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Illicit financial flows and measures to counter them: An introduction

The most common sources of illicit financial flows are tax evasion and money laundering. Countermeasures include institution building strategies, international cooperation and information exchange, and fiscal transparency. Development practitioners need to understand the nature of the problem of illicit financial flows as an obstacle to development, and be aware of interventions that can reduce such flows.

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Illicit financial flows (IFF) are widely acknowledged to be a major obstacle to development.[1] By reducing the capital available for investment, these flows negatively affect economic growth. The main impact is a reduction in public funds, because revenue is reduced or misappropriated. But there is also an effect on private funds, because wealth held outside the country reduces the stock of capital available for productive investment.

Illicit financial flows also undermine the quality and accountability of democratic institutions, helping to keep corrupt elites in power. This in turn impedes the development of a taxpaying culture and reduces investor confidence.

Types of illicit financial flows

Financial flows may be illicit for two distinct though overlapping reasons. In some cases the money involved comes from the proceeds of crime, such as corruption or drug smuggling. In other cases the process of transferring the funds is illegal or illegitimate, even if the funds come from legal and legitimate sources. Such transfers are most often done to escape payment of taxes. When funds from legitimate activity are circulated through illicit methods, such as abusive transfer pricing,[2] these funds also become illicit. Figure 1 shows the most common sources of IFF and the patterns of circulation of illicit and licit funds.

While transfers of funds derived from crimes such as corruption are clearly illegal (and we may include transfers designed to launder the proceeds of domestic tax evasion in this category), determining whether or not an international transfer whose purpose is to minimise tax payments is "illicit" is difficult. Most tax planning is both legal and legitimate. But it is not always possible to draw clear lines between these and more "aggressive" forms of tax planning, tax avoidance (which violates the intent but not the letter of the law), and tax evasion (which violates tax laws). In many developing countries, the existence of tax settlements outside of the legal code,[3] together with poor legal drafting blurs the distinction between "legal" and "licit."Furthermore, if the state itself is considered illegitimate, tax evasion may come to be regarded by many as a licit activity.

Despite their differences, the two categories of IFF share common features. They flourish in the absence of strong institutions charged with regulating and policing the relevant activities. And they depend on secrecy in the jurisdictions that hide the funds from authorities. Neither corruption nor tax evasion necessarily implies that flows leave the country of origin, but the wish to hide them from authorities usually results in IFF crossing borders. In the case of corruption, the proceeds are usually shifted to a location where banking secrecy impedes investigators from prosecuting the owner of the funds. In the case of international tax evasion, moving funds abroad prevents the tax authority from confirming that the taxpayer has undeclared income. Tax avoidance, since it is not in explicit violation of the law, may be effective without such secrecy, but secrecy may still be desired to avoid public attention.

Money laundering and tax evasion

One common type of IFF – transfer of the proceeds of illegal activities – is also referred to as money laundering. Overseas bank accounts and shell companies are often used to hide financial flows derived from corruption.

Diepreye Alamieyeseigha, then governor of Bayelsa State in Nigeria, hid illicit wealth amassed through corruption during his time in office (1999–2005). In July 2007, he pleaded guilty before a Nigerian High Court to six charges of false declaration of assets. Several companies he used to hold property and funds abroad also pleaded guilty to 23 charges of money laundering. He was sentenced to two years in prison, and the court ordered the seizure of his assets in Nigeria and abroad.[4]

Figure 1: Types of illicit financial flows

Source: Adapted from Fontana and Hansen-Shino 2012.

Another common type of IFF involves legitimately generated funds, illicitly transferred to another jurisdiction for the purpose of reducing or escaping tax obligations in the country of origin. This is often done by manipulating "transfer pricing" payments between subsidiaries of the same multinational company in different jurisdictions. A related practice, false invoicing, shifts profits through the use of fake invoices between independent companies.

In 2010, global brewing giant SABMiller was accused of shifting profits generated in its African and Indian operations to avoid tax obligations.[5] The group's African subsidiaries were making transfer pricing payments of an estimated £100 million per year. These were supposedly in return for a range of goods and services and the use of intellectual property from other SABMiller companies in low-tax jurisdictions. The African countries from which profits were shifted were estimated to be losing tax revenue of about £20 million annually as a result.

Debate about cases of transfer pricing has focused on whether these practices were compliant with national and international transfer pricing standards. The most commonly cited are the Organisation for Economic Co-operation and Development (OECD) guidelines. In the SABMiller case, there may have been noncompliance with the OECD guidelines.[6] More generally, the factors at work may include lack of adequate transfer pricing legislation, widespread nonenforcement of existing legislation, lack of transfer pricing expertise and capacity to identify abusive arrangements, and ambiguity inherent in the OECD's "arm's length" standard.

Countermeasures

Figure 2 shows the measures that have been commonly applied to curtail IFF.

Institution building

Some of the international initiatives to combat IFF focus on building institutions. Like other strategies, institution-building strategies differ depending on whether the flows in question are related to corruption or taxation.

Corruption: Efforts to curb corruption-related IFF seek to make it more difficult for individuals to enrich themselves illegally and to transfer such proceeds abroad. Among government institutions, financial intelligence units (FIU) play a leading role. They are tasked with identifying suspicious financial transactions, that is, those with a high probability of being related to illegal activities. Records of such transactions are often the first evidence obtained during an investigation. Therefore, every country needs a functioning FIU.

Once funds have been moved abroad, a country wishing to recover them needs institutions capable of investigation, prosecution, and asset recovery. This involves other state agencies in addition to the FIU. Agencies responsible for investigating and prosecuting crimes, such as police and prosecution authorities, need to be adequately resourced in human and financial terms and independent from external pressure. The prospects for a successful investigation depend on evidence gathered in the country where the funds originate. Without such evidence, it is unlikely that an asset recovery case can be brought to court abroad.[7] In the Alamieyeseigha case, before the successful criminal conviction in Nigeria, UK authorities had advised their counterparts in Nigeria that the evidence presented in the UK alone would not be sufficient to allow seizure of his UK assets.

Taxation: Tax policy makers and administrators in most developing countries face considerable capacity constraints. Record keeping and collection of taxes from millions of potential taxpayers requires a significant infrastructure and a well-trained workforce. In many countries, a sprawling informal sector, encompassing a large proportion of individual taxpayers and small businesses, is an additional obstacle. A well-resourced and independent revenue authority is therefore essential.

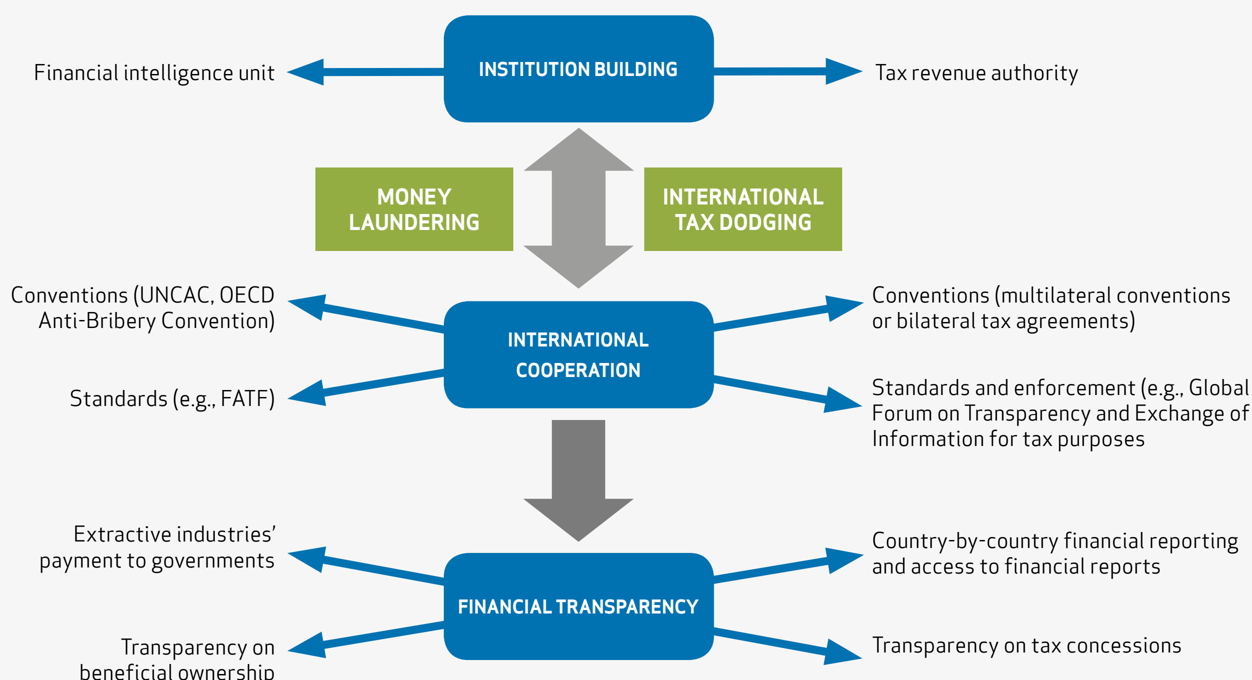
A significant challenge is the technical complexity of the operations involved in preventing large enterprises and wealthy individuals from moving funds abroad to escape taxes. Expertise is needed, for example, in drafting appropriate transfer pricing legislation, conducting detailed audits, understanding sector-specific tax issues, and negotiating tax treaties for information exchange.[8]

Cooperation and information exchange

Most IFF cross national borders. They therefore require international cooperation at the investigation stage, even if legal action is taken in only one country.

Corruption: Cooperation between authorities in different countries to investigate money laundering and recover assets usually requires a treaty or a memorandum of understanding. If both countries have ratified the United Nations Convention against Corruption (UNCAC), which provides legal authority and the obligation to cooperate,

Figure 2: Measures to combat illicit financial flows



they can in theory base their collaboration on the convention. Other treaties focusing on corruption may also apply (for example, the OECD Anti-Bribery Convention). However, UNCAC, which dedicates a chapter to asset recovery, is the most comprehensive.

The Financial Action Task Force (FATF) is an international body that sets standards for financial institutions, seeking to ensure that domestic legislation in each jurisdiction equips public authorities with the information required for this international cooperation. The FATF standards are not in themselves binding, but compliance with them has been incorporated into binding conventions such as UNCAC.[9]

Taxation: Taxpayer confidentiality rules prevent revenue authorities from sharing taxpayer information with authorities of other countries unless a tax convention or agreement allowing this is in place. In the case of SABMiller, this blocked revenue authorities in the six African countries concerned from sharing information on a multilateral basis.

Tax treaties may authorise and obligate the revenue authorities to share information in a number of ways: when information of interest to a treaty partner is uncovered, on receipt of a request for information about a particular taxpayer from another tax authority, or on an automatic basis in cases where taxpayers of one country have financial dealings in another country. Treaties also may allow the signatories to collaborate in investigations.

Such agreements include bilateral tax conventions based on models developed by the OECD and the United Nations tax committee, bilateral tax information exchange agreements, and, increasingly, multilateral instruments such as the European Savings Tax Directive, the Convention on Mutual Administrative Assistance in Tax Matters, and the mutual assistance treaties being developed by the African Tax Administration Forum and the Southern African Development Community.[10] A significant obstacle is including relevant countries that may not wish to conclude such agreements. The Global Forum on Transparency and Exchange of Information, hosted by the OECD, may assist in overcoming this obstacle. This body combines about 100 jurisdictions, including OECD members, low-tax jurisdictions, and a small number of developing countries. Global Forum members are subject to "peer review," examining the extent of their tax treaty network and the effectiveness of information exchange against standards set by the OECD Committee on Fiscal Affairs. In principle, the Global Forum could provide a channel for developing countries to obtain tax treaties with any other Forum members.[11]

Fiscal transparency

Yet another measure that can serve to curb IFF is public disclosure of financial information.

Corruption: One kind of transaction subject to public disclosure is private sector payments to governments. To date, such initiatives have focused on the extractive sector. The Extractive Industries Transparency Initiative (EITI) seeks to ensure that information on payments to governments by companies in this sector is published by both companies and governments. This should make it possible to compare the figures and investigate discrepancies indicating the possibility of IFF.[12]

Going beyond the EITI, several countries have recently taken steps to require that companies listed on their securities exchanges provide a country-by-country (and sometimes project-by-project) breakdown of payments to governments. At the time of writing, such requirements exist in Hong Kong, legislation has been passed in the United States, and a directive is under consideration in the European Union.[13]

Broader requirements for transparency of financial information are another option. Countries may increase transparency by implementing the different FATF standards (e.g., obligations for banks and other

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institutions to conduct due diligence on customers). These may make it possible to identify ownership of bank accounts and other assets and to verify whether they have been used to hide proceeds of crimes.

Taxation: Disclosures of payments to governments, such as those under the EITI, are designed to deal with illicit flows from corruption. They are not sufficient to address illicit flows for the purpose of tax avoidance or evasion, since this requires the additional step of comparing payments made to governments with the size and nature of the economic activity from which they derive. For many developing countries, a first step in this regard would be to improve the public availability of corporate financial reports, including those of foreign-owned subsidiaries incorporated in a country. In most cases these are only available for companies listed on the national stock exchange.

Another kind of disclosure that has been proposed for multinational companies is a country-by-country breakdown of their financial reports, including not only payments to governments but also revenue, profits and other information.[14] Also important is information on tax concessions to businesses. The absence of such information is a common problem, preventing scrutiny by legislators and the public while opening opportunities for corruption. An OECD informal task force on tax and development has proposed a code of conduct for governments in this area.

Notes and references

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2. Transfer pricing refers to trading transactions between companies part of the same multinational group. Most transfer pricing standards are based on OECD’s guidelines, which require that transactions are comparable in substance and value with equivalent transactions conducted between independent companies trading at ‘arm’s length’. We use ‘transfer pricing abuse’ to refer to tax evasion, avoidance or planning that takes place through the use of transfer pricing payments. Some such practices violate the arm’s length principle, while others do not. False invoicing in the IFF context is profit shifting through the use of fake invoices between independent companies
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5. Hearson, M., and Brooks, R., (2010) Calling Time: *Why SABMiller Should Stop Dodging Taxes in Africa*. London: ActionAid http://www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance.pdf
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7. Organisations that support developing countries in building their capacity to implement anti-money laundering measures include the UN Office on Drugs and Crime (UNODC), the World Bank/UNODC Stolen Asset Recovery Initiative, the International Monetary Fund (IMF), some of the regional bodies linked to the Financial Action Task Force (FATF), and different bilateral development agencies.
8. Organisations and projects that support tax-related capacity development include the African Tax Administration Forum (ATAF), the Inter-American Center of Tax Administrations (CIAT), the Commonwealth Association of Tax Administrators (CATA), the IMF, the World Bank’s Global Tax Simplification Project, the capacity-building subcommittee of the United Nations tax committee, and the OECD’s Centre for Tax Policy and Administration, as well as technical service providers such as GIZ and Crown Agents.
9. For a critique of the FATF regime, see Reed and Fontana (2011) *Corruption and Illicit Financial Flows: The Limits and Possibilities of Current Approaches*. U4 Issue 2011:2. Bergen, Norway: U4 Anti-Corruption Resource Centre http://www.u4.no/publications/corruption-and-illicit-financial-flows-the-limits-and-possibilities-of-current-approaches-2/
10. For a critique of the multilateral Convention on Mutual Administrative Assistance in Tax Matters, see Meinzer (2012a) *Analysis of the CoE/OECD Convention on Administrative Assistance in Tax Matters, as Amended in 2010*. Brussels: Tax Justice Network http://www.taxjustice.net/cms/upload/CoE-OECD-Convention-TJN-Briefing.pdf
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12. For a critique of the EITI, see Publish What You Pay Africa (2011) *What Needs to Change for the EITI to Remain Relevant?* London: Publish What You Pay http://www.publishwhatyoupay.org/resources/what-needs-change-eiti-remain-relevant
13. In the United States, the Dodd-Frank Act, drafted to address the 2008 financial crisis, requires extractive companies listed on the New York Stock Exchange to disclose information about their financial activity around the world on a country-by-country basis.
14. The proposal is outlined in detail by Murphy (2009) *Country-by-Country Reporting*. Washington, DC: Task Force on Financial Integrity and Economic Development http://www.financialtaskforce.org/wp-content/uploads/2009/06/Final_CbyC_Report_Published.pdf.It is critically discussed in a 2011 note, “Transparency in Reporting Financial Data by Multinational Corporations,” prepared by a drafting group led by the Oxford Centre on Business Taxation and chaired by Michael Devereux. The note was submitted to the Sub Group on Transparency in Reporting Financial Data by Multinational Corporations at the 2nd Meeting of the OECD Informal Task Force on Tax and Development, Paris, 11–12 April http://www.oecd.org/ctp/47521678.pd

Additional reading

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