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Plugging financial leakages and mobilizing domestic and international resources to deliver on the Sustainable Development Goals

Note by the UNCTAD secretariat

Executive summary

The achievement of the Sustainable Development Goals faces a financing gap of trillions of dollars. Domestic resource mobilization can help close this gap, yet requires a combination of increased public revenues and the establishment of a virtuous profit and investment nexus. Illicit financial flows from developing countries pose an important challenge to the mobilization of development finance, and thus require close cooperation at national and international levels. Estimates of the magnitude of such flows are not specific and vary between studies, yet in all instances are cited as hundreds of billions of dollars per year, with transactions related to cross-border taxes accounting for two thirds of this amount. Illicit financial flows have potentially strong direct and indirect damaging impacts on States and society, and a core concern is the impact on income equality within and across countries. This note provides policy recommendations on combating such flows.

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I. Mobilizing domestic and international resources to deliver on the Sustainable Development Goals: Key considerations

1. The achievement of the Sustainable Development Goals faces a significant financing gap. Estimates vary, but the figure is likely in the trillions of dollars, given current investment levels.[1] From the point of view of domestic resource mobilization, closing this gap requires a combination of increased public revenues and the establishment of a virtuous profit and investment nexus.

2. A profit and investment nexus involves dynamic interactions between high profit expectations that induce private investment and, if realized in the markets, increase the capacities of domestic firms to finance future investment from retained earnings. Investment activity is, therefore, not narrowly determined by levels of pre-existing savings that, by definition, may be low.[2]

3. Crucially, a self-sustaining profit and investment nexus does not emerge spontaneously but requires coordinated and proactive policy intervention. Domestic banking systems that can provide liquidity and align credit creation with developmental priorities are of central importance, including for large-scale public investment in core infrastructural needs characterized by high levels of long-term social returns but low levels of short-term private profitability. A profit and investment nexus also requires the use of financing instruments that create temporary learning rents for dynamic firms in priority sectors, to promote domestic innovation capacity.

4. From the point of view of international resource mobilization for structural transformation, the most important channel is a development-friendly system of international trade that provides increased access by developing countries to export markets, in accordance with target 17.11 of the Sustainable Development Goals. An increase in external demand can reinforce a domestic profit and investment nexus by raising the profit expectations of domestic firms, inducing higher rates of domestic investment and further increasing capacity to finance future investment from retained earnings. In addition, higher exports earnings are an important source of additional tax payments and other public revenue, and thereby of increased fiscal space for development financing.

5. Given the scale of productive investment required to achieve the Goals by 2030, substantial transfers from advanced to developing economies remains essential, whether in the form of aid, other types of international public finance, debt relief or private foreign direct investment. A core consideration is that not only should both public and private international financial resources be scaled up, but that such resources should be appropriately channelled to further support a virtuous profit and investment nexus in developing countries. Many developing countries and their larger firms had ample access to cheap capital inflows in 2011–2014, yet these resources did not, by and large, serve to finance strategically important and productive investment activities.[3]

6. Policies such as financial inclusion and blended finance[4] are insufficient on their own to effectively address the need to substantially scale up development finance and to proactively channel financial resources into long-term developmental investment projects with, initially, low private profitability. Broadened access to digitalized financial services is unlikely to substantially increase the profit expectations of small and medium-sized

[1] UNCTAD, 2014, *World Investment Report 2014: Investing in the [Sustainable Development Goals] – An Action Plan*, United Nations publication, Sales No. E.14.II.D.1, New York and Geneva.

[2] UNCTAD, 2016, *Trade and Development Report, 2016: Structural Transformation for Inclusive and Sustained Growth*, United Nations publication, Sales No. E.16.II.D.5, New York and Geneva.

[3] Ibid.

[4] Financial inclusion refers to the process of providing access to bank accounts and other financial services to poorer sections of the economy and, more broadly, to the digitalization of financial transactions (see http://www.worldbank.org/en/topic/financialinclusion/overview). The Addis Ababa Action Agenda of the Third International Conference on Financing for Development defines blended finance as finance "which combines concessional public finance with non-concessional private finance and expertise from the public and private sector" (A/RES/69/313).

enterprises and thereby contribute to the emergence of a viable profit and investment nexus. Leveraging scarce international public finance, including official development assistance, to attract primarily foreign private capital through subsidies such as public loan guarantees, public–private partnerships, first-loss policies and investment grants, may have high potential opportunity costs. Unless such capital can also be tied into long-term, high-risk transformational investment projects, the direct use of international public finance to support structural transformation might yield more stable results. For example, a recent survey found that blended finance instruments had mobilized an estimated $81.1 billion of private capital in 2012–2015, with government guarantees representing almost half of the private-sector instruments used.[5] This amount is far from meeting the estimated annual financing gap for achieving the Sustainable Development Goals.

7. International and domestic efforts in resource mobilization for development are also closely interlinked through the need to reduce, as much as possible, the exposure of developing countries to external shocks to export prices, cross-border capital flows and external debt-service burdens. Under conditions of frequent shocks of this kind, the ability of developing countries to steer nascent domestic banking and financial systems towards the delivery of effective long-term development financing is dominated by short-term concerns about tackling immediate liquidity constraints and by diverting much needed development finance to hedge against such liquidity risks through the build-up of substantive international reserves.

II. Combating illicit financial flows from developing countries

8. Illicit financial flows from developing countries pose another challenge to the mobilization of development finance that requires close cooperation at national and international levels. There is no single agreed definition of illicit financial flows, but they refer broadly to cross-border economic and financial transactions that make use of financial secrecy to remain hidden from public and regulatory view. A common categorization differentiates illicit financial flows related to crime, corruption and tax. Empirical estimates suggest that, of these three categories, about one third of total illicit financial flows represent criminal funds related to drugs, racketeering and terrorism. Resources emanating from corruption account for only about 3 per cent of the total, while cross-border tax-related transactions account for the remaining two thirds, about half of which emanate from transfer pricing between multinational enterprises.[6]

9. As the term illicit suggests, illicit financial flows include, but are not limited to, illegal flows (the Oxford English Dictionary defines illicit as not sanctioned by law, rule or custom). While the breadth of the term makes it more difficult to arrive at a single agreed definition, avoiding a narrow legalistic definition matters for many reasons. Illicit financial flows are cross-border flows and therefore also operate across national legislative systems that may differ for reasons unrelated to whether such flows are considered harmful or abusive. From a development perspective, a narrow legalistic definition of illicit financial flows results in systematically understating the scale of the problem in lower-income, lower-capacity States. Such States are much less likely than more advanced States to have developed the administrative and legislative capacities to successfully uncover, challenge and sanction illicit activities in court.

[5] J Benn, C Sangaré and T Hos, 2017, Amounts mobilized from the private sector by official development finance interventions, Development Cooperation Working Paper No. 36, Organization for Economic Cooperation and Development.

[6] A Cobham and P Janský, 2017, Illicit financial flows: An overview, Background paper presented at the first session of the Intergovernmental Group of Experts on Financing for Development, Geneva, 8–10 November 2017; UNCTAD, *Trade and Development Report, 2014: Global Governance and Policy Space for Development*, United Nations publication, Sales No. E.14.II.D.4, New York and Geneva.

10. A common element across the varying technical definitions of illicit financial flows is that such flows are hidden, whereby either the illicit origin of the capital or the illicit nature of the transactions undertaken is deliberately obscured. Given the common element of financial secrecy, methods to measure illicit financial flows and consequent quantitative estimates also vary widely and need to be considered with caution. UNCTAD, together with the United Nations Office on Drugs and Crime, is engaged in developing and testing a common methodology to measure illicit financial flows and to provide data for the agreed scale indicator under target 16.4. There is, however, little doubt that the least developed countries and Africa are particularly vulnerable to high and growing levels of illicit financial flows.[7]

11. According to the final report of the High-level Panel on Illicit Financial Flows from Africa,[8] flows may reach $50 billion annually and, in 1970–2008, amounted to around $22 billion annually, on average, or a total of $854 billion, a figure nearly equivalent to all official development assistance received in Africa in this period.[9] Data from Global Financial Integrity suggest that in 2002–2011, Africa registered the fastest rate of growth in illicit financial flows among regions, at a rate of 19.8 per cent per year, and the highest flows as a share of gross domestic product, at 5.7 per cent.[10] The Economic Commission for Latin America and the Caribbean estimates that, in Latin America and the Caribbean, illicit financial flows reached a total of $765 billion in 2004–2013, equivalent to, on average, 1.8 per cent of regional gross domestic product.[11]

12. An area of illicit financial flows in which evidence of stronger impacts on low-income countries has emerged is profit shifting by multinational enterprises. One recent influential estimate indicates that long-term annual losses due to profit shifting are $400 billion in members of the Organization for Economic Cooperation and Development, or 1 per cent of gross domestic product, and $200 billion in lower-income countries, or 1.3 per cent of gross domestic product.[12] The International Monetary Fund found that, in 2012, losses amounted to 5 per cent of corporate income tax in members of the Organization for Economic Cooperation and Development and almost 13 per cent in non-member countries.[13] UNCTAD estimated that, in 2012, losses amounted to around 8 per cent of corporate income tax, or $200 billion globally and $90 billion in lower-income countries.[14]

13. Beyond the rough magnitudes of immediate economic losses, illicit financial flows also have potentially strong indirect damaging impacts on States and society. Such flows undermine States in several ways, namely by lowering tax revenue, by fuelling destabilizing criminal activity and by undermining State legitimacy through corruption. This can result in a vicious cycle in which weakened Governments find it difficult to prevent the growth of illicit financial flows and are, in turn, further undermined by growing illicit financial flows.

14. From a human development perspective, illicit financial flows, by reducing tax revenue, may strongly affect health outcomes in low-income countries. Several studies indicate that tax revenue is a major statistical determinant of progress towards universal health coverage in lower-income countries and that this is overwhelmingly driven by direct

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[7] UNCTAD, 2016, *Economic Development in Africa Report 2016: Debt Dynamics and Development Finance in Africa*, United Nations publication, Sales No. E.16.II.D.3, New York and Geneva.

[8] See https://www.uneca.org/publications/illicit-financial-flows.

[9] Economic Commission for Latin America and the Caribbean, 2017, *Financing the 2030 Agenda for Sustainable Development in Latin America and the Caribbean: The challenges of resource mobilization*, United Nations Publication, Santiago.

[10] M Herkenrath, 2014, Illicit financial flows and their developmental impacts: An overview, *International Development Policy*, 5(3), available at poldev.revues.org/1863#text (accessed 10 April 2017).

[11] Economic Commission for Latin America and the Caribbean, 2017, *Flujos Financieros Ilícitos en América Latina y el Caribe*, United Nations publication, Santiago.

[12] E Crivelli, R A de Mooij and M Keen, 2016, Base erosion, profit shifting and developing countries, Working Paper No. 15/118, International Monetary Fund.

[13] International Monetary Fund, 2014, Spillovers in international corporate taxation, Policy paper.

[14] UNCTAD, 2015, *World Investment Report 2015: Reforming International Investment Governance*, United Nations publication, Sales No. E.15.II.D.5, New York and Geneva.

taxes on profits, income and capital gains. In addition, there appears to be a stronger statistical association between direct taxes and public health expenditure than between indirect taxes and such expenditure, with countries making greater use of direct taxes tending to exhibit higher levels of public health expenditure and broader coverage of and access to public health systems.

15. Another core concern is the impact of illicit financial flows on income inequality, both within and across countries. As has been widely documented, income inequality has risen sharply over the past two decades across a range of measures.[15] Much attention has focused on growing personal income inequality in developed economies for which detailed data is available, yet functional income distribution between wages and profits has also registered sharp changes, with a steep decline in the wage share in both developed and developing countries.[16] However, location is still more likely to determine the place of an individual in the global distribution of income than other factors, reflecting the uneven distribution of productive capacities in the global economy. For example, one study estimates that around 85 per cent of global inequality can be explained by differences in mean incomes between countries, while only 15 per cent can be attributed to variations within countries.[17]

16. Illicit financial flows are likely to exacerbate these trends through their negative impact on State capacity, in general, and on tax revenue and the ability of Governments to implement redistributive policies to correct trends of rising income inequality, in particular. Large public sectors have enabled developed countries to implement redistributive policies to limit the impact of growing inequality in functional income distribution on personal income distribution. In developing countries with much smaller public sectors, such policy space is more limited.[18]

17. Redistributive measures have generally become less effective in modifying the primary distribution of income, reflecting moves towards less progressive tax systems coupled with less generous social transfers in many developed and developing countries, yet the ability of elites, whether individuals or companies, to avoid or evade taxation, further limits space for such measures. One study shows that unaccounted-for inequality due to illicit financial flows is likely to be substantial in estimates of national income distribution, possibly adding 5 points to the Gini coefficient in some instances.[19] Another study shows how tax evasion in some Northern European countries is strongly concentrated in the top 0.01 per cent of wealth distribution, and thus how understated inequality can be if estimates rely on household surveys and data on tax reporting alone.[20]

18. Profit shifting by multinational enterprises further creates a disadvantage for smaller domestic businesses that are typically responsible for the majority of employment in a country. Moreover, cross-country inequality is thereby clearly exacerbated, with only a small number of jurisdictions consistently receiving disproportionate volumes of profit related to economic activity elsewhere, reflecting a race-to-the-bottom pattern of competition between States to attract corporate profits through low-impact tax-related regulatory regimes. In contrast, the scale of shifted profits and revenue losses is widely distributed across other jurisdictions, with the highest values in high-income countries but the most intense losses, with regard to gross domestic product and especially to tax revenue, in lower-income countries.

[15] See, for example, T Piketty, 2014, *Capital in the Twenty-First Century*, Harvard University Press, London, and UNCTAD, *Trade and Development Report, 2012: Policies for Inclusive and Balanced Growth*, United Nations publication, Sales No. E.12.II.D.6, New York and Geneva.

[16] UNCTAD, 2016, *Trade and Development Report, 2016*; UNCTAD, 2012.

[17] B Milanovic, 2012, Global inequality: From class to location, from proletarians to migrants, *Global Policy*, 3(2): 125–134.

[18] UNCTAD, 2012.

[19] A Cobham, W Davis, G Ibrahim and A Sumner, 2016, Hidden inequality: How much difference would adjustment for illicit financial flows make to national income distributions? *Journal of Globalization and Development*, 7(2).

[20] A Alstadsaeter, N Johannesen and G Zucman, 2017, Tax evasion and inequality, available at http://www.nielsjohannesen.net/wp-content/uploads/AJZ2017.pdf (accessed 10 April 2017).

III. Suggested policy recommendations

19. The Trade and Development Board may wish to consider the following policy recommendations:

(a) With regard to measurement-related issues, including the relevant indicator under target 16.4, it is important to keep in mind that simple estimates at the level of individual countries should not be used to imply that countries are primarily responsible for progress in reducing illicit financial flows. Rather, given the nature of illicit financial flows and the importance of financial secrecy beyond their borders, international cooperation to combat illicit financial flows is essential.

(b) A policy that may be pursued at the national level, and also through coordination between Governments, is to require the publication of country-by-country reporting, for example under the new standard of the Organization for Economic Cooperation and Development.[21] Such a policy would increase transparency, and is likely to lead in the longer term to the widespread adoption of unitary taxation approaches, that is, taxation at the level of a multinational enterprise rather than at the level of individual subsidiaries.

(c) Commitments by Governments to full cooperation in the automatic exchange of tax information and public registers of beneficial ownership are helpful. In addition, countries and/or regional groups may consider removing legal protection for companies, trusts and foundations, from any jurisdiction, for which beneficial ownership information is not held in public registers. Measures such as the blacklisting of non-cooperative jurisdictions may also be used to reduce financial relationships with financial secrecy jurisdictions that continue to avoid the required standards of transparency and cooperation.

(d) The underlying problems of financial secrecy, without which illicit financial flows would be on a much lower scale, are global and systemic. Countries can and should take powerful domestic steps, yet there is a need for a global and inclusive forum that takes on board the interests of all countries, to achieve meaningful progress on this matter. Considerable progress has been made by the Organization for Economic Cooperation and Development and the Group of 20 with regard to some aspects of illicit financial flows, yet lower-income countries are excluded from discussions in these forums. Moving towards a high-level global commission under the United Nations may be a long road, and in the immediate future, countries could take a lead in deciding to negotiate and agree on an international convention on financial transparency.

[21] See the agreed policy recommendations of the first session of the Intergovernmental Group of Experts on Financing for Development (TDB/B/EFD/1/3). On the new Organization for Economic Cooperation and Development standard, see https://www.oecd.org/tax/beps/country-by-country-reporting.htm.