Improving methods and data for estimating illicit financial flows (IFFs)

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In 2014-2015, the Bank of Tanzania commissioned a country study of illicit financial flows (IFFs), funded by Norway. The aim of the report was to understand the extent of IFFs, the sectors involved, the channels used and the drivers of the IFFs, and to receive recommendations for effective policy actions. Current methods for estimating IFFs require careful handling and provide little of the insight sought. This note draws out lessons for future country studies of IFFs, especially on the research challenges regarding the main types of IFFs.

The problem of IFFs and related policy issues has been receiving increasing attention from world leaders, most prominently in the Mbeki Report, the Addis Ababa Action Agenda and the United Nations Sustainable Development Goals and the actions agreed in 2016 by the G20 (Leaders' Communique Hangzhou Summit, 4-5 September 2016).

Countries are increasingly coming together to encourage domestic resource mobilisation, tax information exchange and tax enforcement skill sharing, ownership registries, asset recoveries and sanctions compliance, and to discourage secrecy, tax havens, money laundering, terrorist financing, transnational organised crime, trafficking crimes and corruption. This is now beginning to be seen in country-level policy measures and in development assistance (DFID Tender Notice 2016). There are prospects for more, even the coherent and whole-of-government policy actions that have been called for (OECD 2016).

To reach this point, there has been a sustained campaign. Credit must go to the advocates for action, including to the researchers whose estimates have raised the profile of IFFs. But for such a young subject, an unhelpful obsession with measuring has already developed, which is both understandable and frustrating. Understandable because "what cannot be measured cannot be managed". But frustrating, or worse, because IFFs are hidden, the measures that have emerged cannot be proven and the current focus on controversial "big number" estimates risks rendering the IFF agenda ineffective.

The problem is that the crimes are hidden and cross-border crimes are particularly hard to identify, report, record, prosecute and convict.

This article explains why, seen through the prism of the challenges we faced undertaking the Tanzania country study. (Until the country study is published, we cannot recount its findings or limitations.)

A key issue is matching what has been estimated as IFFs with the actual concept of IFFs. The term "Illicit Financial Flows" is broad. The Mbeki Report describes IFFs as "typically originating from three sources: commercial tax evasion, trade misinvoicing and abusive transfer pricing; criminal activities, including the drug trade, human trafficking, illegal arms dealing, and smuggling of contraband; and bribery and theft by corrupt government officials". However, money is fungible, and the IFF concept for consistency has to encompass all activities that involve breaking a national or international law where the flows cross a border (e.g. there must be an international element).

But the well-publicised IFF estimates in multi-country studies have a narrower view (Johannesen and Pirttilä 2016). Two closely related methods have developed for estimating IFFs, from Global Financial Integrity (GFI) in Washington, D.C. (Kar and Spanjers 2015) and the other from Ndikumana and Boyce (N&B 2015) in Massachusetts. Though they differ in detail, both are based on deriving discrepancies in databases of balance of payments and trade statistics, and depend on assumptions that the discrepancies are illegal flows. Their headline estimates are split between two components, a residual in the balance of payments (described by N&B as "capital flight" or by GFI as "hot money narrow") and a mismatch between the international trade a country has recorded and what its trading partners have recorded (which is described by both as "trade misinvoicing", which is one type of IFF).

This paper is not the setting for analysis of the differing approaches (we prefer and use variants of the N&B articulation). Both require care at a country level: the data for one country is much more fragile than it appears in a full dataset of countries. Instead, this paper is an opportunity to encourage researchers to find new approaches that add insight for policy makers.

The chief problem is policy relevance. Annual estimates based on statistical discrepancies are volatile. Nevertheless, they may be useful to policy makers if they can be related over decades to specific changes in the economy, for instance a switch in policy regimes (e.g. from socialism to capitalism, from a tightly-controlled exchange rate regime to a more flexible regime or from taxing exports to taxing imports) or structures (e.g. from oil-importing to oil-exporting). But estimates based on discrepancies say almost nothing about the underlying actors or activities, their importance or drivers, let alone how IFFs might be contained.

A second problem is distraction. Providing an estimate of one type of IFF ("trade misinvoicing") leaves aside, unseen and potentially buried, all the other types of IFFs listed as "typical" by Mbeki.

At this stage, at the level of a country, researchers addressing the other types of IFFs face real difficulties: so few have tried that there are no developed methods in use (Haken 2011). The problem is that the crimes are hidden and cross-border crimes are particularly hard to identify, report, record, prosecute and convict. There are often statistics or media on reported crimes and court outcomes, but there is no systematic compilation of the events, especially those that escape detection or reporting. In addition, there is risk of double-counting, or worse. Almost every crime leading to an IFF also involves tax evasion and money laundering: some activities such as poaching may involve multiple crimes.

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Valuation issues abound. It is easy to consider theft through corruption or fraud and transfer of proceeds abroad as an IFF involving theft, tax evasion and money laundering. But the IFFs resulting from trafficking in ivory are more complex: an externality has to be attributed to the nation's loss of animals killed by poachers, but how should this be valued? And what about damage to the environment, pertinent when considering the SDGs?

It is essential to broaden research from the current narrow focus on one type of IFF ("trade misinvoicing"), but also to stop before the estimation process becomes too difficult to explain.

Another issue will be assessing progress. Can researchers distinguish between changes in IFFs resulting from data collection changes or from behavioural changes? Or prove effectiveness given how little is known about how IFFs would have changed in the absence of policy actions?

Conclusions

The quest to make country estimates of IFFs will not subside, even though the UN expert group for SDG measurement has not yet found an acceptable methodology (United Nations Department of Economic and Social Affairs Statistics Division). It is time for new research approaches to country studies, moving beyond what have come to be the most prevalent (yet unofficial and unendorsed) measures for estimating IFFs. It is vital to broaden the research on IFFs to cover the full range of criminal activities that generate IFFs. These include tax-based, theft-based and trafficking-based crimes and will have to cover undetected crimes. This will be difficult and estimates will lack precision, but it will be better to be broadly right than precisely wrong.

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