development initiatives

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Understanding illicit financial flows in a development financing context

factsheet

International cooperation to tackle dirty money

International cooperation is critical for tackling dirty money that crosses borders. Organised criminals, kleptocrats and large-scale tax evaders often move money into foreign jurisdictions, shopping around for places which don't ask too many questions or that offer attractive investment and consumption opportunities, and using structures and routes that make investigation more difficult. They use networks of relationships to obscure the money flows; such as a bank account in one country owned by a corporation in another jurisdiction, which is in turn owned by a trust in a third jurisdiction[1]. International cooperation has a vital role to play in tracking, stopping and returning these flows (together with domestic law enforcement and regulators).

It is clear that developing countries suffer from the effects of "illicit financial flows" (IFFs), and that often this money ends up in OECD member countries. Large estimates of the dollar value of such IFFs have raised awareness of the issue, and it can be intuitively attractive to think of IFFs as a negative flow of development resources resulting in a direct dollar-for-dollar reduction in resources for public and private investment in hospitals, schools, police officers, roads and bridges. However, the connection is not quite so direct, and IFFs are not so easy to measure as the commonly quoted estimates suggest.

What are IFFs?

The Addis Ababa Action Agenda highlights addressing IFFs as part of the global framework for financing post-2015 development, together with good governance, rule of law, human rights, fundamental freedoms, equal access to fair justice systems, and measures to combat corruption.

There is no single agreed definition of IFFs, but in general the concept relates to flows of money (or other assets used as stores of value) associated with crime and corruption, including tax evasion, usually with a focus on cross border flows[2]. It is closely associated with money laundering – the process of transforming profits from illegal activities and corruption into ostensibly 'legitimate' assets. Organised crime groups, kleptocrats and large-scale tax evaders use three main means to illicitly move assets offshore: physical cash; financial instruments and entities such as bank accounts and 'shell corporations'; and movement of goods through the trade system.

There is an ongoing debate about whether the definition of IFFs should be widened beyond 'dirty money' to include financial flows associated with multinational tax avoidance, which can be legal[3]. Sometimes 'trade misinvoicing' (whereby importers and exporters collude to misdeclare the value of shipments, a form of fraud that can be used to facilitate tax evasion or payment of bribes, or for money laundering) has been confused with the practice of transfer-pricing, which is a compliance responsibility of multinational companies for pricing transactions between their own subsidiaries. Strategic transfer pricing can result in 'base erosion and profit shifting' (BEPS), without necessarily breaking any rules. Updating the international tax system to prevent BEPS and to make sure it is able to tax global digital businesses is an important area for policy making and international cooperation. However, the problem of companies using the tax rules to their advantage is a different problem to the one of individuals and enterprises seeking to get away with breaking the law by hiding or obscuring financial flows.

Are IFFs 'development finance in reverse'?

IFFs have become closely associated with headlines such as 'developing countries losing $1 trillion' or 'Africa losing $50 billion'. It is tempting to think of IFFs as a negative flow of development resources resulting in a direct dollar-for-dollar reduction in resources for hospitals, schools and roads, and for private investment. However, counting IFFs as development finance in reverse is not straight-forward for several reasons:

- **IFFs are by their nature hidden, and estimates are uncertain.** The largest, and most commonly cited estimates of 'trade misinvoicing' based on gaps and mismatches in trade statistics are not reliable, as they can interpret innocent trade as illicit and small changes to underlying assumptions in calculations can have large implications for the resulting estimates[4]. Focusing on the areas where it is easiest to generate eye-catching (but unreliable) annual figures may divert attention away from areas such as crime and corruption – where it is harder to generate any figures at all.

- **One dollar of illicit financial flow is not the same as one dollar of harm**. IFFs are not necessarily direct losses to the public purse. For example, if a trader undertakes misinvoicing for the purpose of evading export duties, the loss to the public purse is the tax evaded, not the total value of the illicit financial flow. On the other hand, the same channel could be used to conceal the transfer of stolen treasury funds, or to take side payments from a public contractor. The harm caused can be even greater than its headline value, since corruption undermines the rule of law, deters investment and corrodes the quality of public works. Similarly, IFFs related to organised crime have wide-reaching impacts on economies, institutions and people[5].

- **Corruption and crime can also generate illicit finances which flow inwards.** Examples include political actors using an offshore account to finance campaigning or patronage at home, and criminals managing cross-border enterprises may transfer funds inwards. In the case of money moved offshore to evade taxation we cannot assume it is lost to the country as potential finance for investment, as funds can be 'roundtripped' back into countries. The most recent set of estimates published by Global Financial Integrity[6] suggest that inward illicit financial flows to developing countries are almost double the level of outflows (although there is a large degree of uncertainty on these estimates on both sides).

- **Amounts recovered and returned through legal processes are often much less (and much later) than the original amounts stolen.** There has been significant progress in countries cooperating to track, stop and return money. But the development impact of this may be more about demonstrating that justice cannot be avoided than raising timely finance for development. For example, it is estimated that

Sani Abacha, who died over 20 years ago, stole several billion dollars during his presidency of Nigeria. Sustained efforts to return funds have resulted in almost $1 billion being returned. In smaller countries the amounts involved are in the hundreds of millions.

Thinking about IFFs as ‘development finance in reverse’ is intuitively attractive but encourages a vision of development as the process of filling up a leaky bucket with resources from the outside, rather than encouraging analysis of what happens ‘inside the bucket’ through the agency and institutions of people and societies. Grand corruption, organised crime and money laundering impair long-term economic growth and increase inequality, harming the welfare of entire economies. Actors in developed countries should take action to help those in developing countries that are fighting corruption, and to prevent facilitating and benefiting from these flows, but the value of jewels, designer clothes, cars, and properties amassed abroad by a few people, while obscene, is only a fraction of the development impact of opportunities that do not attract investment, markets and institutions corrupted, lives disrupted and public agencies corroded.

International cooperation on IFFs

Developed countries can take action on IFFs in four ways: providing technical assistance; building understanding; strengthening their own anti-money laundering practices at home; and acting on specific cases through legal cooperation or sanctions. At the same time it is critical to ensure that anti-money laundering regulations do not push costs onto the poor, making it harder and more expensive for migrants to make remittances, non-profit organisations to assist in emergencies, and small and medium-sized firms to access financial services[7].

International economic and financial crime has not traditionally been a priority area of work for development agencies. However, this is changing with increased focus on IFFs. The Norwegian government has championed action on IFFs through diplomacy, supporting research and civil society coalitions, and aiding capacity building on tax administration and anti-corruption in partner countries. Since 2006, the UK’s Department for International Development (DFID) has assisted specialist police units in tracing, seizing, and returning the fruits of grand corruption and to investigate bribery abroad[8], and provided technical assistance to tax authorities combatting tax evasion. At the same time a law on ‘unexplained wealth orders’ was established allowing assets to be frozen on suspicion of corruption. Germany has an inter-ministry committee on IFFs to coordinate cross-government action. It assists authorities in countries such as Kenya and Peru to detect and trace IFFs and to engage internationally to secure the return of stolen assets. Donors and international organisations have also supported country studies to better understand the channels and drivers of IFFs, for example, in Malawi and Namibia[9]; West Africa[10]; and Kyrgyzstan, Tajikistan, Afghanistan, Pakistan, India, Nepal, Bangladesh and Myanmar[11].

It is critical that rich countries take action to avoid being safe havens for dirty money. This means fully implementing anti-money laundering commitments, expanding networks for exchange of tax information, investigating bribery and unexplained wealth, prosecuting offenders and providing protection to whistleblowers. International standards are set (and progress peer-reviewed) through the Financial Action Task Force (FATF) and associated regional bodies, and the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum). These bodies develop standards that many countries beyond the OECD have also signed up to, while the G20 has also adopted high-level principles on beneficial ownership of companies and trusts. But implementation remains patchy. For example, only eight G20 countries (Australia, China, France, India, Indonesia, Japan, Mexico and the United Kingdom) require financial institutions to use independent and reliable sources to verify the beneficial owner of their customers[12]. In 2014 the OECD undertook a review of progress by OECD member countries in combatting money laundering, bribery, tax evasion, and in the return of stolen assets. It found modest progress, but significant gaps and weaknesses[13]. Since then a large number of OECD member countries have been through a further round of peer review by the Global Forum or mutual evaluation or follow up reports by the FATF. An up-to-date review of progress by the OECD would be helpful to drive a race-to-the-top in making major international economies and financial centres hostile to IFFs.

Notes

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