DIIS POLICY BRIEF
GOVERNANCE IN THE GLOBAL ECONOMY

Combating illicit financial flows from poor countries. Estimating the possible gains

If the UN Millennium Development Goals are to be reached by 2015, development aid needs to be tripled – which is most unlikely. Instead, countries should unite in a concerted multilateral effort to combat illicit financial flows: for every dollar poor countries receive in development assistance, more than eight dollars are illegally transferred back to rich countries, most of it in order avoid local taxation. Effectively combating these illicit financial flows would generate more financial resources for development than foreign aid is likely to ever do – and help build a sustainable tax base in developing countries for the benefit of future development efforts.

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GOODBYE MILLENIUM GOALS?

At the UN Millennium Summit in New York in September 2000, 189 nations agreed upon a declaration stating eight goals – the Millennium Development Goals – that were to be met collectively by 2015. The Millennium Goals were to address the world's main development challenges: to eradicate extreme poverty and hunger, to promote universal primary education and reduce child mortality. More than half way to the 2015 deadline the progress achieved with respect to extreme poverty and hunger has begun not only to slow down but even, in many cases, to reverse, as a consequence of the global financial crisis (UN 2009).

In order to cover the costs of achieving the Millennium Goals it has been estimated that total development assistance needs to be in the order of $350 billion in 2010 and $530 billion in 2015 (UNDP 2005). In 2008, total development assistance was $120 billion. Put in plain English, development assistance needs to be tripled over the next two years from $120 billion in 2008 to, say, $235 billion in 2009 and $350 billion by 2010, if the costs of meeting the Millennium Goals are to be met. Such a dramatic increase of development assistance is unlikely. The $120 billion of development assistance in 2008 corresponded to 0.30 per cent of total national income, compared to 0.28 per cent in 2007. This modest increase must be seen against the background of a shared commitment by developed countries to increase their development assistance to a

POLICY RECOMMENDATIONS

- Developed countries should immediately and consistently assist developing countries in combating tax evasion practices by multinational companies
- Country-by-country reporting should hence be compulsory for all multi-national corporations to increase transparency on sales, profits and taxes paid in all the jurisdictions where they operate
- Tax authorities in all countries should enhance their exchange of information in a joint effort to combat tax evasion
- Donors should fund capacity building for tax collection in developing countries so as to establish a foundation for independent financing of future development efforts

level of 0.70 per cent of total income by 2015. If progress continues at the current rated of 0.02 percentage points per year, development assistance will have reached 0.44 per cent of total national income by 2015, far from the official commitment – and even further from what is actually needed to cover the costs of meeting the Millennium Goals.

So, perhaps it is time to say goodbye to the Millennium Goals? Not necessarily. Every year approximately $1 000 billion is illegally transferred from developing to developed countries. For every $10 developing countries receive from developed countries in the form of development assistance, more than $80 is illegally appropriated from these countries and transferred to developed countries. Around half of these illicit financial flows take place in order to avoid taxation in developing countries and it has been estimated that the loss of corporate taxes alone – as a result of corporate tax evasion practices – amounts to $160 billion a year. In other words, if the world's developed countries got their acts together to combat such illicit financial flows, the costs of meeting the Millennium Goals could be financed by developing countries themselves.

MEASURING 'ILLICIT FINANCIAL FLOWS'

The term 'illicit financial flows' is commonly defined as encompassing three main categories. Firstly, the proceeds from illicit activities such as corruption, including bribery and embezzlement of national wealth; secondly proceeds from criminal activity, such as drugs trading, illegal arms trading and human trafficking and, thirdly, it also includes the proceeds of licit business that become illicit when transported across borders in contravention of applicable laws and regulatory frameworks, which most commonly occurs in order to evade payment of taxes.

'Illicit financial flows' is a delicate and controversial issue for obvious reasons. Add to this the fact that, by their very nature, these types of flows are never declared and it becomes clear why they are difficult to measure. And difficult to measure often means easy to disregard. Now, however, studies have become available which arrive at very credible estimates of illicit financial flows, based on innovative use of standard economic models and IMF and World Bank databases.

In December 2008 Dev Kar and Devon Cartwright-Smith published a report estimating illicit financial flows from developing to developed countries for the period from 2002 to 2006. These estimates of illicit financial flows are based on data on macroeconomic trade and external debt, drawing upon databases maintained by the International Monetary Fund and the World Bank. The models used to analyze these data are widely used by economists. Three types of model – the World Bank Residual Model, the Trade Mispricing model and the Hot Money model – are deployed with a variety of specifications, and combined in a range of ways, to identify the model combination that provides the most reliable estimates. On the basis of extensive comparative analysis of different model combinations and specifications, the report identifies the combined use of the World Bank Residual Model (in its 'external debt' specification) and the Trade Mispricing model (in its 'gross excluding reversals' specification) as optimal. A brief explanation of the key principles of these two models is warranted.

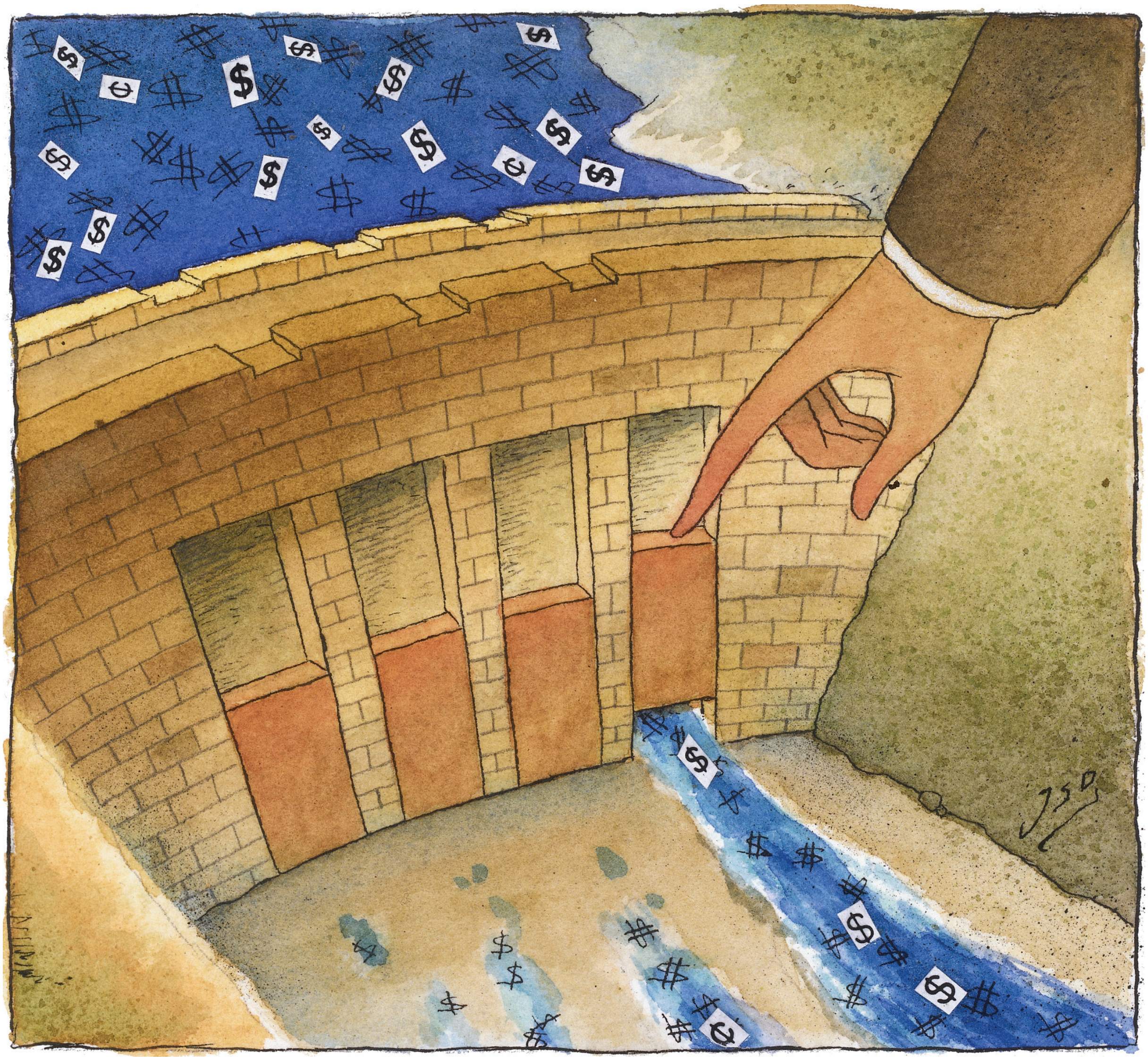
The World Bank Residual model

measures inflows of capital against recorded uses of capital. If inflows of capital are not fully matched by recorded uses of capital, illicit financial flows have taken place. In terms of inflows of capital, the two key variables observed are net flows of foreign direct investment and increases in net public sector debt. Uses of capital inflows, on the other hand, include the current account deficit (financed by capital account flows) and the accumulation of reserves. In this broad macroeconomic framework, outward illicit financial flows exist when the inflow of funds exceeds the use of funds. These data contain no information regarding the types of illicit financial flows involved, nor of the related underlying activities, but only measure the aggregate magnitude of a range of illicit financial flows associated with criminal activity, corruption, etc.

ILLICIT FINANCIAL FLOWS FROM DEVELOPING TO DEVELOPED COUNTRIES, 2002-2006, US$ BILLIONS

	2002	2003	2004	2005	2006
Trade mispricing	261	317	459	475	506
Other illicit financial flows	174	252	256	331	550
Total	435	569	715	806	1,056

Source: Kar and Cartwright-Smith 2008 Appendix, table 5.



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The Trade Mispricing model seeks to capture the practice of 'misinvoicing' trade as a means of 'exporting' a trade surplus to another country, i.e. as a means of tax evasion. In essence this practice consists of over-invoicing imports and under-invoicing exports. To estimate this kind of trade mispricing a developing country's exports to the world are compared with what the world reports as having imported from that country, after adjusting for the costs of transportation and insurance. Additionally, a country's imports from the world are compared to what the world reports as having exported to that country. Discrepancies in partner-country trade data provide a good indicator of the extent to which trade mispricing has taken place between any two given countries.

Combing these two estimation methods Dev Kar and Devon Cartwright-Smith arrive at the following estimates for illicit financial flows from developing to developed countries for the period from 2002 to 2006.

Firstly, in terms of aggregate magnitude, the quantitative estimation based on official macroeconomic data confirms the overall result arrived at in prior studies such as Raymond Baker's much cited work based on an extensive interview survey. Baker's estimate for 2005 was that total illicit financial flows from developing to developed countries were in the range of $539-778 billion, close to the $806 billion arrived at by Kar and Cartwright-Smith.

Secondly, with respect to trade mispricing, the quantitative study confirms a key conclusion made by prior studies: namely that trade mispricing constitutes by far the largest component of illicit financial flows. From 2002 to 2006 the share of trade mispricing in total illicit financial flows varied from 50 to 65 per cent, according to the estimates of Dev Kar and Devon Cartwright-Smith.

HOW BIG IS THE PROBLEM?

How does one know that these estimates do not grossly exaggerate the problem? There are three key components to a rebuttal of this question. Firstly, the data and methods used in this new study are highly reliable. The lead author of the study, Dev Kar, has extensive experience with various forms of macroeconomic modelling and statistical analysis after more than 32 years working as an economist at the IMF. Secondly, the estimates arrived at confirm the main conclusions of previous studies using other methodologies. Estimation of illicit financial flows is robust, in other words, to variation in the methodologies applied. Lastly, the estimates most likely under-estimate rather than over-estimate the volume of illicit financial flows, since some important types of illicit financial flow – such as mispriced asset swaps – simply cannot be captured by these data. If actual illicit financial flows are significantly different from the estimates they are most likely larger, not smaller.

For developing countries, struggling with severe problems such as extreme poverty and high child mortality, this illegal outflow of capital constitutes a highly detrimental drain on their already sparse resources. For developed countries it is embarrassing, to say the least, that for every dollar given in development assistance, at least eight dollars is illegally transferred from the poor countries to the rich.

CONCLUSIONS

What can politicians do to address this illegal flight of capital from developing to developed countries? There are a wide range of policies needed to combat these different types of illicit financial flows, but the three essential policies that must be adopted multilaterally are the following:

- Country-by-country reporting should be compulsory for all multi-national corporations. By requiring companies to publicly report sales, profits and taxes paid in all the jurisdictions where they operate, it will become possible to identify transfer mispricing. The standards developed by the International Accounting Standards Board need to be revised in accordance with this principle. This initiative should be part of wider efforts to advance the tax transparency agenda.

- Existing agreements regarding the cross-border exchange of information between tax authorities should be amended in three ways: (i) exchange of information should be automatic rather than occur only on request; (ii) such exchange of information should be expanded to cover not only individuals but all other forms of actors, including companies, trusts and holding companies; (iii) information should be exchanged not only on interest income, but on a much wider span of capital incomes.

- Development assistance should give greater priority to initiatives aimed at improving the effectiveness and transparency of tax systems in developing countries. Resources, organizational capacity and human capital are the keys to securing a sustainable tax base in developing countries. Most developing countries are short of personnel, resources and infrastructure in this area, and easily fall prey to large multinational corporations with highly paid specialists in accounting and finance.

Jakob Vestergaard (www.diis.dk/jve)
and Martin Højland (www.diis.dk/mhl),
Research unit on Global economy, regulation and development, www.diis.dk/geared

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THE DANISH INSTITUTE FOR INTERNATIONAL STUDIES
Strandgade 56, 1401 Copenhagen K · Denmark · Tel. +45 32 69 87 87 · diis@diis.dk · www.diis.dk