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Economic Commission for Africa
Macroeconomic Policy Division

Summary of the IATF expert group meeting on Illicit Financial Flows – mapping out a way forward on tax avoidance and evasion

Thursday 22 September 2016 • 9:00-11:30am • UN Headquarters

Highlights:

- Members of the **Inter-Agency Task Force (IATF) on Financing for Development (FfD)** held an expert group meeting with academics and other external experts to discuss **tax-related illicit financial flows (IFFs)**. Twelve member agencies and seven external experts from academia, civil society and think tanks actively participated in the event, which was co-hosted by UN-DESA and the UN Economic Commission for Africa.
- There is as of yet no firm agreement on conceptual issues, especially related to the term IFFs, which makes monitoring and assessment of progress challenging. IFFs include both public and private flows and participants noted that **estimates could not be robustly aggregated because of duplications, gaps**, and the problems of wrong impressions given to policy makers. Others, however, noted that **the term IFF has political resonance** and aggregation can help drive political activity.
- There was strong support from a majority of the participants to **keep efforts disaggregated and to work on improving measurement for the separate components and modes of transfer**.
- Exploring **risk and vulnerability to IFFs at the country or sector level** was raised as a useful approach. Operating in a risk-aware way means concentrating efforts on those areas most relevant for the country in question. Global efforts on estimation can help inform this by being sensitive to how they can be disaggregated by countries.
- Some participants argued that 60-70% of IFFs are trade mispricing and this activity is mostly tax evasion so **trade mispricing should be prioritized**. Others said that as **trade mis-invoicing tends to be illegal everywhere, it may constitute a good starting point**, especially because of the availability of data and developed estimation methods, though some still questioned aggregation.
- It was noted that relevant information and data outside of trade data is often very limited, particularly in developing countries, especially in relation to corporate turnover and tax payments. However, because of the country-by-country reporting initiative there would soon be more information available on taxation of multinational enterprises in countries that implement the standard. The **data from the country-by-country reports should allow much better estimates to be made** of tax-related IFFs.
- ECLAC's recently published Economic Survey of Latin America and the Caribbean 2016 included a chapter on IFF estimation using the ECA methodology for trade mis-invoicing, responding to the call in the Addis Agenda for regional estimates.
- Finally, a reminder was made **that any given channel of IFFs includes flows of more than one motivation**, for example that commercial tax evasion is not the only motivation for transfer mis-invoicing.
- Discussions on future work in this area will be open and all Task Force members should feel welcome to participate

Full Summary:

I. Background

The Addis Ababa Action Agenda on Financing for Development outlines a range of actions and commitments in relation to illicit financial flows (IFFs), including to redouble efforts to substantially reduce IFFs by 2030, with a view to eventually eliminating them. Member States agreed to combat tax evasion and corruption and reduce opportunities for tax avoidance, which are constraining development. The Addis Agenda also commits Member States to eliminate safe havens that create incentives for transfer abroad of stolen assets and IFFs. It invites international institutions to publish estimates of the volume and composition of illicit financial flows.

On Thursday, 22 September, Members of the Inter-agency Task Force on Financing for Development were invited by UN-DESA and the United Nations Economic Commission for Africa to a technical discussion on measuring tax-related illicit financial flows (IFFs). More than 30 people including 7 external experts and staff from 12 member agencies of the Task Force attended the meeting.

The meeting began with a clear acknowledgement of the difficulty of work in this area, and the necessarily uncertain nature of measuring IFFs. It was also clarified that the meeting was meant to focus on the tax-related aspects of IFFs, but that future discussions could focus on other aspects, such as corruption and criminal activities.

The participants discussed normative and definitional issues related to the tax avoidance and evasion components of IFFs, including their relationship to BEPS. They also discussed methodological issues in presenting estimates of some measures of the tax avoidance and evasion components of IFFs. The aim of the meeting was to see how the Task Force can add value to existing work, including by discussing key principles and moving towards unifying the diverse approaches being taken.

Questions raised at the meeting included the purpose and rationale of creating a composite IFF estimate; how to link work on data and measurement to work on policy advice and solutions; the language used to describe IFFs and the precision needed to prevent misunderstanding of terms; whether different elements should be aggregated (and whether it makes sense to do so); and how to address issues of risk and vulnerability in country-specific contexts.

Participants generally agreed on the need for improved data in order to make better estimates, thinking cross-disciplinarily, and clarity in presenting data and information

Some participants stressed that this discussion will also inform the follow-up process of the 2030 Agenda for Sustainable Development. Under Sustainable Development Goal 16, target 16.4 concerns reducing the IFFs, but the proposed indicator to estimate the total value of inbound and outbound illicit financial flows is a so-called “orphan” indicator. No agency is serving as custodian and no concrete plan has yet been put forward for development of this SDG indicators. As Member States have decided that progress on SDG 16 should be subject to in-depth review in 2019, there is some time to work towards agreement. Some participants stressed that presenting an aggregate is not only expected for the SDG indicator exercise, but also politically important and useful for ensuring policy makers pay attention to the issue and pursued relevant policy responses. Participants discussed that policy responses would not necessarily be tied to agreement on a definition of IFFs, nor even to improved estimation methodologies or the production of estimates.

Many described an iterative process whereby risk and vulnerabilities are identified through global and country-specific analysis, then policy action can improve information availability and change incentives, which could lead to further refinement of data as well as focus on problematic areas. Many participants argued for pressing ahead as quickly as possible to present the data that is already available while efforts are made to develop new methodologies and estimations. Several times it was noted that successful policy responses may shift activities to other forms of cross-border flows (both licit and illicit) which would not necessarily be more conducive to sustainable development investment.

Key points raised in the meeting are laid out below.

II. Definitions of IFFs

The first session began with a short discussion-starter reviewing the various conceptual issues in defining IFFs, and providing an overview of the definitions found in the literature. It clarified that most commonly IFFs are defined as money that is illegally earned, transferred or used, and that crosses borders. The presentation also noted the difficulty in categorization, with some activities falling in a grey zone that may not be clearly illegal, and that some definitions of IFFs include tax avoidance. Additionally, it reviewed some difficulties that are revealed by an examination of IFF definitions including noting the role of morality in the dictionary definition of illicit, the presumption of innocence in the legal system creating concern with estimates of illegal activities, and the lack of administrative and legal capacity in some jurisdictions. There was a debate on the relevance of these difficulties and the context of lack of consensus on the definition of IFFs.

A main part of the discussion was about the notion of whether it is constructive to aggregate different types of flows and activities into a single measure called IFFs. It was noted that IFFs include both public and private flows and that estimates could not be robustly aggregated because of duplications, gaps, and the problems of wrong impressions given to policy makers. Particular mention was made of the need not to confuse estimates of total IFFs with the potential impact of those IFFs on the level of government revenue.

There was strong support from a majority of the participants to keep efforts disaggregated and to work on improving measurement for the separate components and activities. Others however noted that the term IFF has political resonance and aggregation can help drive political activity, such as has been very successfully done with official development assistance (ODA), which is actually an aggregate of many different types of flows including spending that does not cross borders.

Several participants stressed that legal frameworks and legal systems constrain the applicability of the term IFF. There are a number of international instruments such as UN Convention on Corruption and the recommendations of the Financial Action Task Force that deal with illegality. Many participants felt that ameliorating the problems of tax avoidance and tax evasion requires focusing on legal and regulatory tools, and prosecutions, and thus a focus on illegal activity was both justified and practical. It was noted by a participant that trade mis-invoicing is illegal everywhere and may constitute a good starting point. A participant questioned the use of gross rather than net figures for trade mis-invoicing, at which point it was argued that all mis-invoicing in a country is problematic whether it is over- or under-invoicing and whether it is on the export or import side, so netting out didn't make sense. A participant also noted that harmonization of the criminality of certain tax practices, including transfer and trade mis-pricing, would help clarify things.

The discussion brought out the fundamental role of information. A strong conclusion of the group was that we need to take stock what data we have and what information is available and then make use of it. It was noted that information and data is often very limited, especially in developing countries, and that all economic statistics have uncertainty built into them. Participants mentioned that Action 13 of the OECD BEPS Action Plan will require country-by-country reports by multinational-enterprises in the near future. This data will enable better estimates to be made.

The discussion also surfaced the idea of exploring risk and vulnerability. At the country-level, different economies face difference risks of exposure and vulnerability to different types of IFFs or modes of transfer of illicit finance. It was noted that agencies are working at the country level to improve measurement, especially in a risk-aware way, concentrating efforts on those areas most relevant for the country. This sometimes leads to country-specific methodologies and definitions.

Most of the discussion implicitly focused on commercial activity, but several other areas were also mentioned. Individual tax evasion was mentioned as an area of interest. Also mentioned was the need to focus on both stocks and flows of illicit finance, because tackling illicit flows needs to be done in conjunction with addressing stocks of illicit offshore assets. It was suggested that in some ways it is easier to estimate stocks of offshore assets than illicit flows.

The discussion also covered several related topics including capital flight, corruption and criminality. Participants stressed that legal financial flows should not be included in IFF estimates. It was noted that corruption and the proceeds of criminal activity are important, but very difficult to measure at global scale. It was left open that a future Task Force meeting might consider these issues in more depth.

Overall there was a strong feeling that agencies can focus and take a pragmatic approach, and measure the data that exists. However, policy responses should not only be in areas with strong data. International institutions also need to be solution oriented, coming up with ideas for better policies. There can be a feedback loop that policies improve data and that better data leads to better policies.

III. Tax-related IFFs estimation methodologies

The second session shifted to a more technical discussion of some of the admittedly incomplete estimation methodologies in use. It began with a presentation on the efforts made by the UN Economic Commission for Africa to estimate IFFs. The report of the High Level Panel on Illicit Financial Flows in Africa was conceived in 2012 and finally came to fruition in 2015. The report focused on the commercial component of IFFs due to their having a disproportionate impact on African economies, and it took a broad approach to the commercial component of IFFs including aggressive tax avoidance. For its estimates it predominantly used a trade mis-invoicing methodology. Building on previous methodologies, the report used detailed trade data by UN COMTRADE supported by CEPII and World Bank data to make corrections for time lags in reporting. It also pioneered a model of estimating sector-specific adjustment factors for costs insurance and freight. Future work will continue to update this dataset, but also undertake transaction level analysis, and examine FDI data to try to estimate revenue losses due to transfer pricing.

Many participants lauded this work and its innovative approach. It was noted in the meeting that the Economic Survey of Latin America and the Caribbean 2016 recently published by ECLAC included a chapter on IFF estimation using the ECA methodology. It estimated $100 billion worth of trade mis-invoicing, concentrated in Mexico and Costa Rica, with estimated tax losses of $31 billion. It was noted in the meeting that UNCTAD has also been making calculations on trade mis-invoicing in the World Investment Report.

There was much discussion of the need to look carefully at any data being used. There are idiosyncrasies and peculiarities in the underlying data that make standard application of models problematic. For example, it was also mentioned that even advanced countries have large discrepancies in the trade statistics and this can influence estimates. It was noted that the shift towards South-South trade potentially can introduce greater uncertainty as data might be less robust. There was some discussion on how to adjust trade data to make it comparable and the advantages of disadvantages of the sector-specific adjustment factors developed by ECA.

Additionally, participants welcomed the work being done on risks and vulnerability with the feeling that this is a good direction of travel and it was encouraged that this work be shared if possible. The country-specificity of work was encouraged by some, including noting that the ECA methodology with sector-specific variation allows more relevant country-by-country and sector-by-sector analysis. Country-specific work helps policy responses and even enforcement action.

There was again some mention of the need to focus on the solution rather than exact numbers. It was noted by some that if 60-70% of IFFs are trade mispricing and this activity is mostly tax evasion – then a focus on this component should be prioritized. Finally, a reminder was made that any given channel of IFFs includes flows of more than one motivation, for example that commercial tax evasion is not the only motivation for deliberate trade mis-invoicing.

IV. Conclusions

The moderator summed up some of the key issues for the session: data reliability and data availability but not being too afraid of data uncertainty, careful measurement and careful communication of what is being measured, understanding the political power of a label, and thinking strategically about vulnerability and risk for countries and sectors.

It was agreed that a reading list of papers mentioned in the meeting would be compiled. Participants were also encouraged to comment on the draft discussion paper produced for the first session. It was also mentioned that discussions on future work in this area will be open and all Task Force members should feel welcome to participate. In response to the discussion, the FFDO will also use the dialogue and the 2016 report of the Task Force to begin laying out a list of various components of IFFs, the data and estimation methodologies used, and information on which agencies have produced estimates using that data. This will allow participants to build on the list, identify data gaps, and facilitate efforts to figure out how to move forward on developing estimates.