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Illicit Financial Flows and their impact in developing nations

Introduction

The December 2013 report from Global Financial Integrity (GFI) found that developing countries lost US$947 billion in illicit financial flows in 2011, with a total loss of US$5.9 trillion in the decade from 2002 to 2011. The rate of increase per year of illicit financial flows far surpasses GDP growth and far outstrips aid received. Overall this loss in vital funds significantly impacts on development opportunities in the global south.

What are illicit financial flows?

Illicit financial flows are often defined as the transfer of illegally earned assets or the hiding of legally earned assets to facilitate illegal tax evasion. The Eurodad report *'Giving with one hand and taking with the other: Europe's role in tax- related capital flight'* expanded upon common definitions to include aggressive tax planning or tax avoidance. The report explains tax avoidance is a "technically legal activity that results in the minimisation of tax payments" and significantly contributes to the volume of illicit financial flows.

Illicit financial flows take many forms and circulate through a global maze in which ownership is obscured and profits, assets, and tax authorities become lost. Three common examples are

Transfer mispricing – This is used by large corporations to reduce their tax bill by trading between two related companies. Goods are exported under one invoice which is redirected to a tax haven. The price is then altered on the invoice and sent to the importing country for payment. This process shifts profits out of developing countries and reduces the tax received by governments though either import-overpricing or export-underpricing.

> According to ODI's Kevin Watkins, "transfer mispricing costs developing countries US$550 billion annually."[1]

Illicit Financial Flows	Percentage
Corruption	3
Criminal activities	30-35
Commercial transactions by multinationals	60-65

Sourced from www.UNDP.org

Round-tripping – This is the practice whereby, profits located overseas return to their country of origin disguised as *foreign-direct-investment*. By obscuring ownership and origin companies are able to harvest the favourable tax breaks offered to foreign direct investors.

Hidden ownership – The complex architecture that allows for round-tripping is made up of shell companies, foundations and trusts with nominal beneficiaries that operate to exploit tax loop-holes by concealing who the actual owners are. Profits directed through tax havens can then be disguised or laundered and returned to their owner as profits legitimately earned.

> "In the UK, an unknown person was revealed as official director of more than 1,200 companies – a number so high it immediately created suspicion and debate about ownership manipulation of shell companies and money laundering."[2]

Illicit financial flows and their impact on developing nations

Illicit financial flows have a substantial impact on developing nations. They reduce tax revenue for the provision of public services such as health, education and social services. Illicit financial flows also reduce foreign exchange resources thereby inhibiting growth and the ability of nations to invest in infrastructure and businesses. Additionally, as those who benefit from illicit financial flows grow wealthier they are able to exercise greater influence over the polity within the states they operate. This can curtail the ability of governments to pass transformative policies.

Illicit financial outflows drain hard currency reserves, heighten inflation, reduce tax collection, cancel investment, undermine trade, worsen poverty, and widen income gaps. The illicit financial flow cycle prevents states and citizens from effectively supporting their own development

International policy and illicit financial flows

Illicit financial flows have come under the spotlight recently, following high-profile controversies and growing

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awareness of their negative consequences for developing nations. In 2013 the United Nations High Level Panel Report stated in their vision:

> *"Perhaps the most important transformative shift is towards a new spirit of solidarity, cooperation, and mutual accountability that must underpin the post-2015 agenda… It is time for the international community to go beyond an aid agenda and put its own house in order: to implement a swift reduction in corruption, illicit financial flows, money-laundering, tax evasion, and hidden ownership of assets."*
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> UN High Level Panel on Post-2015

Stemming the movement of illicit financial flows has also been identified as a priority by the OECD and the G20 forum. In late 2013, G20 leaders announced plans to begin the automatic exchange of tax information among G20 members by the end of 2015 and encouraged all countries to join the Convention on Mutual Administrative Assistance on Tax Matters "without further delay" [3]

Future steps and solutions

Several complimentary solutions have been proposed that would close systemic loopholes and restrict the ability of individuals and companies to exploit tax structures around the world. Four of the major ideas under discussion in the international policy arena are:

Automatic exchange of information – Involves the systematic and periodic transmission of taxpayer information across countries. This would improve the current system of exchange that relies on individual information requests between jurisdictions.

Beneficial ownership – Requires businesses to reveal who actually owns and controls a company i.e. - who 'benefits'. A publically available record would limit the use of nominee owners to conceal ownership and mask benefits through shell companies and trusts.

Country-by-country reporting – Is an accounting standard requiring companies to publish their financial reports separately for each country in which they operate. Current rules that permit multinational companies to report these details as a single aggregate (global or regional) figure prevent monitoring of where their activities are taking place.

The arms-length principle – Aims to reduce transfer mispricing. By invoking this principle companies confirm that the amount charged between related companies is the same as it would be were the companies not related. The price of the transaction is the same as it would be on the open market.

Tax havens: the linchpin of the global network

The term tax haven conjures images of tropical islands but 'secrecy jurisdiction' is a more apt term as secrecy is the service provided.

"By providing high secrecy, tax havens are the privileged destination of money from crime, the drugs trade and corruption. But this is just the tip of the iceberg. A much bigger share of activities taking place in tax havens are the result of legal operators. Transnational corporations commonly use tax havens in order to escape tax burdens and regulation as well as to disguise their accounts and indebtedness levels. Big international banks and insurance companies have subsidiary companies registered in tax havens and most of the hedge funds and private equity funds are registered in tax havens." [4]

Together these measures would help curb illicit financial flows. However, illicit practices are largely entrenched within the global financial system. Whether proposed solutions are sufficiently adopted by nations around the world remains to be seen. Nevertheless, if political support for robust changes continues to grow and technological innovations are available to strengthen any regulation, we may make real gains in the fight against illicit financial flows.

Recommended Resources

- Tax Justice Network
- Eurodad
- Report: *Secret structures, hidden crimes: Urgent steps to address hidden ownership, money laundering and tax evasion from developing countries*
- Global Financial Integrity

References:
1. Watkins, K. (2013, June 4) *Delivery is the G8 yardstick*.
2. Eurodad (2013) *Giving with one hand and taking with the other - Europe's role in tax-related capital flight from developing countries*
3. OECD (2013) *Convention on Mutual Administrative Assistance in Tax Matters*
4. Tax Justice Network (2008) *Addressing development's black hole: regulating capital flight*

(Researched and written by Kelly Agassiz for CID)

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