Issue brief: Illicit financial flows

How do illicit financial flows relate to conflict?

Illicit financial flows are increasingly recognised as one of the greatest contemporary global challenges.[53] Such flows include money laundering, tax evasion, transnational corruption/bribery and trade mispricing. They are intertwined with trade in illicit arms, drugs, and war commodities including precious minerals.[54] They have enabled transnational organised crime, racketeering, human trafficking, asset stripping and tax evasion on a massive scale.[55] Illicit financial flows provide crucial nourishment to violent extremists and armed rebels.[56] They also have a corrosive effect on governance and the strength of institutions,[57] as well as draining resources vital to development – including from many of the world's poorest countries.[58] Illicit financial flows have thus been costly – not only in holding countries back from delivering development and undermining social justice but also in carrying a high blood price.

Although there are obvious challenges in estimating illicit financial flows, they are believed to have an annual value of between $1 trillion and $1.7 trillion.[59] To put this into perspective, as one commentator notes, *"Even if the correct figure is only a 10th of the often cited Global Financial Integrity estimates (about US$1 trillion annually) … it is large relative to either official development assistance… or total foreign direct investment in the developing world."* [60]

In 2011, FDI into developing countries was $471.6 billion, and ODA $148.7 billion.[61] According to Kar, developing countries lost at least $1.26 trillion in illicit financial flows in 2008 and $775 billion in 2009.[62] Equally alarmingly, illicit financial flows have grown substantially in recent years: increasing an estimated 14.9% year on year in the decade 2000-2009.[63] Least Developed Countries (LDCs) are thought to be badly affected by this problem: illicit financial flows from the LDCs are thought to have increased from $9.7 billion in 1990 to $26.3 billion in 2008 – that is, by 6.2% per year.[64]

There are many examples of illicit financial flows feeding into and enabling conflict and violence. Illicit financial flows have funded violent competition for power and control by rebel groups, terrorists, organised criminals and governments in a very diverse range of violent contexts. This has been true of conflict related to oil in Nigeria, opium, precious stones and timber in Cambodia and Myanmar, and diamonds in Liberia.[65] Rebel groups funded by illicit flows included the National Union for the Total Independence of Angola (UNITA) whose war against the government was sustained by diamond revenues from 1992 to 2001 – as was that of the RUF in Sierra Leone during the 1990s.[66] Paramilitary groups on both sides of the sectarian conflict in Northern Ireland were significantly reliant on proceeds of organised crime.[67] The flow of illicit proceeds from coca has supported militant groups in Colombia, Peru and Bolivia, while opium proceeds have funded significant militant groups in Afghanistan, Pakistan, Myanmar and Kosovo.[68] Specific groups supported by narcotics proceeds include the Abu Sayyaf Group (Philippines), Al Qaeda in Afghanistan and Pakistan, the Kosovo Liberation Army, the Kurdish Workers Party (Turkey), the Liberation Tigers of Tamil Eelam in Sri Lanka, and the Revolutionary Armed Forces of Colombia.[69]

Case study: Democratic Republic of Congo (DRC)[70]

The Congolese civil war is estimated to have claimed roughly 4 million lives.[71] Although complex in its causes, the war is well known to have been sustained by the military contest to control revenues from commodities. These included diamonds, gold, coffee, timber, but most significantly, coltan, which is estimated to have generated millions of US dollars per month for certain armed actors at the peak of the conflict.[72] These revenues were made possible through the financial flows between the conflict actors and international markets for Congolese commodities. Regional and global businesses, banks and financial institutions played an important enabling role by ensuring that rebel forces and armies were able to maintain lucrative trade in coltan and receive payment for it. A 2000 report by a UN expert panel identified 85 multinational businesses that violated OECD ethical guidelines in relation to DRC, including banks and gem and mining companies in Belgium, Canada, Germany, the UK and US. Funds were also repatriated to banks in neighbouring countries by the conflicting parties, and regional financial institutions also remained engaged in DRC throughout the conflict, profiting from the bloodshed.

As well as directly making violence pay, illicit financial flows have a less visible but important effect in helping to entrench the structural weakness of many states that are badly affected by violence. Illicit financial flows thus leech away resources from weak and conflict affected states – where investment to foster decent

livelihoods and develop legitimate institutions is crucial to the attempt to overcome cycles of persistent collapse into violent conflict.
For example, despite initial optimism and some steady gains, South Sudan has suffered repeated cycles of conflict and rebellion since independence, partly fuelled by popular and elite discontent over who benefits from the fruits of the long liberation struggle. These problems have been made all the harder to face given the extent of corrupt financial flows out of the country, as illustrated by President Salva Kiir's letter of 3 May 2012 in which he directed 75 current and former senior government staff to return over $4 billion in stolen funds to government coffers.[73]

In Yemen, elite families have used private banking channels to transfer large amounts of money out of the country into safer jurisdictions, undermining the country's tax base. This is a vicious circle: weak institutions, weak property rights, insecurity and low growth encourage people to send their money abroad, and this leaves the country ill equipped to address many of the structural problems that are at the root of conflict across the country.[74]

Such cases help to illustrate how illicit flows contribute structurally to weak institutions that are unable to mediate fairly and peacefully between the competing interests of different actors. In the absence of institutionalised popular control of the actions of political elites, those that are willing and able to generate and use corrupt proceeds are thereby motivated to "change the rules of the game to ensure that they can continue playing it in a rewarding way".[75] This can contribute to:

- Tax agencies that have low overall capacity in dealing with complex international issues such as transfer pricing;
- Police services that lack investigatory powers;
- Court systems vulnerable to corruption;
- Weak public audit offices that lack independent authority;
- Legislatures that lack collective cohesion and authority;
- Fragile, unstable political parties motivated by money and patronage;
- Public services that lack a collective, professional ethos; and
- Weak protection of property rights.[76]

These conditions, in turn, discourage those with financial resources from keeping and investing them in country, and coincide with a range of the key attributes of states that are most prone to violence.[77]

In sum, unchecked illicit financial flows make illicit activities of many other kinds viable. They directly enable violent actors to prosper, and they undermine development in, and weaken the institutions of, conflict-affected countries.

What policies or interventions have been employed to address illicit financial flows at the national and international levels?

To address the challenges posed by illicit financial flows, it is important to understand the ways in which they occur. Illicit proceeds are typically generated, hidden and used in the following ways:

- Cash is received in payment for illicit goods
- Invoice documents are falsified with regard to quality/quantity of goods and identity of importer/exporter, often in collusion with purchasers of smuggled or illicit goods
- Illicit goods are smuggled for sale, possibly at below market prices, in collusion with corrupt officials
- Concessions are awarded to shell companies, whose beneficiaries/owners are concealed
- Kickbacks are received for licensing or protecting the production or sale of illicit goods from a territory
- Shell companies are established to engage in import and export transactions
- Overseas trusts are created to shield the ownership of assets – managed secretly by a trusted third party
- Offshore bank accounts are set up in the name of other fictitious trading, investment or service companies
- Local agents act as nominees for shell companies and bank accounts held in the name of shells or fictitious companies
- Underground or alternative remittance systems, including black market currency exchanges, are used to avoid cross-border currency controls
- Traceable commodities, such as oil or timber, are exchanged for less traceable commodities, such as gold and then sold in a major commodities market

- Cash is smuggled to another jurisdiction for placement in a willing financial institution
- Funds held at a foreign bank in a false name or company are used to purchase legitimate businesses which generate new funds
- Goods purchased out of the country with illicit proceeds are sold inside the country to generate new clean revenues
- Payments are received domestically by a broker in local or hard currency in return for the broker making an offsetting payment in another jurisdiction.[78]

At **national** level, development of the capacities to track financial transactions, administer taxation, regulate customs, and investigate and prosecute offences is critical to success of efforts to deal with illicit financial flows.[79] This necessitates the development of laws, institutions and well-trained and sufficiently empowered staff to take on powerful interests. However, there are some important challenges affecting what national capacity building efforts are able to achieve.

Most importantly, capacity building efforts need to be underpinned by political will, and can achieve little where it is absent.[80] Relatedly, measures taken to tackle illicit financial flows and corruption at national level have often been used to suppress internal dissent and undermine political opponents.[81] As such measures have the potential to exacerbate injustices and fuel rather than resolve conflict, it is therefore crucial that tighter regulation of illicit financial flows forms a part of a more holistic development and peacebuilding approach that includes ensuring transparency, public access to information, and public voice and participation – including the creation of constructive channels for dialogue. This is crucial to ensure grievances are dealt with rather than suppressed, and that public accountability underpins political will to tackle illicit financial flows over the long term. This is consistent with DFID's Peacebuilding-Statebuilding approach.[82]

Based on existing experience, options for addressing illicit financial flows at **national level** might focus on efforts to strengthen core state functions, including:

- Taking measures to make payment of taxes and domestic retention and investment of capital attractive:[83]
    - Demonstrating fair and efficient use of tax revenue to strengthen infrastructure and social services [84]
    - Tackling macroeconomic uncertainty by addressing fiscal deficits, external debt, inflation, exchange rates, rates of return and GDP growth.[85]
- Building national laws and capacities:[86]
    - Ensuring arms-length, transparent procurement/contracting procedures
    - Implementing whistle blower laws in the civil service
    - Strongly tackling rent-seeking
    - Reviewing, eliminating or improving targeting of price subsidies and tariffs
    - Regularising customs duties and scrapping ad-hoc exemptions
    - Improving the scope, timeliness and reliability of tax data
    - Strengthening capacity to assess and monitor transfer pricing, including through streamlined procedures
    - Regularly auditing customs procedures
    - Reducing backlog of court cases and establishing small claims courts
    - Prosecuting high profile cases fairly and transparently.
- Strengthening capacity to participate in the range of international co-operation measures highlighted below, including by strengthening customs authorities, laws, capacity to investigate and prosecute crimes, and the integrity of the judicial system.[87]
- Countering the complexity of cases[88] through joint initiatives to investigate crimes across multiple jurisdictions and to establish national mechanisms of control.

Examples of international support to national efforts to tackle illicit financial flows[89]

According to the OECD, the returns from investing in addressing illicit financial flows are significant. The OECD reports that $3.5 million in support to revenue collection capacity in El Salvador in 2004-2010 helped increase revenue by $350 million per year. Similarly in Colombia, the OECD Tax and Development Program cost roughly $15,000 but led to a 76% increase in revenues (from $3.3m in 2011 to $5.83m in 2012). OECD donors have also found that for each $1 spent on investigating flows of corruption from the developing world to OECD countries, up to $20 has been tracked and frozen, with a significant proportion repatriated. It therefore recommends that donors:

- Build technical expertise and capacities to address illicit financial flows, for example:
    - Build capacity to use Exchange of Information instruments working with the Global Forum on Transparency and Exchange of Information for Tax Purposes
    - Strengthen legislative and regulatory frameworks on transfer pricing – linking to initiatives such as the Tax and Development Programme or Tax Inspectors Without Borders
    - Help developing countries access mutual legal assistance (legal/judicial cooperation between states).
- Raise such issues in their political dialogue with partner countries.
- Support civil society organisations in developing countries to hold their leaders to account.

The World Development Report 2011 provides four examples of successful initiatives to prevent or prosecute illicit financial flows. Prevention initiatives include Liberia's Governance and Economic Management Action Program, set up with regional and international assistance, which established 'dual key' oversight by regional and international experts of major contracts and concessions. Liberia also successfully contracted a private firm to track its timber from source to market. Similarly, Mozambique hired a company to run customs inspections and collect customs revenues. Joint prosecution initiatives have included Haiti-US and Nigeria-UK initiatives to combat corruption and money-laundering, which resulted in the culprits being removed from office, imprisoned and heavily fined.

In developed countries, specialised law enforcement units dedicated to identifying the proceeds of foreign corruption and prosecuting those involved have an important role to play. In the UK this has led to long prison sentences for the former Nigerian Governor James Ibori and his accomplices.

With appetite among the G8 and G20, and significant support among the architects of the post-2015 development framework, there is growing momentum to tackle illicit financial flows at **international level.** Effective action at this level is possible but not straightforward. One challenge is fragmentation: there are many examples of international initiatives on this issue, but it would be beneficial to harmonise these into a single, coherent initiative for which there is a clear, critical and independent accountability mechanism.[90] A second challenge lies in ensuring that measures to tackle illicit financial flows do not negatively impact on licit financial flows.[91] This dilemma was illustrated in 2013 when UK bank Barclays was challenged in the courts over its decision to block remittances to Somalia upon which many poor people in the country depend.[92]

Case study: the Financial Action Task Force[93]

Perhaps the most significant current initiative to tackle illicit financial flows is the work of the Financial Action Task Force (FATF). FATF was set up in 1989, and its objectives are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. The FATF is based on a set of '40' recommendations for tackling illicit financial flows. In addition to its own 36 members, through a global network of eight FATF-Style Regional Bodies, over 180 jurisdictions around the world have committed to the FATF Recommendations. A key success of the FATF has been its issue of a list of non-cooperative countries and territories: this has prompted legal reforms in a long list of countries and jurisdictions. A key criticism of the initiative has been that no country has yet been found to be fully in compliance with the entire set of very complex FATF regulations. Pointing to mutual assessment reports of over 600 pages Global Witness, called in 2012 for the FATF to make accountability mechanisms more effective: it has recommended that country reporting focus on clear, accurate information on the strength of implementation of laws – and should provide a prioritised list of follow-up actions. FATF has since agreed to rate countries both for the strength of their legal frameworks and their actual implementation of recommendations.

Looking forwards, successful international action on illicit financial flows would include a combination of the following:[94]

- Identifying and sanctioning transfer mispricing;
- Further limiting the scope for the abuse of tax havens including ending bank secrecy laws;
- Strengthening exchange of information among national tax authorities, including on non-resident individuals and corporations;
- Requiring and regulating banks and businesses to be more vigilant against illicit funds and money laundering;
- Expanding the scope of the Extractive Industries Transparency Index;
- Expanding and implementing extraterritorial controls on corruption overseas by citizens of and companies in richer countries;
- Reforming international accounting standards;
- Establishing specialised investigative units to tackle transnational financial crime;
- Strengthening mechanisms and laws to recover stolen assets located overseas more efficiently;
- Increasing watchfulness on the finances of politically exposed persons;
- Reinforcing the regulation or self-regulation of corporate service providers;
- Ensuring transparency regarding the individuals who own, control and benefit from all public companies, trusts and foundations;
- Requiring large corporations to report sales, profits and taxes paid in all jurisdictions in their audited annual reports and tax returns;
- Systematic exchange of tax information between governments;
- Adopting globally consistent regulations for transfer pricing; and
- Supporting academia and civil society organisations to undertake further research and engage in international advocacy and awareness raising on this issue.

What resources, indicators and data sources exist?

Methods are available to estimate illicit financial flows for most countries, and likewise it would be useful to monitor the proportion of flows that are recovered. Alongside these 'objective' indicators of the volume of flows and their recovery, it would be important for monitoring efforts to consider progress in building the institutional capacity to tackle illicit flows. Likewise, as official statistics and the existence of laws and bodies can be misleading, perceptions of the public and business people as to progress in the fight against corruption offer an important alternative perspective regarding the extent of progress made. Perceptions indicators may not improve as soon as reforms are made, and may not be a reliable reflection of the objective situation, but are nonetheless an important indicator of public confidence, which is in itself a crucial factor in the success of institutional development.

Given these key areas for monitoring, a number of key resources and data sets are available that can help programme staff assess the impact of initiatives intended to help tackle illicit financial flows and develop appropriate indicators for this purpose. The following table identifies a range of key resources and data sets, outlines how they could be used to inform in-country programming, including examples of relevant indicators that could be generated from the resource.

Global Financial Integrity **Link:** iff.gfintegrity.org/iff2013/2013report.html	Global Financial Integrity has produced a number of reports and accompanying data to estimate the cross-border flow of illegal money. As such it is a primary source for data sets on illicit financial flows from developing countries over multiple years.
	Example indicator: Volume of illicit financial flows.
World Bank Stolen Asset Recovery database **Link:** star.worldbank.org/corruption-cases/arwcases/	StAR Asset Recovery Watch compiles information about asset recovery efforts around the world. Users can search for specific cases, countries and individuals.
	Example indicator: Stolen assets recovered as a proportion of estimated illicit flows.
Financial Action Task Force	The most important international initiative to tackle illicit financial activity, the Financial Action Task Force, monitors both the legal framework for compliance

Link: www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/	of its 40 recommendations and their implementation in practice. Countries will receive scores on both issues. It also publishes a list of 'high risk and non-cooperative jurisdictions'. At country level, indicators could be derived from FATF analysis of compliance.
	Example indicator: FATF compliance status (high-risk and non-cooperative, not making sufficient progress, improving global AML/CFT compliance in an on-going process, no longer subject to monitoring).
Basel Institute on Governance **Link:** index.baselgovernance.org/	The Basel AML Index is a country risk ranking to measure the risk of money laundering / terrorist financing and other relevant aspects, such as financial standards and public transparency. It aggregates third party data from sources such as the FATF, World Bank, and the World Economic Forum to assess a country's overall money laundering risk.
	Example indicator: Anti-money laundering index score.
Participation in other international treaties and initiatives **Link:** treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XVIII-12&chapter=18&lang=en	When considering the level of political commitment to tackle illicit financial flows, it may be relevant to consider the extent to which a country has ratified relevant international conventions (such as the Convention against Transnational Organized Crime (2000) and its protocols), as well as the level of its cooperation with bodies such as Interpol and the Egmont Group of Financial Intelligence Units.
	Example indicator: Ratification of the Convention against Transnational Organized Crime (2000).
International Budget Partnership **Link:** internationalbudget.org/what-we-do/open-budget-survey/	The International Budget Partnership considers the publication of and provides indicators on budgetary transparency at the national level in its Open Budget Survey and Index. The 2012 Survey measures whether governments in 100 countries produce and disseminate to the public 8 key budget documents recommended by international good practices. It also examines effective budget oversight and public participation in national budget decision making. Country rankings are built up from a set of 125 indicators.
	Example indicator: Score on the regularity and timeliness of budget and spending data (from the Open Budget Index).
Global Integrity Report **Link:** www.globalintegrity.org/global-report/what-is-gi-report/	Global Integrity Report provides analysis of, and data on, integrity and controls on corruption within public administrations and legal frameworks. Each country assessment contained in the Global Integrity Report comprises a qualitative Reporter's Notebook and a quantitative Integrity Indicators scorecard. The latter assesses the existence, effectiveness, and citizen access to key governance and anti-corruption mechanisms through over 300 indicators. They are scored by a lead in-country researcher and blindly reviewed by a panel of peer reviewers, a mix of other in-country experts as well as outside experts. It published annual reports from 2004-2011 (covering 31 countries in 2011) – but is currently revising its methods. Vera institute of justice has also documented the process of piloting similar indicators (on transparent procurement decisions and bidding processes for public contracts).
	Example indicator: Score for government conflicts of interest safeguards, checks and balances.
Suggested monitoring of company registries **No existing source**	Given that secrecy over who benefits from particular firms, trusts or foundations can aid the concealment of illicit financial activities, many experts also consider transparency regarding the individuals who own, control and benefit from all public companies, trusts and foundations as central to the fight against illicit financial flows. Therefore it could be important to monitor the establishment of a registry to hold and exchange such information in focus countries.
	Example indicator: Existence of an up to date public registry of companies, trusts and foundations including machine-readable information on the individuals who own, control and benefit from all public companies, trusts and foundations.
World Economic Forum –Global Competitiveness	The World Economic Forum Global Competitiveness Report has been produced annually since 2009. Today it assesses the competitiveness landscape of 148 economies, providing a profile of each and an extensive

Report **Link:** www.weforum.org/content/pages/competitiveness-library	section of data tables with global rankings covering over 100 indicators. The indicators are derived from data from other multilateral agencies and WEF's own Executive Opinion Survey – a survey of business people's perceptions. The survey has been conducted annually for a growing number of countries for the last 35 years and includes a section on bribery, ethics and corruption that is a useful source for perceptions of corruption among businesses who are likely to be affected by it.
	Example indicator: 'To what extent does organised crime (mafia-oriented racketeering, extortion) impose costs on businesses in your country?' (Global Competitiveness Report survey question)
World Bank Enterprise Survey **Link:** data.worldbank.org/data-catalog/enterprise-surveys	Enterprise Surveys provide data on perceptions of businesses from over 135,000 establishments in 135 countries, including many developing countries. Data are used to create over 100 indicators that benchmark the quality of the business environment, including a number of indicators on levels of corruption. Each country is surveyed every 3 to 4 years. Country level surveys sometimes include specific questions not included in international data sets. Surveys are conducted by private contractors who are independent of government.
	Example indicator: Percentage of firms identifying corruption as a major constraint.
Gallup World Poll **Link:** www.gallup.com/strategicconsulting/en-us/worldpoll.aspx?ref=f	Gallup conducts surveys in 160 countries, including a range of conflict-affected contexts (eg Somaliland, Sudan, Tajikistan, Uganda, Yemen) on at least an annual basis – and sometimes more frequently. Its public perceptions data is available to purchase, including questions on overall levels of corruption and the sufficiency of government anti-corruption efforts.
	Example indicator: Do you think the government is doing enough to fight corruption or not?
Transparency International **Link:** www.transparency.org/research/	Transparency International provides a range of data on levels of corruption. Perhaps the most useful and relevant for measuring progress on illicit financial flows from the 'supply side' is the bribe payers index, which ranks the likelihood of companies from leading economies to win business abroad by paying bribes. The Global Corruption Barometer, published eight times since 2003, in 2013 offered data on public experiences of corruption in 107 countries. A fuller range of data on most developing countries is provided by the corruption perceptions index, which measures the perceived levels of public sector corruption in 177 countries and territories.
	Example indicator: 'Is the government effective in the fight against corruption?' (global corruption barometer survey question); corruption perceptions index score.
World Justice Project **Link:** worldjusticeproject.org/sites/default/files/WJP_Index_Report_2012.pdf	The World Justice Project compiles data on the rule of law and justice. Its third annual rule of law index report in 2012-13 covered 97 countries, providing data on 48 indicators on a range of relevant topics – including absence of corruption, open government, regulatory enforcement – presented in innovative and user-friendly ways. Its data are drawn from two surveys: one for the general public and another for 'qualified' or expert respondents.
	Example indicator: Absence of corruption score.
World Bank Country Policy and Institutional Assessment (CPIA) & Worldwide Governance Indicators **Links:** datatopics.worldbank.org/cpia/cluster/overall-cpia-score info.worldbank.org/governance/wgi/index.aspx#home	The World Bank provides a range of data relevant to the quality of governance and management of revenues, in a range of different data sets. The CPIA is a diagnostic tool that is intended to capture the quality of a country's policies and institutional arrangements. It offers ratings on financial management, transparency, accountability and corruption. The Worldwide Governance Indicators (which provides aggregate and individual governance indicators for 215 economies over the period 1996–2012, for six dimensions of governance) include a further score for 'control of corruption'.
	Examples indicators: Country score for 'quality of budgetary and financial management' (CPIA).