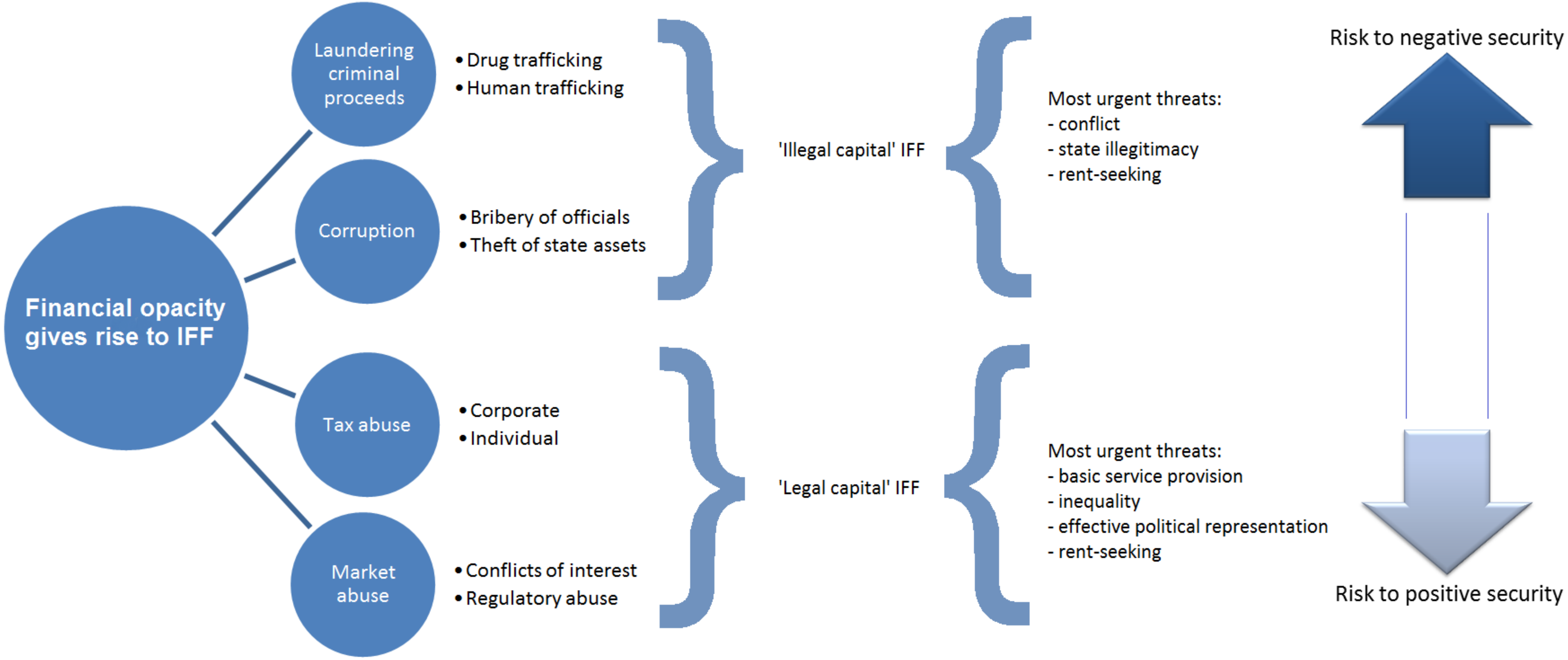
The 4 Rs of tax

- Revenue
- Redistribution
- Re-pricing
- Representation

=> Importance of *direct* taxation in particular:

for how revenues are raised <u>and</u> 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
'Legal capital' IFF
Most urgent threats:
- conflict
- state illegitimacy
- rent-seeking
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
  - **A**utomatic exchange of financial information
    - OECD CRS: opportunity but failure of multilateral inclusion
    - Indicator: **% of world pop, GDP with which information exchanged**
  - **B**eneficial ownership (public registers for companies, trusts & foundations)
    - Emerging international standard: SDGs could confirm
    - Indicator: **% of entities for which BO information public**
  - **C**ountry-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

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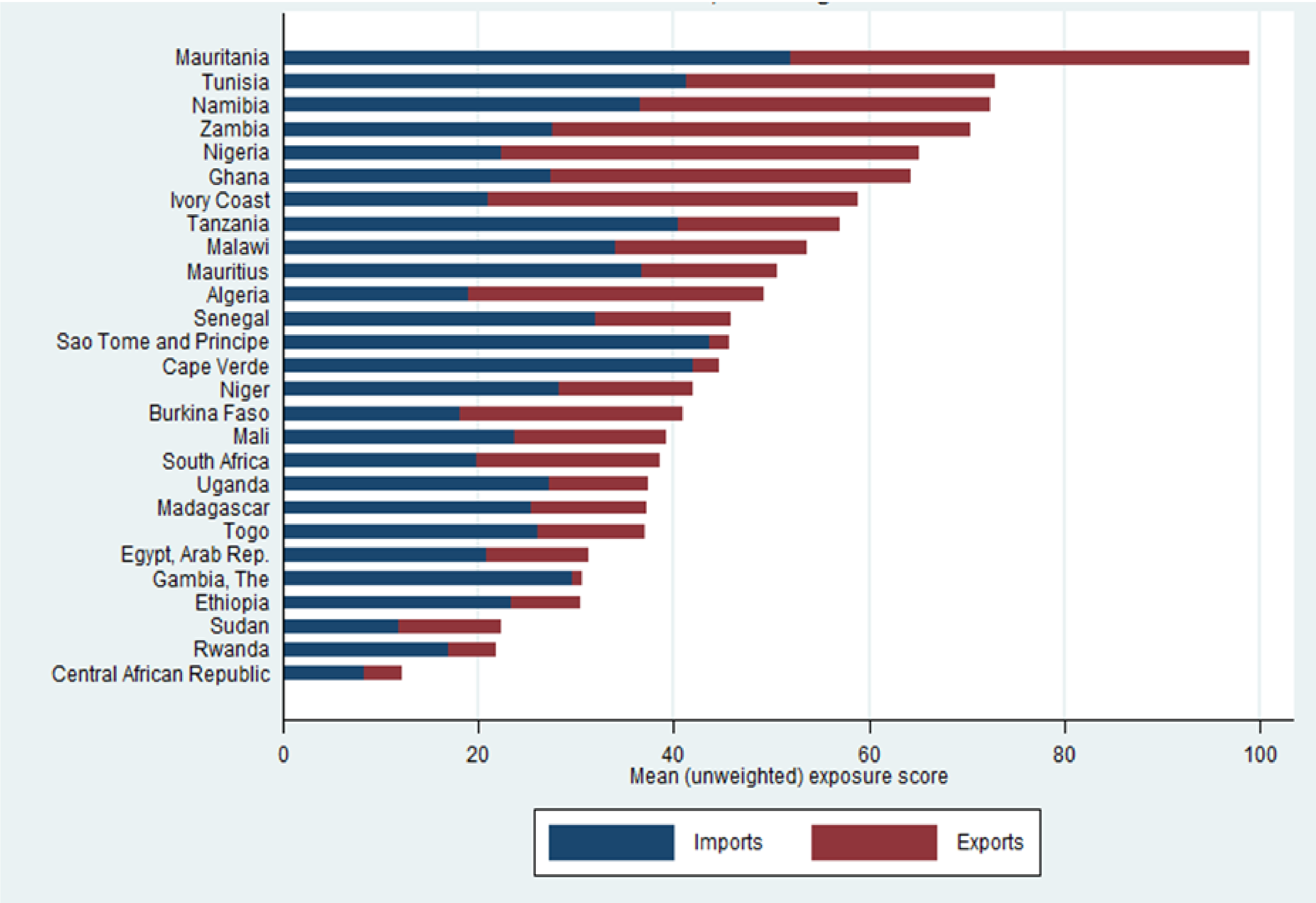
Vulnerability	Intensity	Exposure
$V_i = \dfrac{\sum F_{i,j} \cdot SS_j}{F_i}$	$I_i = \dfrac{F_i}{Y_i}$	$E_i = \dfrac{\sum F_{i,j} \cdot SS_j}{Y_i}$

$i: \{1, \ldots, I\}$	Country of interest
$j: \{1, \ldots, J\}$	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.



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Progressive policies (national/regional): Taxing multinationals differently

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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, => unitary taxation with formulary

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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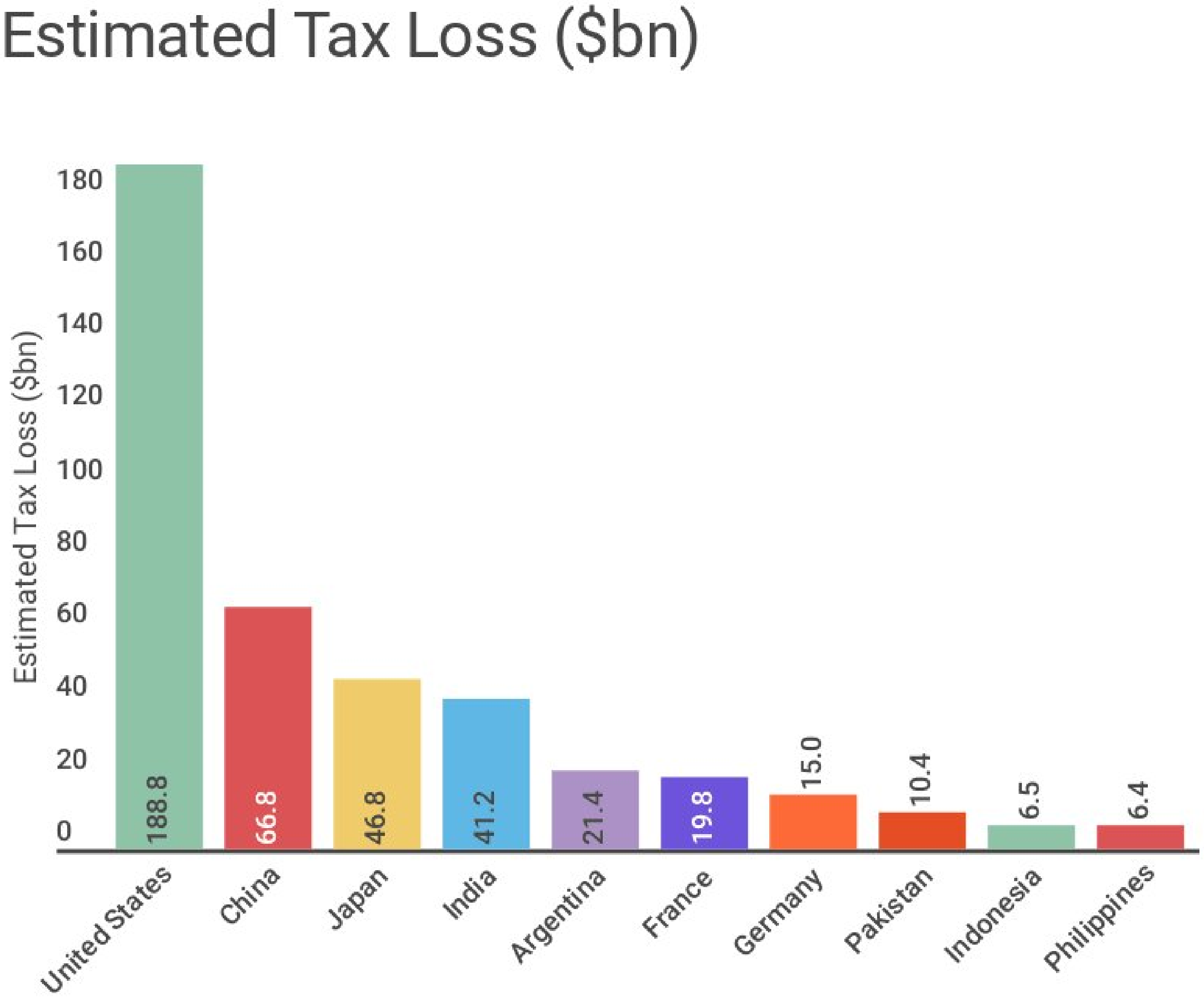
Distribution of impact: tax avoidance



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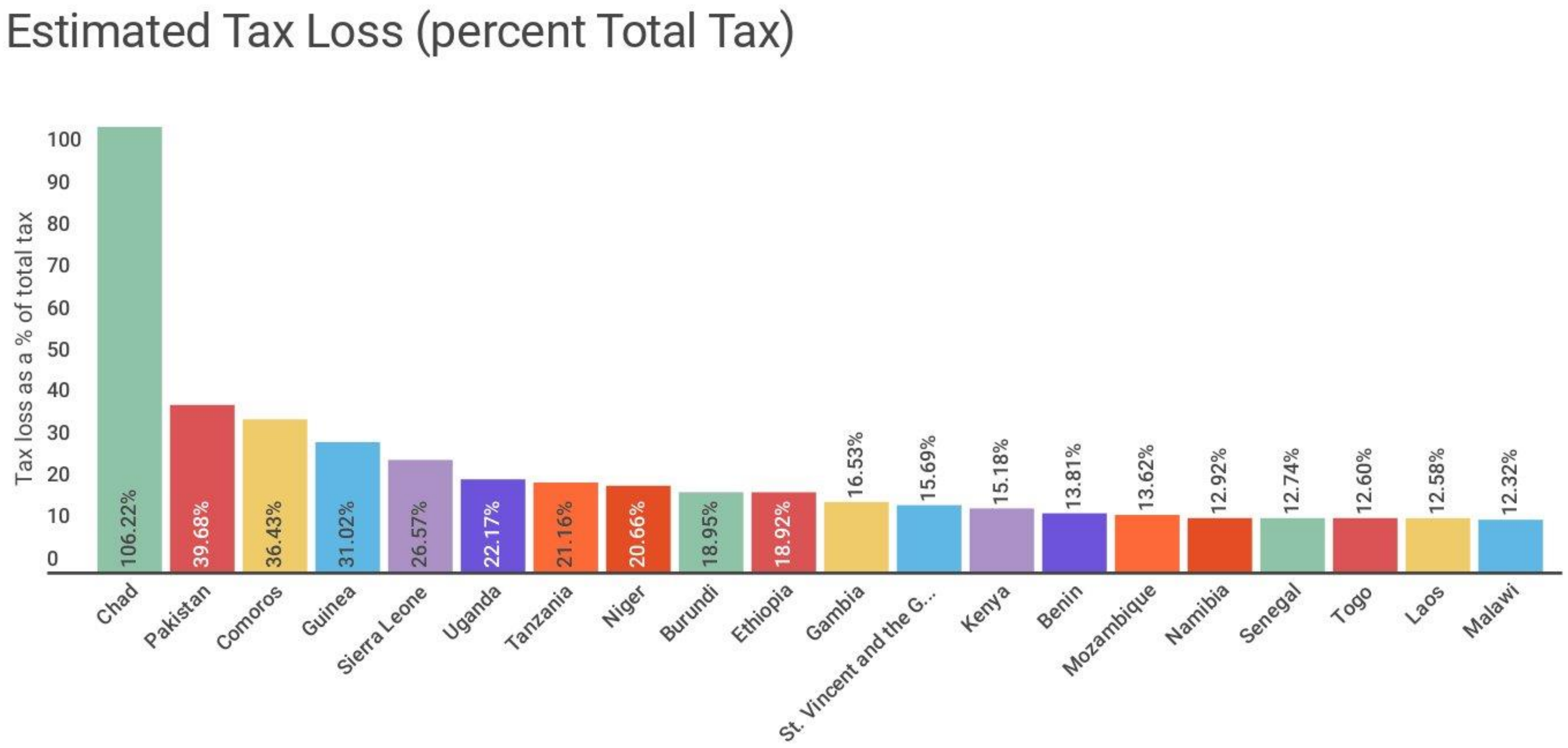

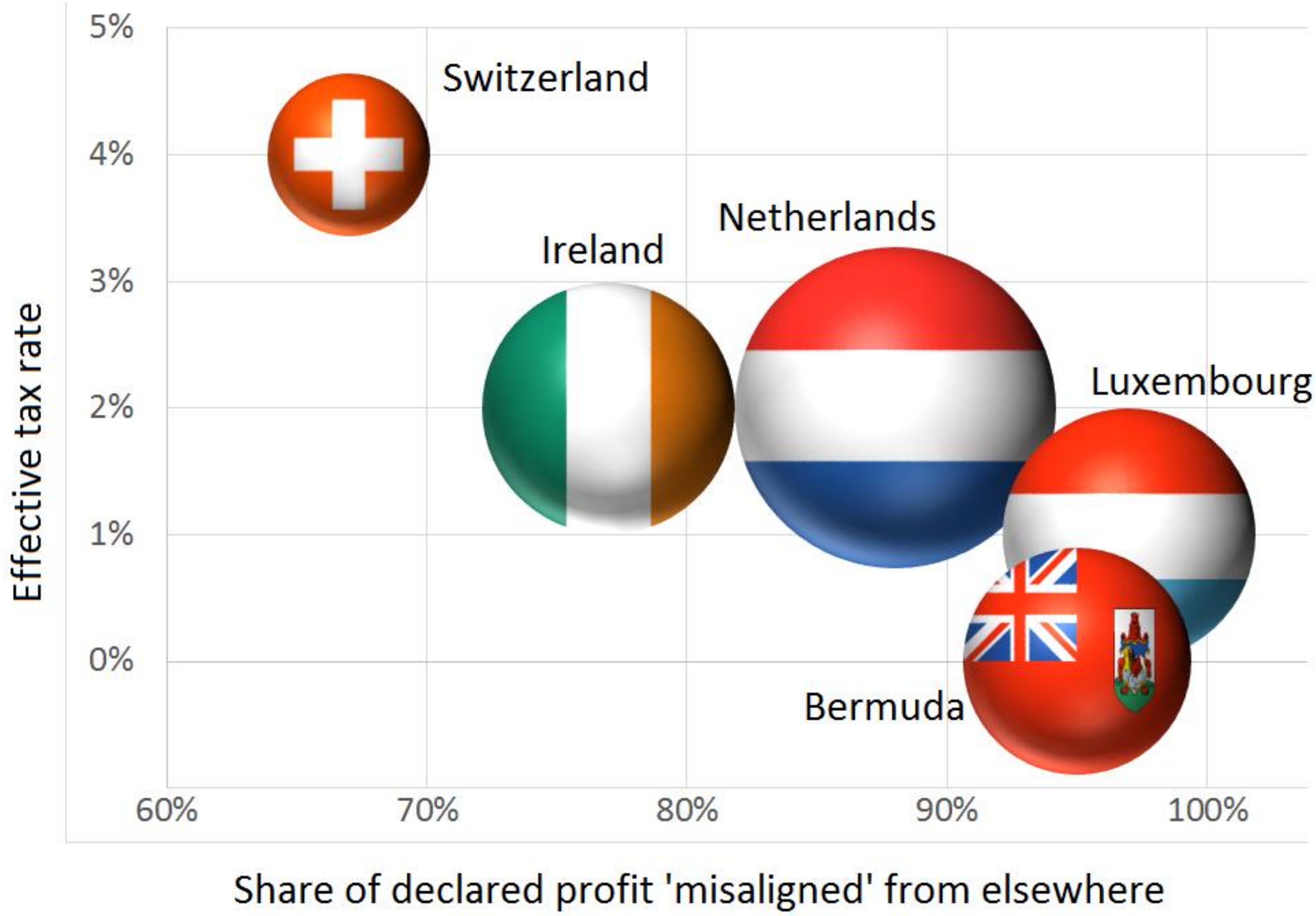

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