SPOTLIGHT 13

Illicit financial flows

In spring 2016, 11.5 million confidential documents were leaked from a private legal firm based in Panama. News of the leak quickly spread worldwide. The documents contained information on assets held in offshore companies in more than 40 countries by wealthy individuals, including public officials.[1] Although holding assets in a tax haven is not illegal per se, the prevailing sentiment expressed in newspaper articles and the reaction from the public mainly took the form of condemnation and criticism of a practice interpreted as powerful economic and political elites concealing taxable income from domestic fiscal authorities, with the assistance of the financial systems of many developed countries.

What are IFFs?

These undisclosed accounts are one manifestation of what has become known as illicit financial flows (IFFs). The definitions of IFFs vary, but there are two main interpretations of what makes these financial flows illicit (see Epstein 2005, 7).[2] The normative interpretation suggests that financial flows become illicit not only because they hinder development, but also because they are deemed “illegitimate from the perspective of an existing consensus about the social (developmental) good” (Blankenburg and Khan 2012, 32).

The legal interpretation, on which the empirical literature on IFFs is predominantly built, suggests that IFFs refer to money that is earned, transferred, or used in contravention to existing law. In some cases, this could mean money that is earned legally but transferred out of the country illegally to evade taxes or currency controls. There are many different sources of illegally earned IFFs, ranging from drug trafficking to embezzlement. IFFs can be classified based on whether the actors involved are criminal organizations, individuals, or corporations (Janský 2013). Table S13.1 presents a few examples.

Although estimates of the size of IFFs are controversial, the consensus among development scholars and practitioners is that IFF outflows on average actually exceed official development assistance in developing countries (Herkenrath 2014).

Rethinking the approach to IFFs

IFFs deprive developing countries of resources that could be used at least partially for redistribution, for financing public goods, and for fostering private investments in local businesses. In doing so, IFFs support existing inequalities and are particularly detrimental to the poor. IFFs are also deeply connected to the governance process. Corruption and embezzlement thrive in environments in which accountability to citizens is low, which in turn weakens trust in state institutions. Tax evasion—a manifestation of a lack of cooperation in society—is fueled by a state’s lack of commitment to using resources for the delivery of public goods. That lack of commitment in turn undermines the outcome legitimacy of the state, which is based on the delivery of public services. Criminality also flourishes in environments in which trust is low and the state fails to provide the means for large population groups to effectively participate in the

WDR 2017 team, based on inputs from Peter Reuter.

Table S13.1 Actions generating illicit financial flows

		Source of earnings	
		Money legally earned	Money illegally earned
Actors involved	Criminal organizations		• Drug trafficking • Human smuggling
	Individuals	• Tax evasion • Evasion of currency controls	• Corruption • Embezzlement
	Corporations	• Tax evasion • Profit shifting	• Violation of intellectual property rights • Illegal exploitation of natural resources

Source: WDR 2017 team.

legitimate economy. The WDR 2017 framework sheds light on how to think about approaching reforms to combat IFFs.

Think not only about the form of institutions, but also about their functions

As discussed in chapter 1, importing forms of institutions is not enough to change the facts. Kenya is often cited as a major destination for the proceeds from piracy in the Indian Ocean and a key transit point for terrorist funds to neighboring Somalia. Seeking to fight illicit financial activities, especially money laundering and terrorism financing, Kenya established the Financial Reporting Centre (FRC) in 2012. Although creating the FRC enabled Kenya to be removed from the list of countries that could be sanctioned for noncompliance by the Financial Action Task Force (FATF), little else seems to have changed.[3] There was substantial evidence of high-level corruption in the Kenyan government at that time, and yet no cases were brought against senior officials for violating money laundering regulations. To make the FRC meaningful, the administration would have had to pursue many of its own senior members.

Think not only about capacity building, but also about power asymmetries

The lack of capacity of developing countries to manage complex laws and regulations is often cited as the source of their difficulties in curbing IFFs. Some developing countries do not have any transfer pricing rules, thereby ensuring that a multinational corporation operating in their jurisdiction can transfer as much of its profits elsewhere as it wishes.[4] However, the low capacity of developing countries is often based on power: it is in the interest of someone to keep capacity low because it allows them to extract rents (Leite 2012). Lack of political incentives has indeed been recognized as more difficult to overcome than any legal, institutional, or operational issues in this context (Stephenson and others 2011).

Think not only about the rule of law, but also about the role of law

Incumbents may appear to be complying with international laws and regulations to gain legitimacy, while continuing to do business as usual. One important requirement of the FATF Anti-Money Laundering (AML) regime is to facilitate requests for information and cooperation from nations that are pursuing money laundering cases involving another country's nationals (Recommendations 35–40). Most nations have adopted statutes and regulations that conform to the FATF rules. However, authorities in many countries have a history of dragging out the process of cooperation for so long that, in fact, the laws are effectively nullified. For example, countries may delay responding to requests by other countries made under the aegis of Mutual Legal Assistance (MLA) about where illicit funds are hidden (Chêne 2008). On the other hand, using delays to deny politically motivated requests from developing countries through the MLA may be fair in systems that are essentially corrupt (Terracol 2015).

A way forward

Fighting the illicit flow of capital abroad is an important development concern. In 2009 Switzerland returned US$93 million to Peru from the accounts of Vladimiro Montesinos, the de facto chief of intelligence and main adviser to former Peruvian president Alberto Fujimori (1990–2000). In 2004 the Philippines recovered US$683 million from the Swiss accounts of Ferdinand and Imelda Marcos, the former president and first lady of the Philippines (1965–86). In both cases, the money recovered would have been enough to fill at least 25 percent of the nation's poverty gaps in the same year.[5]

In the aftermath of the 2016 legal document leak described earlier, the top five European economies (France, Germany, Italy, Spain, and the United Kingdom) announced actions to improve information sharing in order to fight tax evasion and money laundering. Of these economies, the United Kingdom plays a particularly important role in this respect because a number of its Overseas Territories and Crown Dependencies, such as the British Virgin Islands and Jersey, derive a substantial share of their gross domestic product (GDP) from providing financial nonresident depositor services. Recently, all such offshore jurisdictions have joined this initiative and started to implement rising transparency standards. Panama has also recently taken steps to strengthen its tax transparency and financial integrity frameworks. Fundamental reforms that seemed imaginary just 10 years ago are now being discussed as active proposals by powerful bodies such as the G-7, G-20, and Organisation for Economic Co-operation and Development (OECD). These proposals include country-by-country reporting of corporate profits, which facilitates detection of transfer pricing abuses and other instruments to shift profits to low-tax jurisdictions, and the creation of public lists of beneficial ownership to prevent concealment through shell corporations.[6]

That said, each type of IFF featured in table S13.1 involves a different and complex network of actors, including domestic and foreign state institutions, domestic and foreign public officials, and foreign financial institutions, all influenced by different factors for moving money abroad and using different channels (such as bulk cash smuggling, shell corporations, informal value transfer systems, or trade-based money laundering). Failure to take into account the mutually sustainable relations of incentives among all the actors involved in IFFs—and to disaggregate the different types of IFFs—risks generating ineffective reforms (Reuter 2016). In particular, attempts to solve the issue should concentrate not only on the countries of origin, but also on the countries receiving IFFs.

Notes

1. Although the legal firm in question was based in Panama, more than 75 percent of the offshore companies were in jurisdictions outside the country.
2. For a recent review of the various definitions found in the literature, see Tropina (2016).
3. The FATF is an intergovernmental body established in 1989 by the ministers of its member jurisdictions to set standards and promote effective implementation of legal, regulatory, and operational measures for combating money laundering, terrorist financing, and other threats related to the integrity of the international financial system. Currently, it comprises 35 member jurisdictions and two regional organizations (the European Commission and the Gulf Cooperation Council). As for the situation in Kenya, Findley, Nielson, and Sharman (2014) find that in that country it is easier than elsewhere to open an anonymous shell company, one of criminals' preferred devices for transferring money internationally.
4. Multinational corporations are often the initiating actors in these matters. See, for example, Global Witness (2006).
5. WDR 2017 team estimates, based on the World Bank and United Nations Office on Drugs and Crime's StAR (Stolen Asset Recovery Initiative) database and the World Bank's World Development Indicators (database). According to the StAR, recovered assets amounted to US$5 billion in the 15 years up to 2011 (Brun and others 2011). Although "currently no single tool or process can effectively establish a comprehensive measure of IFFs at the global or country level" (United Nations 2016, 37), such recovered assets would be only a tiny share of the total flow according to different estimates—for example, taking the lower bound estimates of US$20 billion per year from Brun and others (2011), the recovery rate would be just 0.5 percent.
6. For a summary of the measures currently adopted and being discussed within OECD and the G-20, see OECD (2016).

References

Blankenburg, Stephanie, and Mushtaq Khan. 2012. "Governance and Illicit Flows." In *Draining Development? Controlling Flows of Illicit Funds from Developing Countries*, edited by Peter Reuter, 21–68. Washington, DC: World Bank.

Brun, Jean-Pierre, Clive Scott, Kevin M. Stephenson, and Larissa Gray. 2011. *Asset Recovery Handbook: A Guide for Practitioners*. Washington, DC: World Bank-United Nations Office on Drugs and Crime (UNODC).

Chêne, Marie. 2008. "Mutual Legal Assistance Treaties and Money Laundering." U4 Expert Answer (July 29), U4 Anti-Corruption Resource Center, Chr. Michelsen Institute, Bergen, Norway.

Epstein, Gerald A., ed. 2005. *Capital Flight and Capital Controls in Developing Countries*. Cheltenham, U.K.: Edward Elgar.

Findley, Michael G., Daniel L. Nielson, and J. C. Sharman. 2014. *Global Shell Games: Experiments in Transnational Relations, Crime, and Terrorism*. Cambridge Studies in International Relations Series. Cambridge, U.K.: Cambridge University Press.

Global Witness. 2006. "Heavy Mittal? A State within a State: The Inequitable Mineral Development Agreement between the Government of Liberia and Mittal Steel Holdings NV." Global Witness, Washington, DC, October.

Herkenrath, Marc. 2014. "Illicit Financial Flows and Their Developmental Impacts: An Overview." *International Development Policy*, Articles and Debates 5.3, Graduate Institute, Geneva.

Janský, Petr. 2013. "Illicit Financial Flows and the 2013 Commitment to Development Index." CGD Policy Paper 034 (December), Center for Global Development, Washington, DC.

Leite, Carlos A. 2012. "The Role of Transfer Pricing in Illicit Financial Flows." In *Draining Development? Controlling Flows of Illicit Funds from Developing Countries*, edited by Peter Reuter, 235–64. Washington, DC: World Bank.

OECD (Organisation for Economic Co-operation and Development). 2016. "OECD Secretary-General Report to G20 Leaders, Hangzhou, China, September 2016." OECD, Paris.

Reuter, Peter. 2016. "Illicit Financial Flows and Governance: The Importance of Disaggregation." Background paper, WDR 2017, World Bank, Washington, DC.

Stephenson, Kevin, Larissa Gray, Ric Power, Jean-Pierre Brun, Gabriele Dunker, and Melissa Panjer. 2011. *Barriers to Asset Recovery: An Analysis of the Key Barriers and Recommendations for Action*. StAR Initiative Series. Washington, DC: World Bank.

Terracol, Marie. 2015. "Mutual Legal Assistance and Corruption." U4 Expert Answer 17 (September 24), U4 Anti-Corruption Resource Center, Chr. Michelsen Institute, Bergen, Norway.

Tropina, Tatiana. 2016. "Do Digital Technologies Facilitate Illicit Financial Flows?" Background paper, *World Development Report 2016: Digital Dividends*, World Bank, Washington, DC.

United Nations. 2015. "Resolution Adopted by the General Assembly on 27 July 2015, 69/313: Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda)." Document A/RES/69/313 (August 17), United Nations, New York.

———. 2016. *Addis Ababa Action Agenda: Monitoring Commitments and Actions.* New York: Inter-Agency Task Force on Financing for Development, United Nations.

World Bank. Various years. World Development Indicators (database). Washington, DC, http://data.world bank.org/datacatalog/world-development-indicators.

World Bank and United Nations Office on Drugs and Crime. Various years. The Stolen Asset Recovery Initiative (StAR). Washington, DC, http://star.worldbank.org/star/.