

Measurement of Illicit Financial Flows

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12-14 December 2017

UNODC-UNCTAD Expert Consultation
on SDG Indicator on Illicit financial flows

Outline

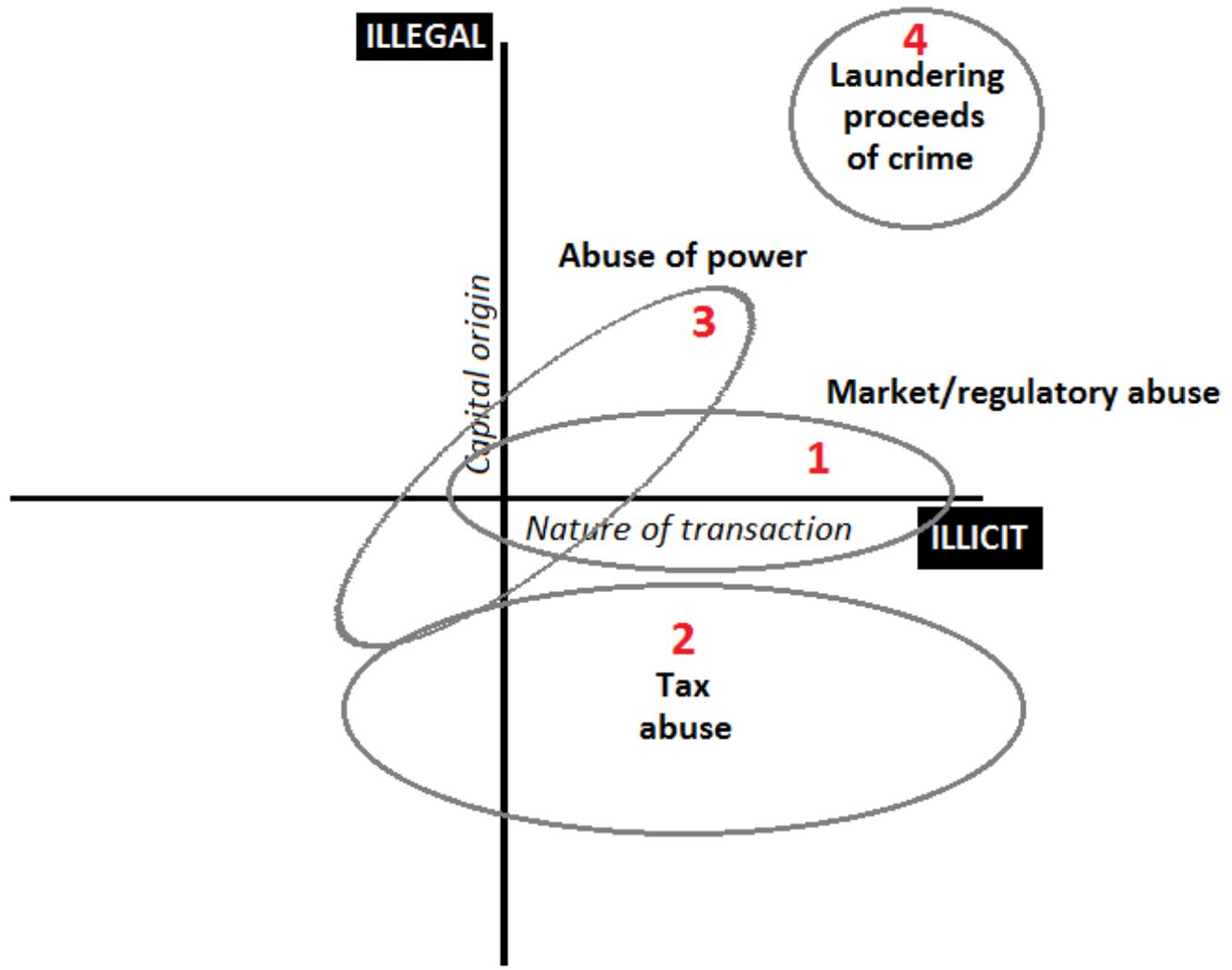
- Introduction: definitions, classifications, criteria
- Overview of scale indicators
- Proposal of preferred indicators
- A risk-based approach

Introduction: definitions, classifications, criteria

- Definitions
- Classifications
- Criteria

Legal category	Origin of assets	Behaviour type	Result when transferred abroad
Legal	Legally generated profits, capital gains and income	Tax compliance	Licit: Legally generated, fully tax compliant and legally transferred assets abroad
		Lawful tax avoidance	Illicit? Lawfully tax avoiding assets abroad
Unlawful		Unlawful tax avoidance	Illicit: Legally generated, but unlawfully tax avoiding assets abroad
		Market/regulatory abuse	Illicit: Circumvention of regulations via hidden (offshore) ownership for unlawfully earned profit at home/abroad
Criminal		Illicitly transferred, and/or transferred for illicit purposes	Illicit: Legally generated but violating regulations for cross-border transactions such as evading currency controls, or transferred to fund illegal activities (including terrorism)
		Tax evasion	Illicit: Legally generated, but criminally tax evading assets abroad
		Proceeds of corruption	Bribery; Grand corruption; Illicit enrichment; Embezzlement
	Proceeds of theft/related crime	Theft; Extortion; Kidnapping; Fraud; Bankruptcy	Illicit: Theft-related illegal assets transferred abroad
	Proceeds of illegal markets	Drug trafficking; Counterfeiting; [...]	Illicit: Illegal assets (from illegal economic activities)

Legal category	Origin of assets	Behaviour type	Result when transferred abroad	
Legal	Legally generated profits, capital gains and income	Tax compliance	<i>Licit</i>	
		Lawful tax avoidance	<i>illicit?</i>	
Unlawful		Unlawful tax avoidance	illicit	
		Market/regulatory abuse	illicit	
Criminal		Illicitly transferred, and/or transferred for illicit purposes	illicit	
		Tax evasion	illicit	
		Proceeds of corruption	Bribery; Grand corruption; Illicit enrichment; Embezzlement	illicit
		Proceeds of theft /related crime	Theft; Extortion; Kidnapping; Fraud; Bankruptcy	illicit
	Proceeds of illegal markets	Drug trafficking; Counterfeiting; [...]	illicit	



Overview of scale indicators

- Capital account
- Trade
- Offshore wealth
- Corporate tax avoidance

Capital account indicators

- Anomalies in the capital account - unrecorded capital movements
- The World Bank Residual method and the Hot Money 'Narrow' method
- The World Bank Residual method subtracts the total of funds actually used by a country from the total of funds entering that country
- The Hot Money 'Narrow' method is given by the net errors and omissions
- Ndikumana & Boyce, Global Financial Integrity

Trade indicators

- Trade misinvoicing, mismatches in reporting
- At a country-, commodity-, or transaction-level
- De Boyrie, Pak & Zdanowicz (2005), UNECA (2012)
- Combination of capital account- and country-level trade-based: Ndikumana & Boyce, Global Financial Integrity
- Transaction: France - Vicard (2015), France - Davies, Martin, Parenti, & Toubal (2017), US - Flaaen (2017), Denmark - Cristea and Nguyen (2016), UK - Liu, Schmidt-Eisenlohr, & Guo (2017), South Africa - Wier (2017)

Indicators of offshore wealth

- Untaxed private offshore wealth
- Financial wealth of households held in tax havens
- Henry (2012), Zucman (2013), Alstadsaeter, Johannesen, & Zucman (2017)

Indicators of corporate tax avoidance

- Profit shifting by multinational enterprises
- A vast literature, only few papers (7 or so) with country scale estimates and near-global coverage
- IMF's Crivelli et al. (2016) and Cobham & Janský (2018), UNCTAD (2015) and Janský & Palanský (2017), OECD (2015b), Clausing (2016), Cobham & Janský (2017), IMF (2014), and Tørsløv, Wier, & Zucman (2017)
- The discussed numbers often annual corporate income tax loss estimates rather than profits shifted (i.e. the IFFs)

	Annual tax loss estimates	What is estimated	Methodology	Journal	Country estimates
IMF's Crivelli et al. (2016), Cobham & Janský (2018)	\$400 billion for OECD countries (1% of GDP) and \$200 billion for other countries (1.3%).	BEPS related to tax havens.	BEPS related to tax havens by looking at what if the havens' tax rates were not lower.	Yes	Yes (by a later study of Cobham & Janský (2018))
UNCTAD (2015), Janský & Palanský (2017)	USD 200 billion in 2012 globally and USD 90 billion for lower-income countries 8% of CIT.	BEPS through tax avoidance schemes.	Losses due to tax avoidance on the basis of lower rate of return for investment from havens.	No	Yes (by a later study of Janský & Palanský (2017))
OECD (2015b), Johansson et al. (2017)	USD 100-240 billion, or 4-10% of global corporate income tax revenues in 2014.	BEPS due to tax rate differentials and differences in average effective tax rates for large affiliates.	BEPS related to tax rate differentials and differences in average effective tax rates for large affiliates of MNEs and domestic companies.	No	No
Clausing (2016)	\$279 billion for a group of selected countries in 2012, 20 % of CIT.	Profit shifting due to tax rate differentials.	Profit shifting scale from derived semi-elasticities	Yes	Yes

	Annual tax loss estimates	What is estimated	Methodology	Journal	Country estimates
Cobham & Janský (2017)	Up to \$133 billion for US multinationals in 2012 (profits shifted of up to \$660 billion, or almost 1 per cent of world GDP).	Misalignment between the location of US multinationals' economic activity versus the location of their profits.	The extent of misalignment between reported profits and indicators of economic activity.	Yes	Yes
IMF (2014)	5% of CIT in OECD and almost 13% in non-OECD countries in 2012.	Corporate income tax efficiency, the spillover effects of profit shifting.	Corporate income tax revenues related to differences in countries' corporate income tax efficiency ratio.	No	Yes
Tørsløv, Wier, & Zucman (2017)	Around 200 billion euro in 2015 (around 12% of CIT). (45% of multinationals' profits shifted, i.e. more than 600 billion euro.)	Profit shifting to tax havens	They argue that relative to a number of employees, firms in tax havens are abnormally profitable. They assume that all profitability in tax havens above world average reflects inward profit-shifting.	No	Yes

Proposal of preferred indicators

- **Profit shifting: SDG 16.4.1a**
- An indicator of misaligned profits, estimated on the basis of country-by-country reporting data
- The value of profits reported by multinationals in countries, for which there is no proportionate economic activity

Proposal of preferred indicators

- The misaligned profit indicator is defined as the value of profits reported by multinationals in countries, for which there is no proportionate economic activity of MNEs. It is defined for each jurisdiction and it can be summed across some or all countries. For each jurisdiction we define the misaligned profit as:

$$\chi_i = \omega_i \Pi - \pi_i$$

- where: ω_i is the share of all multinationals' economic activity in jurisdiction i ; Π is the global, gross profits of all multinationals; and π_i is the share of all multinationals' gross profits declared in jurisdiction i .

Proposal of preferred indicators

- We propose to capture economic activity as the simple average of single indicators of production (the share of full-time equivalent employees in a jurisdiction, ι_i) and consumption (final sales within each jurisdiction, γ_i). We define, for all i :

- $$\omega_i = \frac{1}{2} (\iota_i + \gamma_i)$$

- We also use the label Ω for the global total of multinationals' economic activity, and define:

- $$\Omega = \sum_{i=1}^n \omega_i; \text{ and}$$

- $$\Pi = \sum_{i=1}^n \pi_i$$

- It follows that the global sum of misaligned

Proposal of preferred indicators

- We propose that the profit misalignment indicator for use in SDG target 16.4 is the global sum of *positively misaligned* profits – that is, the total excess profits declared in jurisdictions with a greater share of profits than would be aligned with their share of economic activity. Equivalently, this can be calculated as half the sum of the absolute values of misaligned profit:

- $SDG_{16.4.1a} = \frac{1}{2} \sum_{i=1}^n |\chi_i|$

Proposal of preferred indicators

Note that the SDG indicator is expressed as the sum of inward and outward IFF, so the sum of absolute profit misalignment could be used; this seems inelegant at best. Note also that the underlying country-level misalignment measures provide monitoring and accountability for individual states seeking to reduce the (negative) misalignment suffered – for example, to demonstrate to citizens and domestic businesses that multinationals are being fairly taxed; and for states that benefit from profit-shifting at the expense of others, an accountability mechanism to demonstrate their own commitment to global progress.

Proposal of preferred indicators

- **Undeclared offshore assets: SDG 16.4.1b**
- Automatic exchange of tax information to address offshore tax evasion by individuals
- The global sum of country-level undeclared assets
- An example of specific data sources (e.g. the OECD Common Reporting Standard)

Proposal of preferred indicators

- The undeclared offshore assets indicator is defined as the excess of the value of citizens' assets declared by participating jurisdictions under the CRS, over the value declared by citizens themselves for tax purposes. For each jurisdiction we define the undeclared assets as:
 - $\phi_i = \sum_{j=1}^n \beta_{j,i} - \alpha_i$
 - where: α_i is the sum of assets declared by citizens of jurisdiction i as being held in jurisdictions $j = 1, \dots, n$ where $j \neq i$; and
 - $\beta_{j,i}$ is the sum of assets of citizens of jurisdiction i reported as being held in jurisdiction j .

Proposal of preferred indicators

- We propose that the undeclared offshore assets indicator for use in SDG target 16.4 is the global sum of jurisdiction-level undeclared assets:
- $SDG_{16.4.1b} = \sum_{i=1}^n \phi_i \quad \dots(4)$

Risk-based approach

- Exposure to the risk of IFFs
- Combining the partner opacity and scale
- Financial Secrecy Index
- African Union/Economic Commission for Africa's High Level Panel on Illicit Flows out of Africa (2015)
- Cobham, Janský, and Meinzer (2015)

Conclusion

- The inherent difficulties of estimating IFFs mean that even the stronger estimates may not rise to the level necessary for a global policy framework such as the SDGs.
- We propose two measures using newly available data that allow precise measurement of particular aspects of illicit flows:
 - first, the annual flow of profit misalignment achieved by multinational companies (16.4.1a);
 - second, the annually recorded stock of undeclared offshore assets (16.4.1b).

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