Illicit Financial Flows and the 2013 Commitment to Development Index

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Abstract

Over the past years illicit financial flows have attracted increasing attention from researchers and policy makers because of their negative effects on developing countries. In 2013 the OECD DAC Senior level meeting acknowledged illicit flows as an issue of "central importance".

Since 2003, the Center for Global Development has been publishing the Commitment to Development Index (CDI) which ranks rich countries on their policies which affect development abroad.

This paper discusses the possible inclusion of indicators of policies affecting illicit financial flows. It provides a survey of existing approaches to measuring these flows, discusses possible metrics which could be included in the CDI, evaluates how such indicators might be incorporated into the Index, and proposes changes to current CDI indicators. The qualitative indicators of the Financial Secrecy Index emerge as the best available contribution to the newly renamed and updated Finance component of the CDI.

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Foreword by Owen Barder

For the past 10 years the Center for Global Development has been publishing the Commitment to Development Index (CDI) which ranks rich countries on their contribution to development abroad. The CDI assesses countries' performance in 7 policy areas: aid, trade, migration, environment, security, technology and investment.

The CDI does not pretend to be a complete measure of the impact of the policies of rich countries on the developing world. Rather it aims to focus on the most important policies, to the extent that data are available.

The CDI has adapted and evolved over the years, in the light of changes in our understanding of the impact of policies on development and as a result of changes in available data. When the index is improved, the calculations are applied to the previous years as well, so that we can be confident that changes in the index over time are caused by changes in policy and not by changes in methodology of the index.

In recent years there has been growing recognition of the harm done to development by illicit financial flows, and the role of rich countries in providing an environment which tolerates or discourages them. To investigate whether indicators of illicit finance should be included in the CDI, Center for Global Development commissioned this background paper from Petr Janský, a Czech academic economist from the Charles University and CERGE-EI in Prague.

The paper explains the rationale for including illicit finance in CDI, explores the most relevant indicators, and discusses their advantages and limitations. Petr Janský proposes the inclusion of Financial Secrecy Index (FSI) into the investment component of CDI. This recommendation has been accepted, and the FSI has been added to the 2013 CDI. The FSI has been added to the investment component (now renamed *finance*) which assesses donor contributions to financial transparency and promoting investment in developing countries.

There will always be scope to improve the CDI, and we will continue to look for ways to make it as useful and relevant as we can. This paper has helped to shed important light on a way that rich countries affect the developing world, and to make a significant change to the CDI which will help to draw attention to this in the years to come.

Introduction

This is a background paper on the potential inclusion of indicators of illicit financial flows in the CGD's 2013 edition of the Commitment to Development Index (CDI). It establishes a rationale for assessing those policies in the CDI that are related to illicit financial flows, provides a survey of existing approaches to measuring these flows, discusses potential metrics relevant to the CDI, evaluates how such indicators might be incorporated into the Index, and critiques current CDI indicators from this perspective.

Development and Illicit Financial Flows

General rationale for including policies relating to illicit financial flows in the CDI

What kinds of measures can rich countries take to curtail the illicit financial flows out of poor countries, and to ensure that the global financial system supports and does not detract from the development of the poorer countries? The answers to these and other questions below involve a certain amount of conjecture.[1]

While the topic of illicit financial flows is currently on the rise in research, political and media agendas, it remains generally understudied, and a number of key research questions have yet to be fully and rigorously answered. That is because of the topic's illicit nature, and the generally low availability of data, as well as the relatively limited attention that was paid to it by researchers in the past. Although I do not repeat this disclaimer, it holds for most of the discussed questions below. Nevertheless, even though the evidence base for the impact of illicit financial flows' on poor countries is not yet comprehensive, and despite a number of uncertainties, there is now a widespread belief among many policymakers and other experts that illicit financial flows impact poor countries and deserve more attention.[2] A case in point would be their inclusion in the CDI.

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1 Paraphrasing the opening questions of (Moran 2012), who in a similar way assesses rich country efforts to support poor country growth via foreign direct investment, earlier documented in (Moran 2006). Conceptually, (Moran 2012) assesses how rich country efforts can make the supposedly good (investment) even better, whereas this paper assesses how rich country efforts can make the supposedly bad (illicit flows) somewhat better for poor countries.

2 An example of confirmation of this belief among policymakers is the Communiqué from the Meeting of the High-Level Panel of Eminent Persons on the Post-2015 Development Agenda in Bali, Indonesia, 27 March 2013, which highlighted "strengthened means of implementation" as one of four key areas in which progress is needed to achieve our post-2015 vision. They agreed that a post-2015 agenda should clearly specify the means of implementation, including financing for development, and stating that the regulation of tax havens and illicit financial flows will be particularly important. Another example is the final document of the Fourth High Level Forum on Aid Effectiveness, (Busan Partnership for Effective Development Cooperation 2011) under the heading "Combating corruption and illicit flows" and section 33. b): "Accelerate our individual efforts to combat illicit financial flows by strengthening anti money laundering measures, addressing tax evasion, and strengthening national and international policies, legal frameworks and institutional arrangements for the tracing, freezing and

Financial flows are crucial for poor countries and have played an important role in some countries that have made development progress.[3] Nevertheless, since not all financial flows are good for development, the integration of poor countries into the global financial system poses opportunities as well as risks.[4] Illicit financial flows seem to facilitate many of these risks and seem to have an overall negative impact on poor countries.

Illicit financial flows are generally believed to be high in value and have arguably an overwhelmingly negative impact on poor countries. Although specific figures are disputed, illicit financial flows out of poor countries are estimated to be significantly higher than aid inflows.[5] Therefore, curtailing the illicit financial flows – as well as recovering any assets already illegally held abroad – could significantly help the financial needs of the poor countries.[6] This potential source of finance for poor countries has become even more

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recovery of illegal assets. This includes ensuring enactment and implementation of laws and practices that facilitate effective international co-operation." More recently, rich countries stated their interest in curtailing illicit financial flows out of poor countries in (OECD 2013c) (under the title "Stemming illicit financial flows" and it continued to say that "Curbing illicit financial flows is essential, given their damaging impact on developing countries' ability to raise revenues.") and, in more detail, (OECD 2013d).

3 In a similar way that I am going to argue that not all illicit financial flows are necessarily bad, it also holds that hardly any type of financial flows is necessarily good. For example, the evidence, if any at all, of benefits of foreign direct investment for poor countries is not as strong as commonly thought (for relevant discussion, see pages 130-135 in (Select Committee on Economic Affairs 2012).

4 The positive role of financial linkages is partially accounted for in the existing (2012) CDI's aid and investment components, whereas the negative role of illicit financial flows out of poor countries – largely absent from the 2012 CDI and a topic on which there is generally not much analytical or academic work – is taken up here and has been recently highlighted in a topical book published by the World Bank, (Reuter 2012). A report from an NGO (Eurodad 2013) discusses all these – foreign investment, aid, curtailed illicit financial flows – and other financial resources potentially available for development.

5 For estimates see (Kar & Freitas 2012) as well as a discussion in a corresponding section below. These estimates deal with the illicit financial flows out of poor countries, although inflows are also important. Even if the real illicit financial flows were somewhat lower than these estimates suggest, they would still be large enough to deserve more attention and curtailing them would still represent a huge opportunity for poor countries. Also, the head of the OECD, (Gurría 2008), stated at the beginning of the global financial and economic crisis that poor countries could be losing three times the amount they receive in aid because of illicit financial flows in the form of tax evasion and avoidance through tax havens. Interestingly, (OECD 2013c) contemplates introducing another (in addition to dollar amounts) dimension of comparability between aid and illicit financial flows as it notes that "For each USD spent on investigating the proceeds of corruption originating from the developing world, and transferred to OECD countries, up to USD 20 has been tracked and frozen, with a significant proportion of that sum repatriated to the treasury of the developing country in question. As a component of a new measure for total official support for development, research could be undertaken on how to account for budgetary efforts associated with official actions to curb illicit financial flows.", or the OECD might be after creating a similar ranking to the CDI with illicit financial flows included.

6 The focus here is mostly on the prevention part – curtailing the illicit financial flows rather than recovering the assets. This is mostly because this is the planned focus and there is no space to cover asset recovery as well, but, to some extent, it might be because there seems to be more perspective in reducing the flows rather than recovering the assets, as noted by Peter Reuter on page x of (Reuter 2012): „Far better than reducing barriers to asset recovery is to not have to recover the assets in the first place. If we can find ways to stop the illegal outflow of money, developing countries can refocus their energies on development."
Nevertheless, the recovery of assets held illegally abroad, highlighted by the recent mass findings by a number of

promising in recent years, given that aid flows from rich countries have in general not lived up to expectations and promises.[7] Rich-country policies can affect illicit financial flows, and, given the magnitude of these flows, relatively small policy changes could make a significant difference for poor countries.

What are illicit financial flows?

There is no clear consensus on a single definition of illicit financial flows, since the word illicit can be understood to mean both illegal and legal, but legally or morally contentious and otherwise not fully legitimate.[8] But there are many reasons why finance flows out of poor countries illicitly, often in contravention of national or international rules.

Rather than insisting on one definition,[9] I explain the understanding of the term through classifying illicit financial flows into three groups: illegal (or criminal), individual illicit, corporate illicit. (or commercial).[10] Three caveats apply. First, there might obviously be other illicit financial flows that do not fit well in any of these groups, but these are probably not of significant volume or importance. Second, although I do group them, illicit financial flows are very diverse. They range from something as simple as an individual transferring income abroad without having paid taxes, to highly complex money laundering schemes involving criminal networks setting up multi-layered multijurisdictional structures to hide ownership

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media organizations and reported, for example, by (Leigh 2013) in the Guardian, is an important development issue for poor countries. Asset recovery was recently discussed by (Marshall 2013) and it can, in a similar way to preventing future illicit financial flows and therefore increasing the assets, serve as an important source of development finance. Also, successful asset recovery seems to be a very good deterrent of future illicit financial flows.

7 The fact that aid flows from rich countries generally did not live up to expectations and promises in recent years is documented, for example, by the OECD, (OECD 2013a).

8 An illustrative overview of these various reasons is provided by (Fontana & Hansen-Shino 2012) and discussed also by (Fontana & Hearson 2012). The word illicit in illicit financial flows is used with the meaning of illegal or legally contentious, as opposed to licit or legal and as used, for example, by a recent special report on offshore finance in The Economist, (Valencia 2013), but the distinction between the two types of flows is not always clear. Indeed, the definitions are a source of controversy, as was noted by Peter Reuter on page 7 of (Reuter 2012), who also suggested that "perhaps, the defining characteristic of illicit is that (1) the acts involved are themselves illegal (corruption or tax evasion) in a regime that has some democratic legitimacy, or (2) the funds are the indirect fruits of illegal acts (for example, benefits given to those who have provided illegal funding for a presidential election)".

9 One good definition, used by (Kar & Freitas 2012), is the following: „Illicit financial flows are funds that are illegally earned, transferred, or utilized and cover all unrecorded private financial outflows that drive the accumulation of foreign assets by residents in contravention of applicable laws and regulatory frameworks."

10 This classification is similar to the classification introduced by (Baker 2005) and differs mainly in including explicitly the individual illicit group. (Baker 2005) differentiates between financial flows related to legal commercial activities and those assigned to criminal activity (illicit corporate and illegal, respectively, in my classification). (Baker 2005) further distinguishes the flows related to legal commercial activities according to three channels through which they leave poor countries: the mispricing of goods traded between independent parties, the distortion of transfer prices charged on goods traded within a multinational firm, and fake transactions.

and transfer stolen funds.[11] Third, the groups are partly overlapping. For example, all of them include tax evasion – an illegal activity practiced by both corporations and individuals.

Income from illegal activities transferred across borders is considered as the first group of illicit financial flows.[12] The original sources of these illicit financial flows can be both illegal (e.g. drug trafficking) and legal (e.g. some legitimately generated funds can be transferred in an illicit way to another country for the purpose of reducing tax obligations in the country of origin).[13] This group includes illegal activities such as money laundering, drug and human trafficking, smuggling, illegal trade with weapons, counterfeiting, corruption, bribery, customs fraud, or terrorist financing.[14] These illegal activities may be practiced by individuals, corporations, governments or other entities. Cross-border financial flows associated with any of these illegal activities are considered illicit financial flows.

In the case of the second group, individual illicit, illicit financial flows are associated with tax avoidance, tax evasion and other illicit and illegal practices by individuals, often so-called "high net worth" individuals. These illicit financial flows might not account for a high proportion of the total amounts, but they are very visible in the media and in politics.[15]

Corporate illicit is the third group, and a major source of illicit financial flows. A large proportion of illicit financial flows derive from corporations that strive to maximize profit and avoid taxes.[16] Financial flows involved in tax evasion as well as tax avoidance, profit shifting and other similar practices by corporations and other legal entities are considered to be illicit financial flows. Corporations might engage in mispricing trade and other transfers or otherwise shifting profits out of poor countries into others, including rich countries and tax havens. Although the empirical evidence is not conclusive, transfer and trade mispricing

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11 Examples adopted from (OECD 2013d).

12 Although illicit has a different meaning from illegal, financial flows associated with illegal activities are among the less disputed financial flows considered as illicit. For example, there may be cases of contracts involving a legal transfer such as a natural resource export, but which are a part of money laundering as a consequence of a corruption deal between officials and foreign companies.

13 (Baker 2005) estimated that over 60 per cent of total illicit flows arise from legal commercial activities, and most of the remainder from criminal activities. Specifically (Baker 2005) estimates that illegal markets account for US$168 billion–US$231 billion of these outflows. This and other estimates seem to suggest that illegal markets such as with drugs or humans account for significant illicit financial flows from poor countries, but mostly they have not been studied rigorously (maybe with the exception of drug markets).

14 The Financial Action Task Force (FATF) was established in 1989 to examine and develop measures to combat money laundering. In 2001, the FATF expanded its mandate to incorporate efforts to combat terrorist financing. On illegal trade with weapons, see, for example, the following opinion article (Ostfeld 2013).

15 (Leigh 2013) and related revelations provide recent examples of such visibility.

16 Tax evasion breaks the law, tax planning complies with the law and tax avoidance is somewhere in between, following the letter of the law, but not its intentions. The distinction between them is not always clear. Furthermore, of course, there are motivations other than tax behind shifting income abroad such as, as discussed by (De Boyrie et al. 2005) or (Fuest & Riedel 2012), the threat of expropriation or confiscation of private property, economic and political uncertainty, fiscal deficits, financial repression, or devaluation; these may be the real driving forces.

are estimated to be important sources of illicit financial flows and short descriptions of these practices follow.[17]

Transfer pricing is used by multinational corporations to price transactions between affiliates in different countries. The practice of transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing, involves the manipulation of transfer prices – interest payments, license fees or payments for goods and services transferred between subsidiaries of the same multinational company in different countries – contrary to international agreements and often in order to reduce taxes.[18] Therefore, transfer pricing permits large financial flows that are viewed as illicit. For example, corporations might use transfer mispricing to reduce their taxes and thus enrich themselves by failing to specify properly the price at which natural resources are exported from poor countries.

Trade mispricing is transfer mispricing beyond the limits of a single multinational corporation, and refers to transactions between both related and unrelated parties when trade documents use false prices. While the transfer may be legal, the underlying contract might either result from corrupt dealings between officials and corporations, or the result of corporations optimizing their profits without adhering to the laws and best practices. Therefore trade mispricing is deemed to be important both as a source of tax evasion and as a channel for the movement of illicit funds.

Why are illicit financial flows bad?

Together with the excessive global financial secrecy that facilitates them, illicit financial flows are a worldwide obstacle to global development. Although illicit financial flows are a problem for both rich and poor countries, there are good reasons to believe poor countries are more vulnerable to their negative effects than rich countries.[19] For example, poor countries have weaker institutional, legislative and administrative capacity and do not have suitable frameworks to deal with illicit flows and with multinational companies when it comes to transfer pricing; the government incomes are low and their financing need high

17 Estimates of the size of the various sources of illicit financial flows are from the research by Global Financial Integrity, (Kar & Freitas 2012). (OECD 2013b) discuss profit shifting and the existing evidence on rich countries including the convincing study of (Huizinga & Laeven 2008), whereas (Fuest & Riedel 2012) focus on poor countries and rigorously investigate the role of international profit shifting in poor countries and (Janský & Prats 2013) build on their research by providing additional evidence of profit shifting our of poor countries.

18 Contrary to international agreements and recommendations, set in this case mostly by the OECD, (OECD 2010), or other international agreements or local tax laws.

19 Ragnar Torvik in an appendix to the (Norwegian Government Commission on Capital Flight from Poor Countries 2009) argues that the negative effects of tax havens are greater for developing countries than for other countries. Furthermore, Alex Cobham in chapter 11 of (Reuter 2012) finds that the exposure of poor countries to tax havens is on a par with, if not more severe than, that of rich countries. A recent Guardian article, (Tran 2013) spells out arguments by the OECD staff as to why poor countries are more vulnerable than rich countries, especially in the area of transfer pricing.

and therefore each dollar of missing tax revenue has a higher social cost in poor countries; the institutions are weaker and therefore more vulnerable in poor countries.[20]

The harmful impacts of illicit financial flows include hampering the poor countries' ability to mobilize their own private and public funds and therefore lowering the amounts of finance available for consumption and investment in poor countries, undermining their institutions, distorting economic activity and facilitating illegal activities. There are three broad channels through which illicit financial flows can damage poor country development, but it is important to keep in mind that their impacts differ across the various types of illicit financial flows and more research is needed into the empirics and heterogeneity of these impacts.[21]

First, illicit financial flows directly lower the funds available to the government. For instance, this can happen as a result of reduced tax revenue or inappropriate spending that could be otherwise used on public services such as schooling or health care. Together with the assets held illicitly abroad by high net worth individuals, illicit financial flows seem to increase the inequitable distribution of tax revenues and can contribute to income inequality both within and between countries.[22]

Second, illicit financial flows directly lower private funds and prevent countries from receiving appropriate benefits from their economic production, and furthermore lower national savings and capital available for private investment. Lower investment translates into less infrastructure, fewer jobs and lower long-term development prospects. Motivated by tax evasion or other crimes or incentives, illicit financial flows enable resources to flow to informal parts of the poor countries, or to other countries. Illicit financial flows have been discussed as a contributing factor in the recent global financial crisis and they pose a risk to the stability of financial markets and undermine effective financial regulation. [23] Also, for some countries, illicit financial inflows might pose bigger risks than outflows, through mechanisms like exchange rate changes.[24]

Third, and probably most importantly, illicit financial flows harm institutions. They can weaken the role of government, citizens' willingness to pay taxes, undermine tax systems' morale and governments' accountability towards citizens, and lower investors' confidence and overall institutional environment. Illicit financial flows often catalyze illegal activities or tax avoidance. For example when illicit financial flows are used to launder the proceeds of corruption and bribery, they could help keep corrupt politicians and other elites in their

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20 (Azémar 2010) supports this argument by finding that that low degrees of law enforcement are associated with higher income shifting.

21 (Reuter 2012) provides one of the most comprehensive treatments of the various reasons behind illicit financial flows. Existing initiatives for further research include the International Centre for Tax and Development, a global policy research network, based at the University of Sussex.

22 (Christensen et al. 2012) discuss the relationship between financial secrecy and inequality.

23 This has been articulated, for example, in (Leading Group on Solidarity Levies to fund development 2008) and discussed by (Cobham et al. 2008).

24 This might be the case with countries that supply the world's drug trade, more in (Reuter 2012).

positions, sustain criminal activities, or hide the profits of their crimes.[25] Also, the fact that some illicit financial outflows are actually misappropriated aid inflows does not increase support for aid and other development policies in rich countries.

The negative impact of illicit financial flows on most countries is facilitated by countries that allow illicit financial flows to thrive, such as tax havens, offshore financial centres, secrecy jurisdictions and other countries providing similar regulatory and secrecy services. I prefer to use the term secrecy jurisdiction, defined as a jurisdiction which provides facilities that enable people or entities escape or undermine the laws, rules and regulations of other jurisdictions elsewhere, using secrecy as a prime tool.[26]

Also some other economic entities can play an important role in illicit financial flows such as certain banks, law and accounting firms: so called secrecy providers or enablers.[27] Some multinational companies also seem to take advantage of the weaker institutional, legislative, technical and administrative environment, or corrupt officials, in the poorer countries, to avoid paying their full share of taxes.[28] All those who facilitate illicit financial flows enable related illegal activities and tax avoidance and other negative phenomena that are an obstacle for the development of poor countries.

It is useful to shortly discuss whether illicit financial flows could also be beneficial for poor countries, although I consider illicit financial flows overwhelmingly bad and a worldwide obstacle to global development and this argument is also explicitly the focus of this paper.

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25 One example where secrecy jurisdictions – defined and promoted by Richard Murphy, e.g. in (Murphy 2008) – served as the destination for the bribes received by dictators is documented by James Maton and Tim Daniel in chapter 13 of (Reuter 2012), who describe how Sani Abacha, the dictator of Nigeria in the late 1990s, kept substantial liquid funds on the Isle of Jersey. Further negative effects associated with this type of finance with the focus on the countries enabling illicit financial flows is discussed by (Shaxson & Christensen 2013).

26 This definition is based on (Meinzer 2012) and it was discussed and promoted by (Murphy 2008). It is not entirely clear when the term 'secrecy jurisdiction' was used for the first time; but it does feature in a report by the Permanent Subcommittee on Investigations by the US Senate, dated 200, page 29, (U.S. Senate 2001).

27 The focus in this paper is on the policies of countries ((Picciotto 1992) , (Corbridge et al. 1994) and (Palan 2002) were among the first to discuss the various negative roles of financial secrecy), but it is important to note that the practices of other economic players, such as banks, law and accounting firms, hedge funds and wealth managers, also have a major influence. For evidence and discussion of some of these other economic players see (Harari et al. 2012) or a section on accounting firms in (Valencia 2013). Also, illicit financial flows from poor countries most likely mostly end up in legitimate financial institutions in rich countries and therefore, as (Reuter 2012) on page 487 notes, governments of the rich countries that serve as the domicile for many of the recipient banks can more forcefully push the institutions to ensure they are not taking in illicit flows. Overall, harmful financial secrecy should not be seen as a location-based service and tax havens as just geographical locations. Because of their connectedness to major international financial centres, tax havens need to be understood as a fundamental element of a broader system and industry that supports illicit financial flows, tax evasion and tax avoidance.

28 A specific example is analyzed in detailed by (Action Aid 2013). These issues are more systematically discussed in the relevant parts of this paper as well as in (OECD 2013b) and more systematic empirical evidence for poor countries is provided, for example, by (Fuest & Riedel 2012) and also by (Janský & Prats 2013). An earlier example of this analysis is (Desai et al. 2004), who find that affiliates of a multinational based near a tax haven in which there is also an affiliate pay the equivalent of a 20% lower tax rate than they would do otherwise.

With limited evidence on illicit financial flows, it is of course always difficult to judge their actual impact and the relative importance of how bad (or good) they are. So why might illicit financial flows, or related criminal activities such as tax evasion, be actually good for poor countries? The main argument seems to be that in some countries in some years, the governments of poor countries are illegitimate and not representative of their country's well-being. It might then make a good sense, the argument goes, to avoid governmental interventions such as nationalization or taxes for one's benefit, for example, through illicit financial flows of one's wealth out of the country.[29]

In theory it could be possible to extend this argument to formulate the research hypothesis of whether the additional financial resources in private hands do more for development than the same in public hands. However, I hesitate to seriously do so, because I believe that the long-term negative impact of illicit financial flows on government and overall institutional environment is deemed to make this question significantly less relevant than it might seem. It is intuitively appealing to think that illicit flows under an illegitimate government are less damaging – or perhaps less illicit – than under a legitimate government. Indeed, some define illicit flows to exclude some flows which are only illegal by decision of illegitimate governments.[30] However, there are two further crucial considerations here.[31] First, if illicit flows undermine economic growth for when a government is legitimate, it is not clear why this would be less true under an illegitimate government. Second, there may be a parallel with the governance benefit of tax that people hold governments to account when they feel it is their own money being spent.[32] Further research is of course needed on the relationship of governance and illicit flows relationship, but on the basis of current knowledge I am hesitant of suggesting that there may be such a thing as beneficial illicit financial flows.[33] Overall, curtailing illicit financial flows seems therefore a suitable and an urgent objective for rich-country policies.

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29 These seem extreme cases, but there are some good historical examples and they seem to reappear again and again together with wars, civil wars or extreme corruption and state capture. Examples include countries such Burma, Indonesia or Czechoslovakia at some points in history. More recent or current examples include countries such as Zimbabwe or Syria.

30 For example a chapter by Blankenburg and Khan in (Reuter 2012).

31 I am grateful to Alex Cobham for useful discussion on this topic.

32 An illegitimate but effective state may be able to impose taxation and other regulation, but may find that this process leads over time towards greater demands for political representation, ultimately increasing its own accountability and legitimacy. If the middle classes and elite are able, through illicit flows, to step out of taxation imposed by an illegitimate and ineffective state, such a positive cycle may never emerge – with the possibility that illicit flows undermine the potential for improvements in governance, by defusing potential political pressure for change.

33 It is probably not easy or even possible to distinguish between the majority of bad illicit financial flows and the possibly good ones and it will be always a question of who and how is to judge that they are good. M y reading of the existing evidence and literature is that the benefits of curtailing all illicit financial flows outweigh the costs of limiting the uses that can be good for poor countries.

Which kinds of rich-country policies influence illicit financial flows?

Both rich countries' national policies and their influence over internationally agreed upon policies influence the impact of illicit financial flows on poor countries and, more generally, how the global financial system works, or does not work for poor countries.[34]

Generally, there is a distinction between direct policy measures that aim to curtail (or reduce or limit) the flows, and indirect policy measures that aim to curtail underlying activities that generate or motivate illicit financial flows. The focus here is more on the former, although the two are often interconnected. At one extreme, rich countries could in theory be actively and explicitly supporting illicit financial flows and the activities behind them. At the other extreme – considered here as the desired one – rich countries could be doing all they can to curtail the illicit financial flows and related activities.[35] Most rich countries are probably currently in between, though some closer to the former (such as tax havens and secrecy jurisdictions) and some closer to the latter extreme.

The policies governing financial relationships between countries create a complex system of various multilateral and bilateral agreements, treaties and organizations with varying degrees of formality, explicitness and accountability. These policies include improving transparency, policing foreign corruption, international tax cooperation, and preventing excessive transfer mispricing and profit shifting out of poor countries.[36] Importantly, if a rich country serves itself as a secrecy jurisdiction – or lets its policies allow other jurisdictions under a direct or indirect influence to serve as such –, it helps to facilitate illicit financial flows, profit shifting, underdeclaration of income or assets by individuals and therefore their negative impacts on poor countries, for example, by letting multinational corporations avoid tax payments in poor countries.

In many of the issues related to illicit financial flows it is in the very interests of rich countries to support a global financial system that works for poor countries as well.[37] This is therefore one of the relatively rare policy issues where the interests of rich and poor countries are, or at least should be, often aligned. Still, there are important cases when rich countries benefit from excessive financial secrecy or tax avoidance at the expense of a poor country, such as when a multinational company headquartered in a rich country is using transfer mispricing to shift its profits out of a poor country's subsidiary to its headquarters, or when the countries in question serve as tax havens or secrecy jurisdictions.

34 Recent confirmation of this by rich countries themselves is found in (OECD 2013c) and (OECD 2013d).

35 Rich countries should change these policies to be more favorable and less damaging to poor countries in the sense of the concept of policy coherence for development.

36 More specific examples of these policies are included in the section below on the measurement of these policies.

37 These policy issues include, for example, the case of excessive financial secrecy that allows tax evasion, money laundering, terrorist financing or other criminal activities, or cases relevant for financial regulation or macroeconomic policy, or cases concerning third countries such as tax havens and secrecy jurisdictions.

Although illicit financial flows are a problem for rich as well as poor countries, poor countries are less likely to find themselves in a position of strength, since they have a smaller influence on the global financial system and in shaping bilateral rules through unilateral actions.[38] Therefore two things are often beneficial for poor countries. First, if a multilateral international agreement on common policy measures is reached, in contrast to bilateral or unilateral measures. Second, if that agreement takes into account the interests of poor countries – in contrast to some measures that have been proposed by groups or institutions dominated by rich countries, such as the OECD, a rich countries' think tank and regulatory authority.[39]

The argument for a global approach is further strengthened by the fact that although rich countries' policies play an important role, each individual country's policy has a limited effect due to the availability of excessive financial secrecy in other countries, to which illicit activities can be relatively easily moved. Therefore, global policy coordination and international agreements are crucial.

Nevertheless, some continue to question whether it is a good idea to focus policy efforts on illicit financial flows despite their nature and despite their importance, if only because they are usually the consequence of underlying problems such as corruption or other illegal activities that policy can deal with more directly.[40] Although illicit financial flows are mostly symptoms of other problems identified as the reasons behind these flows, the flows are so important and so large that – alongside dealing with the other problems of governance or crime – there is also a need to address the flows directly.

How have illicit financial flows been measured?

How can illicit financial flows be measured? In theory in many ways, but in practice there are only some available currently. For example, it might seem suitable to evaluate the impact of

38 An extreme example is provided by Michael Levi in chapter 12 of (Reuter 2012), where he notes the many difficulties of creating an effective anti-money laundering regime if the government is thoroughly corrupt.

39 First, Tax Information Exchange Agreements or double taxation agreements are examples of bilateral, rather than multilateral agreements, and often seem to harm poor countries since, beyond the bigger poor countries of the G20 that have a stronger negotiating position, these countries often have problems negotiating and enforcing such agreements and measures. Second a specific and recent example of this is the discussion of new transfer pricing rules supported by the recent OECD publication, (OECD 2013b), on base erosion and profit shifting, which does not mention profit shifting out of poor countries into or via rich countries. (OECD 2013b) looks at whether, and if so why, the current rules allow for the allocation of taxable profits to locations different from those where the actual business activity takes place. OECD is set to provide proposals for change by summer 2013.

40 For example, Peter Reuter in chapter 15 of (Reuter 2012) on page 484 deals with the question of whether "it is useful to focus policy attention on illicit flows, given that they represent a consequence of more fundamental and troubling problems (corruption, tax evasion, criminal markets, and so on)?" and "The root cause argument,

then, is that one should focus on ways of reducing the underlying problems: corruption, tax evasion, and so forth. The international flows are only a manifestation of these problems. Cut down on corruption, tax evasion, and the rest, and the IFFs will take care of themselves."

illicit financial flows and consider such measure for the CDI, but there are hardly any results that could be used. Currently there are mainly two kinds of measures available, either of the volumes of the flows or, arguably more relevant for the CDI, of the policies and policy efforts aimed at curtailing illicit financial flows. Starting with the discussion of the first kind, there are some metrics that look at how much finance flows out of poor countries illicitly. Nonetheless, even though it is expanding, the empirical evidence on the size of the flows and their determinants remains rather scarce. Ideally, there would be reliable and comparable measures of various illicit financial flows and their impact but the evidence base is relatively limited for a number of reasons.[41]

Illicit financial flows are therefore obviously difficult to measure. Still, there are different ways of estimating illicit financial flows, which reflect both the variety of mechanisms available for tax evasion or money laundering and various methodological approaches including surveys, case studies, interviews, statistics or composite measurements.[42]

I group the estimates of illicit financial flows into three interlinked groups: tax revenue lost, trade mispricing and other. This order approximately corresponds with the development of the estimates over time and somewhat increasing rigorousness, though possibly decreasing in how accessible the results are to the media and the general public. Early research mostly by non-governmental organizations and some academics starting in the year 2000 provided some of the first estimates of illicit financial flows, assets held offshore and associated government revenue losses, using various methodologies that succeeded in highlighting the importance of illicit financial flows and bringing these issues to wider attention.[43]

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41 These reasons include the very nature of illicit flows and associated lack of data and low information quality. Furthermore, academic and other researchers, as well as policy makers, have so far paid inadequate attention to these issues given the importance of the phenomenon. For example, it seems that there are neither good data nor estimates for human trafficking. In chapter 6 of (Reuter 2012), Pierre Kopp discusses the lack of estimates for illicit financial flows related to human smuggling. Furthermore, in the last chapter (Reuter 2012), Peter Reuter argues that illegal activities are unlikely to be the source of substantial illicit flows out of developing countries because most of the value added is in rich countries, and much of all that is earned by poor county nationals is repatriated home.

42 Good overviews of the direct methods of measuring illicit financial flows are in (Fontana 2010) and, more critically, (Reuter 2012) and especially one of its chapters, (Fuest & Riedel 2012).

43 Among the first were Oxfam, Transparency International, Raymond Baker and an organization that he founded, Global Financial Integrity, followed by Christian Aid, Tax Justice Network and other organizations. (Oxfam 2000) estimated that poor countries suffered a yearly loss of around USD 50 billion due to tax havens and their estimate is based on global figures for foreign direct investment and the stock of capital flight, combining these with estimated returns to investment and interest income, along with estimated tax rates; the sum is around USD 35 billion in untaxed foreign direct investment and USD 15 billion in untaxed personal income. Although (Oxfam 2000) considered these figures conservative estimates, the methodology relies on a number of questionable assumptions and, as discussed by (Fuest & Riedel 2012) on page 120, their approach raises a number of questions. (Transparency International 2004) estimated that 10 of the most notoriously corrupt heads of states in poor countries may have together been responsible for as much as USD 60 billion in illicit financial flows out of their countries during their respective tenures in office. Raymond Baker, the director of Global Financial Integrity, in his book, (Baker 2005), estimated that more than USD 540 billion flows out of

Research based on trade price data usually explores trade mispricing, which includes transactions between both related and unrelated parties (in contrast to a more narrowly defined transfer mispricing that includes transactions between related parties only, usually within a multinational corporation). Trade mispricing uses the so-called re-invoicing process to shift profits out of developing countries either through import over-invoicing or export under-invoicing. There are two main groups of models using internationally comparable and available data. First, the so called World Bank residual and hot money models are based on balance of payments data. The World Bank residual model subtracts the total of funds actually used by a country from the total of funds entering that country and, if there are more funds coming in than funds being used, the resulting shortfall is considered to be illicit flows.[44] The hot money model considers all errors in a country's external accounts as illicit flows.[45] The second group of models is based on trade data and estimates trade mispricing and trade misinvoicing, which is trade mispricing for trade between unrelated parties.[46] These methods capture the quantity of illicit flows by contrasting what a country claims it imported from (or exported to) the rest of the world with what the rest of the world states it

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poor countries each year thanks to a combination of tax evasion, fraud in international trade, drug trafficking, and corruption, by combining various methods and conducting hundreds of interviews. Motivated by the objective of recovering what assets might be illegally already held abroad, (Tax Justice Network 2005) estimated that the value of assets held offshore lies in the range of USD 11 - 12 trillion and suggested that the global revenue loss resulting from wealthy individuals holding their assets untaxed offshore may be as much as USD 255 billion annually ((Cobham 2005) on the basis of (Tax Justice Network 2005) derived that proportions equivalent to the shares of world GDP (20%) would imply a loss to poor countries of around USD 51 billion a year) and it updated its estimates when (Henry 2012) estimated that a global super-rich elite had at least USD 21 trillion hidden in tax havens by the end of 2010 and that poor countries could be losing USD 189 billion in associated tax revenue every year. James Henry in a similar way for (Oxfam 2009) estimated that at least USD 6 trillion of poor country wealth is held offshore by individuals, depriving poor countries' governments of annual tax receipts of between USD 64 and 124 billion. (Kapoor 2007) is an extensive Christian Aid briefing on the problem of illicit capital flight. (Reuter 2012) report on page 5 of an odd official Chinese report estimating that around USD 100 billion were detected as being transferred from China by 16 to 18 thousand escaped officials over a recent roughly 10-year period.

44 (Fontana 2010) summarizes the World Bank residual method by the following equation: Illicit flows = (increase in foreign debt + increase in FDI) – (financing of the current account deficit + additions to the country's reserves)

45 (Fontana 2010) summarizes the Hot Money model by the following equation: Illicit flow = all funds coming in (credit) – all funds going out (debt)

46 This kind of methods have been applied in (Christian Aid 2009), who provide evidence on the scale of trade mispricing and revenue losses for poor countries, and (Pak 2007) among other projects. (Christian Aid 2010) on page 23 provide an illustrative example with Zambia, which is a major copper exporter and whose economy is dominated by copper. In 2008, half of Zambia's copper exports were consigned to Switzerland as they left the country's customs (but according to Swiss import data, most of this never arrived at the other end, which is interesting in its own right). Switzerland's copper exports have much higher declared prices than those of Zambia. Given that trade data allow comparisons of quite detailed categories, quality variances should not be behind all these price differences. Were Zambia to receive Swiss export prices for its exports to Switzerland, the total value received would in 2008 have been almost six times higher than it was, adding some US$11.4bn to Zambia's GDP, which in 2008 was just US$14.3bn in total. It is possible that there is another straightforward explanation for this, but it is also possible that this loss of revenue is at least partly the result of transfer mispricing. A further and more general treatment of this phenomenon is discussed and analyzed in (Cobham et al. 2013).

exported to (or imported from) that given country. It is also possible to combine these two types of models and create a composite measure. Most notably, the research by Global Financial Integrity uses the World Bank residual and hot money models and further makes adjustments for trade misinvoicing. Their hot money-based model estimates that the developing world lost USD 859 billion in illicit outflows in 2010 (significantly more than the USD 129 billion in aid by OECD countries in 2010).[47]

Rather than estimating the aggregate illicit financial flows, it is also possible to focus on country-specific evidence, which has been done quite well in the case of estimating the extent of profit shifting.[48] Another approach looks at the likely extent of returns and income declarations using data on the financial positions of secrecy jurisdictions with regard to specific poor countries.[49]

There are difficulties with these estimates; usually each estimation method has its pros and cons, and together they have many problems.[50] Let's discuss briefly three groups of problems that most of them share: assumptions, interpretation and policy. Most of the methods necessarily rely on strong assumptions about the sizes of flows or assets or tax rates that can seldom be verified.[51] Many of the estimates do not allow a straightforward interpretation.[52] Furthermore, most of the estimates do not shed more light on specific policy measures.[53]

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47 Their estimates, (Kar & Freitas 2012), suggest that bribery, kickbacks, and the proceeds of corruption continued to be the primary driver of illicit financial flows from the Middle East and North Africa, while trade mispricing was the primary driver of illicit financial flows in the other regions. On the basis of this kind of estimates, (Hollingshead 2010) estimates the loss of tax revenue to poor country governments resulting from illicit financial outflows. She uses national corporate income tax rates to estimate the tax revenue loss from trade mispricing. She finds the average tax revenue loss in poor countries was between USD 98 billion and USD 106 billion annually over the years 2002 to 2006. This figure represents an average loss of about 4.4% of the entire developing world's total tax revenue.

48 (OECD 2013b) discuss profit shifting and the existing evidence including the evidence of (Huizinga & Laeven 2008) on the scale of profit shifting within Europe, whereas (Fuest & Riedel 2012) focus on poor countries and relatively rigorously investigate the role of international profit shifting in poor countries. (Janský & Prats 2013) build on their research by providing additional evidence of profit shifting out of poor countries. These studies use detailed firm-level financial and ownership data for multinational corporations to estimate the extent of profit shifting. Some, such as Richard Murphy in chapter 9 of (Reuter 2012), point out the problems with the data employed in the above empirical analyses.

49 This was proposed and partly exercised by Alex Cobham in chapter 11 of (Reuter 2012).

50 Some of the more detailed criticism of individual methods is in (Reuter 2012), (Fuest & Riedel 2012) or (Hines 2010).

51 One consequence of this can be that the resulting estimates are sometimes considered to be the best available estimates, since no better alternatives exist, but are not considered to be a reflection of the reality. In this and other ways, these methods are similar to those that estimate the losses caused by the existence of a shadow economy – for example, (Schneider 2005) estimated that developing countries could lose as much as USD 285 billion.

52 Alex Cobham in chapter 11 of (Reuter 2012) explains this group of problems in the following way: „The second major criticism of these approaches is that no reasonable counterfactual is put forward. Imagine, for

Alternatively, it is possible to measure policies aimed at curtailing illicit financial flows, rather than measuring the extent of flows themselves. There are various measures and proposed systematic changes focused on curtailing illicit financial flows and, correspondingly, it is possible to evaluate these efforts towards the implementation and effectiveness of these measures. Many of these measures are largely influenced by rich countries' policies with overwhelming impact on poor countries. Also, some rich countries have focused their efforts on curtailing illicit financial flows more than others.[54]

Ideally the policies should be comprehensive and they should focus in their entirety on excessive and often abusive financial secrecy, a crucial phenomenon interconnected with illicit financial flows. When rich countries allow excessive financial secrecy to prevail in the global financial system, they also allow illicit financial flows to blossom and, in effect, significantly lower public as well as private funds and weaken the associated institutions in poor countries.[55]

Although the role of rich-country policies in curtailing illicit financial flows and excessive financial secrecy is difficult to identify and quantify, in the discussed respects the most detailed, complex and overall suitable metric is the Financial Secrecy Index (FSI).[56] The FSI is also the first ever and most likely the only existing attempt to make a comprehensive global effort to identify each country's contribution to excessive financial secrecy.

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example, that there are two main channels for illicitly reducing tax liabilities in developing countries. If the second is, say, 95 per cent as effective as the first, then shutting down the first is likely to yield only a small revenue benefit. In a world with multiple channels of illicitly reducing tax liabilities, it is unrealistic to expect a definition of an appropriate counterfactual to estimate the benefit of closing down any particular channel. In effect, however, this criticism applies not to the quantification approaches, but to a popular interpretation that the resulting estimates represent readily available revenues."

53 The results seldom provide more guidance for policy other than a general recommendation to reduce illicit financial flows or recover the assets held offshore.

54 The most prominent example is probably Norway which, for example, is one of the most active members of Task Force on Financial Integrity and Economic Development (Global Financial Integrity serves as this organization's secretariat) and was instrumental in the creation of one of the best analytical books on the topic, (Reuter 2012). In recent years, rich countries have seemed to focus more on curtailing illicit financial flows out of poor countries as a part of their development policies, as presented recently in (OECD 2013c) and (OECD 2013d). (OECD 2013d) recognizes the importance of illicit financial flows for poor countries and specifically aims to measure how well OECD countries are "implementing their commitments to combat money laundering, tax evasion, bribery and corruption, and to track, freeze and return assets to foreign jurisdictions? Finally, how are development agencies supporting this agenda, and what more can be done?"

55 A similar argument can be made for assets held offshore. Assets brought illegally from poor countries abroad and through illicit financial flows can theoretically be brought back, but it might be a mission impossible if financial secrecy prevails and laws (or their poor enforcement) governing trusts and corporations provide anonymity to conduits as well asset holders. (Global Witness 2009) provides some specific examples of both insufficient rules and their enforcement and (Eurodad 2013) is another, more recent report from an NGO reflecting these issues.

56 The FSI is managed by Tax Justice Network and the latest edition was published in 2011 with the next one prepared for the autumn of 2013, (Tax Justice Network 2011). Among the FSI's objectives is to rid the world of financial secrecy and therefore improve the global financial system in a sustainable and systemic way. Also (OECD 2013d) recently discussed the policies of rich countries focused on curtailing illicit financial flows.

Financial Secrecy Index (FSI)

The FSI evaluates countries according to how much they contribute to global financial secrecy and how much they serve as a secrecy jurisdiction, i.e. how much financial secrecy they provide. According to the FSI website, harmful financial secrecy comes in three broad flavours: the most well-known, bank secrecy (such as that offered by Austria, Luxembourg, and Switzerland); the second, less well known, but more important on a global scale, involves jurisdictions permitting the creation of entities (whether trusts, corporations, foundations, anstalts or others), whose ownership, functioning or purpose is kept secret; the third level of secrecy involves jurisdictions putting up barriers to co-operation and information exchange. Many of these three flavours involve complex systems that are difficult to identify. Policies that aim to regulate financial relationships between countries are also complex and this fact is reflected in the similarly complex construction of the FSI, especially its secrecy scores that identify a number of policy measures, both direct and indirect.[57]

The FSI consists of a quantitative part (so called global scale weights reflect the countries' contributions to offshore finance) and a qualitative part (so called secrecy scores reflect the excessiveness of financial secrecy).[58] The FSI thus captures some important distinctions such as countries that are very secretive, but do not provide many financial services, and countries that are not very secretive but have large offshore financial sectors. The global scale weights are based on the International Monetary Fund's balance of payments data of exports of financial services, which are complemented by those of portfolio liabilities and assets. The following are the fifteen categories (called secrecy scores by the FSI) that are used to assess jurisdictions:

1. Banking Secrecy
2. Trusts and Foundations Register
3. Recorded Company Ownership
4. Published Company Ownership
5. Published Company Accounts
6. Country by Country Reporting
7. Fit for Information Exchange
8. Efficiency of Tax Administration
9. Avoids Promoting Tax Evasion
10. Harmful legal vehicles
11. Anti Money Laundering
12. Automatic Information Exchange
13. Bilateral Treaties
14. International Transparency Commitments

57 See (Tax Justice Network 2011) for details.

58 This description of the FSI here refers to its latest, 2011 edition, but the new 2013 edition should not change significantly (coverage of countries is expected to increase along with some changes in the secrecy scores and weighting).

15. International Judicial Co-operation

Financial secrecy facilitates the evasion of personal income and wealth taxes on individual assets held abroad and is well captured by the FSI, but it might be somewhat weaker in reflecting the trade and transfer mispricing used in aggressive corporate tax planning, tax avoidance and tax evasion practices.[59]

A somewhat related policy index to the FSI is the Basel Anti-Money Laundering Index, which rates countries according to money laundering and terrorist financing risk, on the basis of components including international organizations' ratings. Interestingly, the Index includes scores from the FSI (25%). Because of its composite nature (a further 10% is for example from the Transparency International's Corruption Perceptions Index) and a narrow focus on anti-money laundering, the Index does not seem very suitable for calculating illicit financial flows accurately.

Commitment to Development Index (CDI)

What metrics could be appropriate for inclusion in the CDI? How do considerations of practicality, cost, relevance, and timeliness affect these choices?

The previous versions of the CDI do not take into account the issues discussed here, namely illicit financial flows, and its new editions would clearly benefit from reflecting these. The most straightforward way to do so would be to include some of the existing metrics in the CDI. There appear to be two major alternatives, the FSI and the estimates by the Global Financial Integrity.

The Financial Secrecy Index in the CDI?

The FSI provides very detailed evaluations of countries' policies that are country-specific, transparently researched, and well established – it was first published in 2009 and has since then been updated to incorporate feedback and new developments. The great transparency

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59 The FSI reflects many, but not all important factors. To a full extent, the FSI does not evaluate countries according to how much they serve as a tax haven in a narrow tax sense, i.e. how low their tax rates are (countries with low or zero corporate tax include the Cayman Islands and Bermuda, while countries with preferential tax regimes for certain types of corporations include Belgium and Switzerland, and profits are often shifted out of poor countries to these countries in various ways) or to what extent they indirectly help to access very low tax rates through being conduit countries, such as is the case of the Netherlands and Luxembourg (multinational corporations invest flows via these countries to take advantage of beneficial tax treaties, for example to avoid taxation of capital gains or dividend payments or channel intra-group). To fully reflect these phenomena, additional indicators needed to be used and, more likely, developed in the first place. Furthermore, the FSI does not aim to evaluate countries according to how much they serve as an offshore financial center, i.e. what level of financial services they provide to nonresidents, but uses this information only to weight the importance of secrecy.

and detail of the FSI should give the CDI the option of including only some of the indicators included in the FSI, such as secrecy scores, and not others. From its 2013 edition onwards, the FSI will cover all countries evaluated in the CDI.

The drawbacks include the fact that, at least so far, the FSI has been published only every other year (2009 and 2011) and the use of the FSI by the CDI either would require a change to annual publication of the FSI or would necessitate the use of one-year-old FSI results every other year in the CDI. Also, the quantitative part (global scale weights) is not very robust due to limited data availability, and usually relies on data two-year-old data and estimation methods. Financial secrecy facilitates the evasion of personal income and wealth taxes on individual assets held abroad and is well captured by the FSI, but it might be weaker in reflecting the trade and transfer mispricing used in aggressive corporate tax planning, tax avoidance and tax evasion practices.

Another drawback is common to most of the metrics discussed here, and to country indices more generally. In an attempt to evaluate countries, a simplified view of the world as a collection of countries is often necessary, but this is also unhelpful in highlighting some important issues. For example, the United Kingdom is, especially through the City of London, a leading financial centre, but is also in one way or another responsible for a number of other financial centres, including its Crown dependencies and overseas territories, such as Jersey or the Cayman Islands. Another issue is that of illicit financial flows transferred through a number of countries – should we penalize only the country that is the final destination, or the other countries as well, and to what extent? The important questions are whether and how these phenomena should be reflected in the index. It could be argued that it would be partly reflected in the global scale weights if the overall FSI was taken into account. Or it could be reflected more specifically, maybe adjusting a country's score according to its historical and other responsibilities. These questions remain unanswered here as they are rather to be answered by the creators of the FSI.

A further disadvantage of the FSI – or of any similar indicator – is that it naturally focuses more on the areas where there are available data and available policy efforts or agreements to be evaluated. Therefore other important areas may be omitted due to the lack of data or existing policies, although their importance would warrant inclusion.

A potential further drawback is connected with the way the FSI evaluates jurisdictions' secrecy scores in cases when the jurisdiction in question consists of a number of parts (such as the USA). Currently, it considers the worst score (Delaware in the case of the USA) to be the representative score for the whole jurisdiction.[60]

[60] The FSI is not ideal or comprehensive, and an explanation of one of the reasons for this follows. The fact that many financially secret companies based in very secretive jurisdictions through links to other less and less secretive jurisdictions benefit from both from established markets and financial secrecy is a ladder-like aspect of

Global Financial Integrity or other estimates of illicit financial flows in the CDI?

The advantages of using the estimates of illicit financial flows by Global Financial Integrity or of a similar type are obvious from their relative success – they provide clear figures that many people can relate to, and that the media as well as researchers and policy makers can reference.

The drawbacks might be less obvious, but are numerous and important. These estimates indicate the extent of the flows rather than the policy efforts, which are the focus of the CDI. The models rely on official statistics that are generally of poor quality, especially in poor countries, and that do not take into account flows resulting from illicit activities, such as smuggling or black market activity, because proceeds from such activities are not captured in national accounts. Also, no single model measures the totality of illicit flows and there are no consistent models for measuring all the types of flows including corruption money, criminal money and tax evasion. Due to data publication time lags, the Global Financial Integrity has a nearly two-year delay in publication of its estimates, similar to the delay to the quantitative part of the FSI. Additionally, they provide results for individual poor countries, but not for their rich country counterparts; these results could possibly be arranged with Global Financial Integrity or re-estimated.

All in all, after weighing up the pros and cons, the FSI seems better suited for the CDI than the estimates by the Global Financial Integrity. Therefore, the FSI is the best candidate to be included in the CDI.

Do any policies currently rewarded in the CDI contradict the concern about illicit financial flows? Should these lead to revisions?

Some of the policies currently rewarded in the CDI might be seen as contradictory to concern about illicit financial flows, but these are rather minor issues and it is not clear that these should lead to revisions.

The potentially contradictory policies are in the CDI's investment component. The investment component addresses five issues: official provision of political risk insurance; avoidance of double taxation of profits earned abroad; actions to prevent bribery and other corrupt practices abroad; other measures to support foreign direct investment; policies that affect portfolio flows.[61]Almost all of them are relevant to the issues discussed in this current paper, maybe with the exceptions of political risk insurance and other measures that are relatively narrowly aspects of foreign direct investment in poor countries.

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the global financial system that FSI fails to capture. When dealing with illicit financial flows, it is often difficult to distinguish between countries of origin, conduits and ultimate destinations.

61 As described in (Moran 2012) and (Roodman 2012).

Both the existing investment component and the FSI take into account so called double taxation avoidance agreements, but they seem to highlight different aspects of this issue.[62] The existing investment component focuses on how to avoid a situation in which profits earned in poor countries are taxed in both the poor country and the rich country. From the point of view of the FSI, this is an understandable objective, but it focuses too narrowly on this objective and ignores other important issues. The discussion of double taxation does not properly reflect the potential costs of double taxation avoidance agreements. Specifically, it does not consider how some of the details could fuel tax competition in poor countries and incentivize them to lower their tax rates in order to attract foreign investment. Also, and importantly for the proposed finance component, the investment component seems not to reflect the practice where double taxation avoidance agreements could facilitate so-called "double non-taxation," when a corporation is not adequately taxed in either the poor or the rich country.[63]

Nevertheless, there is not much that could be improved. Those areas that could be include the so-called tax sparing and tax credits. The investment component gives a maximum and a high score for tax sparing and tax credits, respectively, while the FSI gives a zero score for tax sparing in line with the changes in international policy consensus, and only credit for tax credit system in a spectrum of payments.[64] These specific differences stem from more general ones. The FSI does not agree with the investment component's argument for low tax rates and tax holiday.[65] Overall, it might be possible to keep both of these in the final index,

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62 Specifically, as outlined in (Roodman 2012), this part reads: „2) Procedures to prevent double taxation of profits earned abroad—taxation, that is, in both source and receiving countries (20 points)

a) Does the county have tax sparing agreements with developing countries, whereby the government allows investors to pay taxes only under the (potentially favorable) tax code of the receiving country (20)? Or does the country at least offer a tax credit for foreign taxes paid so that there is no double taxation (18)?

b) Does the developed country deny investors the benefits from favorable tax treatment in developing countries (–6)?

c) Does it treat foreign taxes paid as a deductible expense rather than providing a full credit (–10)?"

63 Nowadays, as evidenced by for example, (OECD 2013b), there seems to be more worry about double non-taxation rather than double taxation (a contrarian view is presented, for example, by (Quinlan 2013)). Furthermore, as (Norwegian Government Commission on Capital Flight from Poor Countries 2009) notes, tax treaties between tax havens and poor countries are typically negotiated with the former in a position of strength, and, as a result, the tax havens receive a transfer of taxing rights from the poor countries, which hope that greater investment and subsequent economic benefits will follow.

64 On both tax sparing and tax credit, compare the investment components with the Key Financial Secrecy Indicators 9: Avoids Promoting Tax Evasion in (Tax Justice Network 2011) and on tax sparing compare it with (Development & OECD 1998).

65 For example, (Moran 2012) argues that "a tax sparing agreement helps the developing country to attract foreign direct investment by offering a low tax rate or a tax holiday", whereas the FSI in a draft 2013 methodology (to be available at its website later in 2013) celebrates that "countries wishing to attract foreign investment will not feel compelled to lower the tax rates in the hope of increasing their inward stock of foreign investment".

although revision of the investment component would be probably more consistent. There are also some other common issues, but without any conflicts.[66]

Should new indicators be incorporated as an 8th component or integrated into the (renamed?) investment component?

There are two ways of incorporating concern about illicit financial flows into the CDI: either a new 8th component based on the FSI, or an update of the existing finance component with the FSI.

There are some arguments in favor of a new component, such as the fact that it would adequately highlight the importance of illicit financial flows for poor countries, alongside the other mostly financial components of aid and investment.

However, the arguments against the creation of a new component seem to be stronger. First, if the new component was called, for example, Finance, such a name could mislead the reader into thinking that it is dealing with all the aspects of rich country policies regarding finance (much of which is beyond both it and the scope of this paper), when it is in fact focused only on illicit financial flows and financial secrecy. In this respect, a two-word name such as illicit finance might be more appropriate, but would break the good tradition of one-word names for all the CDI components. Also, if the FSI was integrated into the investment component, renaming the combined metrics a finance component would seem more suitable. Furthermore, eight components might be simply too high a number for the CDI, or any other policy index.

Overall, the merge of the existing investment component with the FSI, while possibly renaming the resulting component as Finance seems the best option. The Finance component would reward countries both for catalyzing the good flows and for penalizing the bad flows, which is consistent with the approach of the CDI in certain other of its existing components.

Nevertheless, I carry out the simulations below as if an eighth component based on the FSI was added to the CDI, not only because it is relatively easier to do so, but also due to the

66 In the area of actions to prevent bribery and other corrupt practices abroad, there seems to be a logical consistency between the existing investment indicators and the proposed illicit financial flow components. They both aim to measure the policy efforts of rich countries to prevent bribery and other corrupt practices in poor countries, but largely employ different metrics and therefore rather complement than duplicate or even contradict each other. Furthermore, the two questions of the investment component focused on portfolio investments view them as being generally beneficial for poor countries, for which there is not overwhelming empirical evidence and also international policy consensus is shifting in a different direction. The investment component focuses on inflows in poor countries and the benefits, whereas the proposed finance component stresses flows out of poor countries and challenges and in this way the two components could complement each other, reflecting the fact that the world is, indeed, a complicated place.

fact that I do not know the weights of the FSI in the merged component at the time of writing.

Below I simulate the inclusion of a new, eighth component into the CDI 2012 results on the basis of the FSI 2011 results in two alternatives (in both cases inverting the values of FSI indicators so that higher values imply positive policies as with other CDI components):

1. Finance 1 – including the overall FSI results, i.e. FSI value
2. Finance 2 – including the secrecy score of FSI, i.e. only the qualitative part of the FSI

Table 1 shows the simulated results of these two versions of the finance component for countries for which FSI results are available (16 out of 27) and it also updates the overall results and compares these with the original results.

Table 1. Simulated results of a new proposed finance component based on the 2011 FSI for the CDI 2012 results

Original rank	Country	Original overall (Average)	Finance 1 (based on FSI values)	Finance 1- updated overall results	Finance -1 difference between the original and updated results	Finance 2 (based on FSI secrecy scores)	Finance 2- updated overall results	Finance -2 difference between the original and updated results
22	Hungary	4.0	13.1	5.2	1.2	5.5	4.2	0.2
15	Spain	5.2	12.6	6.1	0.9	7.6	5.5	0.3
10	Portugal	5.5	10.4	6.1	0.6	5.1	5.4	-0.1
1	Denmark	7.0	10.2	7.4	0.4	6.5	6.9	-0.1
20	Italy	4.7	5.4	4.8	0.1	5.3	4.8	0.1
6	Netherlands	6.1	6.2	6.1	0.0	5.3	6.0	-0.1
17	Ireland	5.1	4.7	5.1	0.0	5.9	5.2	0.1
26	Japan	3.4	1.8	3.2	-0.2	4.0	3.5	0.1
11	Canada	5.4	3.4	5.2	-0.2	4.6	5.3	-0.1
13	Belgium	5.3	2.7	5.0	-0.3	4.4	5.2	-0.1
9	United Kingdom	5.7	2.4	5.3	-0.4	5.8	5.7	0.0
11	Germany	5.4	1.9	5.0	-0.4	4.5	5.3	-0.1
19	United States	4.8	1.1	4.4	-0.4	4.5	4.8	0.0
5	Austria	6.2	2.7	5.7	-0.5	3.9	5.9	-0.3
18	Switzerland	5.0	0.7	4.4	-0.6	3.3	4.8	-0.2
4	Luxembourg	6.3	0.8	5.6	-0.7	3.8	6.0	-0.3

Source: Based on CDI 2012, FSI 2011 and author's calculations.

Conclusion

Illicit financial flows seem very high and there is thus a great opportunity for poor countries if they can be curtailed. Even if that was the only reason, the topic of illicit financial flows warrants further research: to advance the estimates, to learn whether and how poor countries are affected differently by these flows compared to rich countries, and to compare rigorously the costs of illicit financial flows with their benefits, if any.

Even with what is now known, it seems safe to say that both illicit financial flows and financial secrecy do make most countries poorer, especially those that are already poor. Rich countries' policies regarding financial secrecy vary, and there is good cause for all of them to become more responsible with respect to illicit financial flows and poor countries. Updating the current CDI investment component, or adding a new finance component focused on illicit financial flows, would be a great contribution in this direction. Given that there is not a lot of reliable data available, the FSI currently provides the best option for including a measure of illicit financial flows in the CDI.

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