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Illicit Financial Flows and Development

Comments on “Capital Flight and Tax Havens: Impact on Investment and Growth in Africa”

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1  THE SCALE AND IMPACT OF ILLICIT FINANCIAL FLOWS

Every year huge sums of money are transferred out of developing countries illegally. These illicit financial flows strip resources from developing countries that could be used to finance much-needed public services, from security and justice to basic social services such as health and education, weakening their financial systems and economic potential.

While such practices occur in all countries – and are damaging everywhere – the social and economic impact on developing countries is more severe given their smaller resource base and markets. Estimates vary greatly and are heavily debated, but there is a general consensus that illicit financial flows likely exceed aid flows and investment in volume.

The most immediate impact of illicit financial flows (IFFs) is a reduction in domestic expenditure and investment, both public and private. This means fewer hospitals and schools, fewer police officers on the street, fewer roads and bridges. It also means fewer jobs. Furthermore, many of the activities which generate the illicit funds are criminal; and while financial crimes like money laundering, corruption and tax evasion are damaging to all countries, the effects on developing countries are particularly corrosive. For example,
corruption diverts public money from public use to private consumption. We know that, in general, private consumption has much lower positive multiplier effects than public spending on social services like health and education. Proceeds of corruption or criminal activities will generally be spent on consumption of items such as luxury vehicles, or invested in real estate, art, or precious metals. The social impact of a Euro spent on buying a yacht or importing champagne will be very different from that of a Euro spent on primary education.

Money laundering is harmful to the financial sector too: a functioning financial sector depends on a general reputation of integrity, which money laundering undermines. In this way, money laundering can impair long-term economic growth, harming the welfare of entire economies.

2 WHAT ARE ILICIT FINANCIAL FLOWS?

There are various definitions of illicit financial flows, but essentially they are generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws.

Current literature on this issue suggests that illicit financial flows generally involve the following practices: money laundering, bribery by international companies and tax evasion, trade mispricing.

These categories, however, do not tell us anything about the source or origin of such flows. They may have arisen from illegal or corrupt practices such as smuggling, fraud or counterfeiting; or the source of funds may be legal, but their transfer may be illegal, such as in the case of tax evasion by individuals and companies. Nor do they tell us about their intended use. They may be intended for other illegal activities, such as terrorist financing or bribery, or for legal consumption of goods.

In practice, illicit financial flows range from something as simple as a private individual transfer of funds into private accounts abroad without having paid taxes, to highly complex schemes involving criminal networks that set up multi-layered multi-jurisdictional structures to hide ownership.

In the limited literature on this phenomenon, most attention has been given to outflows of corrupt profits, particularly those of kleptocrats such as Sani Abacha (Nigeria), Valdimiro Montesinos (Peru) and Ferdinand Marcos (Philippines). Each of them in some way looted their country, whether through
direct control of the central bank (Abacha), extortion of defence contractors (Montesinos) or confiscation of businesses (Marcos). After having left power, whether through death, political upheaval or criminal conviction, each was found to have large fortunes invested overseas in a wide variety of assets. Just below this level are semi-autonomous political figures, such as the governors of two Nigerian states recently convicted in London courts of having acquired assets in the United Kingdom with funds stolen from state development funds. The money was generally moved by quite simple means, such as wire transfers through complicit banks or the carrying of cash in large denominations across borders. There are numerous reasons for kleptocrats to move money to other countries. The funds are less subject to seizure if a new regime, kleptocratic or otherwise, takes power. Keeping funds in foreign jurisdictions also provides access to luxury goods that may not be available domestically. Finally, funds held abroad can be used to curry favour in other countries which might later provide a safe haven if the kleptocrat has to exit. Much less is known about the outflows associated with tax evasion, perhaps the most ubiquitous of the sources of illicit financial flows. Again, the purpose of moving the money out of the country illicitly may be protective; the domestic tax collection agency may improve its monitoring efficiency; assets held outside the country are harder to trace.

The responsibility of addressing illicit flows is shared between developing and developed countries. It is widely recognised that to address illicit flows, developing countries should continue to build effective and accountable institutions. More recently, the OECD has examined the responsibilities of OECD countries and the domestic effort they make to address illicit flows originating from the developing world. The key findings are as follows:

3 MONEY LAUNDERING

Illicit financial flows often leave developing countries via the commercial financial system. Through this system, funds are laundered to disguise their origin. Anti-money laundering and counter-terrorist financing (AML/CFT) regimes are effective tools to prevent illicit funds from being held, received, transferred and managed by major banks and financial centres. Anti-money laundering and counter-terrorist financing efforts are governed

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1 This paper is a synopsis of Measuring OECD Responses to Illicit Financial Flows from Developing Countries, OECD, 2013.
by the recommendations of the Financial Action Task Force (FATF). OECD countries’ anti-money laundering regimes have improved since the first set of Recommendations was established in 2003, but not evenly across the board. On average, OECD countries’ compliance with central FATF Recommendations is low. Twenty-seven out of 34 OECD countries store or require insufficient beneficial ownership information for legal persons, and no country is fully compliant with the beneficial ownership recommendations for legal arrangements.

Countries should strengthen their regulatory and supervision regimes, and fully implement the new 2012 Financial Action Task Force Recommendations.

4 TAX EVASION

Fighting international tax evasion is important because it is a major source of illicit financial flows from developing countries. Sub-Saharan African countries still mobilise less than 17% of their gross domestic product (GDP) in tax revenues. To combat tax crimes, effective exchange of information among countries is essential. Since 2000, the number of agreements on exchange of information between OECD countries and developing countries has steadily increased (to roughly 1300). Although most of the agreements signed since 2005 comply with standards of the Global Forum on Transparency and Exchange of Information for Tax Purposes, there is room for improvement. Automatic exchange of information can be a powerful tool in this respect, deterring tax evaders and increasing the amount of taxes paid voluntarily. While automatic exchange of information is becoming more widely recognised for its effectiveness, it remains an exception. Developing countries’ tax systems suffer from weak capacity and corruption, and therefore often lack the capacity to engage effectively in exchange of information. Strengthening institutions and systems to prevent tax evasion is the priority.

5 INTERNATIONAL BRIBERY

An estimated USD 1 trillion is paid each year in bribes. Reducing bribery reduces the opportunities for illicit gains, and hence illicit financial flows. The
1997 OECD Anti-Bribery Convention tackles the supply side: the bribe payers. The criminalisation of bribe payers outside of developing countries, as well as their effective prosecution, is central for drying up this source of illicit financial flows. In OECD countries, the sanctions for foreign bribery offenses are increasing (as of 2012, 221 individuals and 90 companies have been sanctioned for foreign bribery). While peer reviews confirm that OECD countries are taking a harder stance against corruption, around half of OECD countries have yet to see a single prosecution. Some countries have loopholes for bribe payers in their legal frameworks, including overly narrow definitions or short statutes of limitations; other countries impose impractical burdens of proof, or let strategic considerations influence whether or not to pursue a bribery case. To mitigate these challenges, potent mechanisms to uncover bribery and prosecute bribe payers are needed, including penalties that will constitute a tangible deterrent. Effective protection for whistle-blowers is also essential.

6 STOLEN ASSET RECOVERY

Repatriation of stolen assets to their country of origin can provide developing countries with additional resources, offering a powerful deterrent as well as justice for the societies whose funds are repatriated. Progress in OECD countries in repatriation has been modest, however, with only a limited number of countries having frozen or returned assets. Between 2010 and 2012, OECD countries have returned USD 147 million and frozen almost USD 1.4 billion of stolen assets.

The countries that are the most successful in tracing, freezing and repatriating assets have legal frameworks that allow for non-conviction based forfeiture and civil prosecutions. Proving that assets are linked to criminal conduct can be a complex process. As seen in some cases, one successful way to counter this problem is to require proof that excessive wealth has a legitimate origin. In addition, countries can contribute by accepting foreign confiscation orders and providing assistance to foreign jurisdictions. Adequately resourced and trained specialist units to investigate stolen assets and prosecute offenders are central, as is enhanced information sharing on asset recovery cases among jurisdictions and institutions. By offering legal and technical assistance, and encouraging proper cost sharing arrangements OECD countries can encourage developing countries to seek co-operation.
7 THE ROLE OF DONOR AGENCIES

Over the past years, donor agencies have become increasingly involved in tackling illicit financial flows. Agencies have supported civil society organisations and researchers working on this agenda, and have supported countries’ efforts to build capacity in fighting tax evasion, money laundering and corruption. Donor agencies are the link between OECD countries and countries that are the source of illicit financial flows. They can play an effective role by supporting the fight against illicit financial flows and strengthening their own preventive and investigative capacities against economic crime.

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