FfDO Paper in support of the

INTER-AGENCY TASK FORCE
ON FINANCING FOR DEVELOPMENT

Working Paper Series

Draft

Illicit Financial Flows: concepts and scope

Peter Chowla
Tatiana Falcao

December 5, 2016

More Information
http://www.un.org/esa/ffd/ffd-follow-up/inter-agency-task-force.html

Illicit Financial Flows: concepts and scope

***By Peter Chowla and Tatiana Falcao*[1]**

1. Introduction

Domestic public resources are a central component of financing across the Sustainable Development Goals (SDGs) and targets, forming one of the chapters of the Addis Ababa Action Agenda[2] (the Addis Agenda). They are essential to providing public goods and services, increasing equity, and helping manage macroeconomic stability. The 2030 Agenda described the need for "the mobilization of financial resources" as a means to implement the agenda and repeatedly called for increased investment. It also includes a target of strengthened domestic resource mobilization and increased capacity for revenue collection. The Addis Agenda "recognize[s] that significant additional domestic public resources … will be critical to realizing sustainable development and achieving the sustainable development goals" and Member States stated their commitment to "further strengthening the mobilization and effective use of domestic resources".

While the Addis Agenda discusses the importance of improving national tax systems and enhancing revenue, it also stresses the need to combat illicit financial flows (IFFs). The Addis Agenda outlines a range of actions and commitments in relation to IFFs to redouble efforts to substantially reduce IFFs by 2030, with a view to eventually eliminating them. The Addis Agenda also commits Member States to eliminate safe havens that create incentives for transfer abroad of stolen assets and IFFs. Importantly, it invites international institutions to publish estimates of the volume and composition of illicit financial flows.

However, there is as of yet no firm agreement on conceptual and definitional issues related to the term IFFs. Even though there is substantial work from the United Nations system, the World Bank, the IMF, the OECD and civil society on the subject, countries' inability to reach a political consensus has left the international community without a proper definition. This lack of agreement makes developing methodologies for monitoring and assessment of progress difficult if not impossible. There are also well-known disagreements and dissatisfaction with methods to estimate the volume of IFFs. In part, the problems stem from continued lack of conceptual clarity, but fundamentally, given the illicit nature of the flows, all approaches to estimates will have problems in accurately capturing the phenomenon. Even if a definition were agreed, additional concerns relate to whether it makes sense to take estimates of different kinds of IFFs and add them together for presentation purposes.

---

[1] The authors are Economic Affairs Officers in the Financing for Development Office of the United Nations Department of Economic and Social Affairs. They would like to thank Michael Lennard, Alex Cobham, Attiya Waris Shari Spiegel and participants of an Inter-agency Task Force on Financing for Development technical meeting on illicit financial flows for their comments. All remaining errors, omissions and other shortcomings are the sole responsibility of the authors. The views expressed in this paper should not be construed as reflecting the view of the Financing for Development Office, UN DESA, or the United Nations. Comments are encouraged and should be sent to chowla@un.org and falcao@un.org.

[2] A/RES/69/313

The objective of this paper is to reflect some of the definitional proposals that have been put forward in the past, and to initiate a discussion as to what a modern concept of IFFs could look like. This paper builds on previous work conducted within the UN System, particularly a 2013 background paper by Ilka Ritter written for the UN Task Team Working Group on Sustainable Development Financing[3]. It proceeds in section two to review the definitions of IFFs already developed in the academic and official literature. Section three discusses the classification of tax avoidance activities given definitions of illicitness and illegality in relation to taxation. Section four provides some concluding remarks.

2. Definitions in the literature

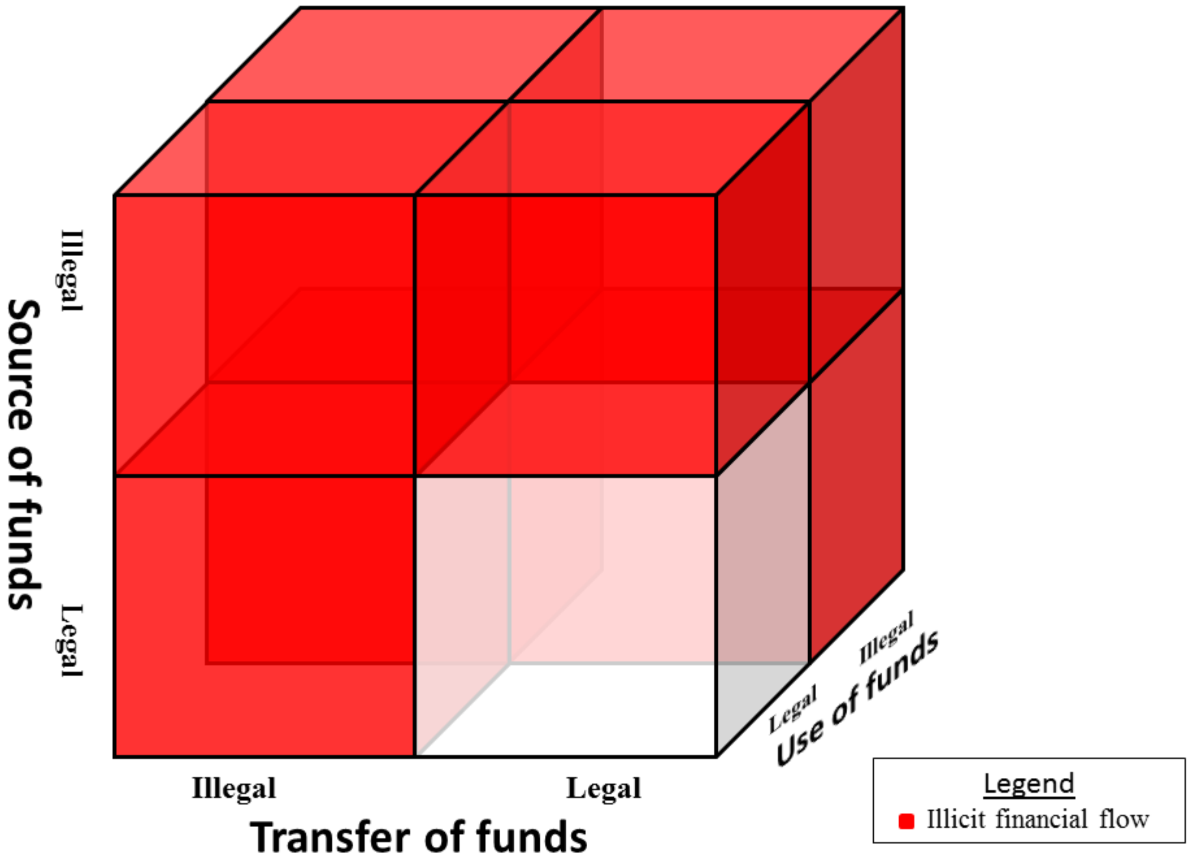
Illicit finance

In order to conceptualize IFFs, one must first put it into the wider concept of illicit financing. Illicit finance is the wider genre of which IFF is the species. Illicit finance thus involved both national and cross border financing of illicit activities.

Illicit financial flows are the subset of illicit finance that crosses borders. The scope of all illicit finance will clearly be larger than the scope of illicit financial flow, as not all illicit finance will cross borders. Domestic tax evasion, criminal activity and corruption are significant and impact on the ability of countries to raise the finance needed to investment in sustainable development. Policy recommendations for tackling purely domestic illicit finance will vary by country and will be within the competence of national governments.

[3] More about the UN Task Team is available at https://sustainabledevelopment.un.org/sids/index.php?menu=1558. The paper was revised by the author and published externally as: Ritter, I (2015) Illicit financial flows: an analysis and some initial policy proposals, Friedrich Ebert Stiftung, http://library.fes.de/pdf-files/managerkreis/11487.pdf.

Figure 1: Three-dimensional rendering of a common IFF definition



Source: Authors' elaboration

Given the rapid advance of globalisation and the growing ease with which individuals and corporations can transact across borders, the share of illicit finance with a cross-border component, commonly referred to as an IFF, is becoming more important. For IFFs, international cooperation among governments becomes important and decision-making becomes more difficult, to the extent normative rules are issued across multiple venues with different membership and levels of exclusivity. Bilateral agreements and cooperation as well as multilateral instruments are all important mechanisms that must be considered in order to provide a greater level of coordination amongst the different institutional players.

Illicit financial flows

The objective of this section is to provide a literature review of the definitions which have been proposed in the past for illicit financial flows, and identify the points of convergence.

The main organs of the United Nations have several times considered the topic of illicit financial flows, but have never agreed on a definition of the term. In the 2010 Salvador Declaration on Comprehensive Strategies for Global Challenges: Crime Prevention and Criminal Justice Systems and Their Development in a Changing World, Member States called for: "developing strategies or policies to combat illicit capital flows and to curb the harmful effects of jurisdictions and territories uncooperative in tax matters."[4] This gave rise to resolutions in the Economic and Social Council in 2011[5] and General Assembly in 2012[6] which make reference to "illicit financial flows" but usually with further narrowing of the concept when discussing the substance, for example: "to prevent, detect and deter illicit financial flows originating from transnational organized crime".

In the United Nations "Coherent Policies for Combatting Illicit Financial Flows" ("UN 2016 (1)"),[7] the first footnote mentioned that:

> The term "illicit financial flows" (IFFs) is not defined in the international normative framework. For the purposes of this paper, IFFs are defined broadly as all cross-border financial transfers, which contravene national or international laws. This wide category encompasses several different types of financial transfers, made for different reasons, including: funds with criminal origin, such as the proceeds of crime (for example tax evasion, money laundering, fraud and corruption); funds with a criminal destination, such as bribery, terrorist financing or conflict financing; transfers to, by, or for, entities subject to financial sanctions under UN Security Council Resolutions such as 1267 (1999) and its successor resolutions (e.g. Al Qaida and other terrorist organisations); and transfers that seek to evade anti-money laundering/counter-terrorist financing measures[8] or other legal requirements (such as transparency or capital controls).

The definition suggests the involvement of a variety of actors across different sectors. It deals with illegal action which results in criminal activity. The examples used in this definition clearly signal the need for a typified criminal conduct in order for there to be an illicit financial flow. The action must contravene national or international law, but the result of the action can have an impact on international law, tax law, public policy and the regulation of financial services. The consequences are far reaching and impact, to a certain extent, the sovereignty of States.

---

4 A/RES/65/230

5 E/RES/2011/32

6 A/RES/66/177

7 United Nations, *Coherent Policies for Combatting Illicit Financial Flows,* United Nations Office on Drugs and Crime (UNODC) and Organization for Economic Co-Operation and Development (OECD), Issue Brief Series from the Inter-Agency Task Force on Financing for Development, July 2016.

8 According to the IMF, Money Laundering "requires an underlying, primary, profitmaking crime (such as corruption, drug trafficking, market manipulation, fraud, tax evasion), along with the intent to conceal the proceeds of the crime or to further the criminal enterprise. These activities generate financial flows that involve the diversion of resources away from economically and socially productive uses—and these diversions can have negative impacts on the financial sector and external stability of member states. They also have a corrosive, corrupting effect on society and the economic system as a whole." According to the IMF, money laundering and financing terrorism are financial crimes with economic effects. As per IMF, Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT), website, available at: http://www.imf.org/external/np/leg/amlcft/eng/.

The World Bank has recently stated that the concept of IFFs:

> "Now generally refers to cross-border movement of capital associated with illegal activity or more explicitly, money that is illegally earned, transferred or used that crosses borders.
>
> This falls into three main areas:
>
> - The acts themselves are illegal (e.g., corruption, tax evasion); or
> - The funds are the results of illegal acts (e.g., smuggling and tracking in minerals, wildlife, drugs, and people); or
> - The funds are used for illegal purposes (e.g., financing of organized crime)." (WB, 2016)[9]

In 2015 the OECD produced a thematic module on illicit financial flows[10] which proposed the following definition:

> "Illicit financial flows (IFFs) means all cross-border financial transfers which contravene national or international laws. This is a wide category which encompasses several different types of financial transfers, made for different of reasons. It can include:
>
> - Funds with criminal origin, such as the proceeds of crime (including corruption);
> - Funds with a criminal destination, such as bribery, terrorist financing or conflict financing;
> - Funds associated with tax evasion;
> - Transfers to, by, or for, entities subject to financial sanctions; and
> - Transfers which seek to evade anti-money laundering /counter-terrorist financing measures or other legal requirements (such as transparency or capital controls)." (OECD, 2015)

The OECD had already written about *Illicit Financial Flows from Developing Countries* in 2014.[11] In that report, it attempted to define illicit financial flows through its constituting activities. The focus of the report was on developing countries and there was a strong emphasis on corrupt practices occurring in developing countries and capital flight initiated by members of the public administration. In spite of that, the definition adopted in the report was in line with the definitions provided in other institutional documents. According to the report:

> "There are various definitions of illicit financial flows, but essentially they are generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws.

[9] World Bank, *Illicit Financial Flows,* April 14, 2016, available at: http://www.worldbank.org/en/topic/financialmarketintegrity/brief/illicitfinancialflowsiffs.

[10] OECD, *Policy Coherence for Sustainable Development (PCSD)*, Thematic Module on Illicit Financial Flows, Workshop, 2015, pg. 3.

[11] OECD, *Illicit Financial Flows from Developing Countries: Measuring OECD Reponses,* 2014, pg. 16.

> Current literature on this issue suggests that illicit financial flows generally involve the following practices: money laundering, bribery by international companies and tax evasion, trade mispricing.
>
> These categories, however, do not tell us anything about the source or origin of such flows. They may have arisen from illegal or corrupt practices such as smuggling, fraud or counterfeiting; or the source of funds may be legal, but their transfer may be illegal, such as in the case of tax evasion by individuals and companies. Nor do they tell us about their intended use. They may be intended for other illegal activities, such as terrorist financing or bribery, or for legal consumption of goods.
>
> In practice, illicit financial flows range from something as simple as a private individual transfer of funds into private accounts abroad without having paid taxes, to highly complex schemes involving criminal networks that set up multi-layered multi-jurisdictional structures to hide ownership.
>
> In the limited literature on this phenomenon, most attention has been given to outflows of corrupt profits, particularly those of kleptocrats such as Sani Abacha (Nigeria), Valdimiro Montesinos (Peru) and Ferdinand Marcos (Philippines).
>
> (…)
>
> Much less is known about the outflows associated with tax evasion, perhaps the most ubiquitous of the sources of illicit financial flows. Again, the purpose of moving the money out of the country illicitly may be protective; the domestic tax collection agency may improve its monitoring efficiency; assets held outside the country are harder to trace."

As with the previous definition, the crux of this explanation relies on the "contravention of national and international law." The definition and the examples cited rely on the occurrence of some form of criminal or illegal activity.

In a previous document from 2013, the OECD characterized IFFs as:

> "a set of methods and practices aimed at transferring financial capital out of a country in contravention of national or international laws. In practice an 'illicit financial flow' ranges from something as simple as a private individual transferring funds into his/her account abroad without having paid taxes on the funds, to highly complex money laundering schemes involving criminal networks setting up multi-layered multi-jurisdictional structures to hide ownership and transfer stolen funds." (OECD, 2013).[12]

[12] OECD (2013), *Measuring OECD responses to illicit financial flows*, available from: http://www.oecd.org/dac/SLM2013_issue%20paper%20illicit%20flows.pdf

This definition focused on the transfer of funds and on the recipient countries. This is in line with recent efforts by the OECD's Centre for Tax Policy and Administration (CTPA) addressing tax-related IFFs through a project on base erosion and profit shifting (BEPS). It is interesting to note, however, that the terms tax avoidance and evasion were not considered to be consistent with the definition of illicit financial flow. The year of the publication marked the beginning of the BEPS work programme and the definition is a reflection of the fact that countries were not eager to see the "criminalization" of tax avoidance operations.

The definition proposed on the second part of the paragraph draws attention to the ownership of corporate structures, but it mentions the need for some form of criminal activity in order to be considered an illicit financial flow.

The issue of the repatriation of stolen assets has also increased in prominence and been discussed in connection with the topic of IFFs. One of the elements of an illicit flow is that it may result in a misplaced asset in a third jurisdiction. Although repatriation of stolen assets is in itself a different subject matter, some have supported that a fully encompassing definition of IFFs should make reference to the treatment of stolen assets deriving from that illicit flow.[13]

Within the European Union, the notion of IFFs is not formally recognized. There are two separate terms that cover the similar material scope of IFFs. These are artificial capital flows and financial crimes. The first term appears to cover aggressive tax planning, whereas the latter covers money laundering and terrorist financing.[14]

More recently in 2016, the United Nations reiterated that:

> "There is no agreed definition of the concept of illicit financial flows (IFFs), but it is generally used to convey three different sources of IFFs: the proceeds of commercial tax evasion, revenues from criminal activities, and public corruption." (UN, 2016(2))[15]

It is therefore clear from all of the above that the concept of IFFs tends to be reduced to its elements. The uncontested characteristic of those definitions is the illegality associated with the flow. In order to meet the definition, either the act must be illegal, or the funds must have resulted from the pursuit of illegal or criminal activity.

[13] The StAR (Stolen Asset Recovery) initiative is a partnership between the World Bank Group and the United Nations Office on Drugs and Crime (UNODC) that supports international efforts to end safe havens for corrupt funds. StAR works with developing countries and financial centres to prevent the laundering of the proceeds of corruption and to facilitate more systematic and timely return of stolen assets. The practicalities, technical expertise and costs associated with such efforts however mean that to-date the return of stolen assets to their countries of origin has been fairly limited. See in this respect, http://star.worldbank.org/star/.

[14] European Union, *Promoting Good Tax-Governance in Third-Countries: The Role of the EU*, Directorate General for Internal Policies, Economic and Monetary Affairs, 2015, pg. 10.

[15] United Nations, *World Economic Situation and Prospects 2016, (*UN 2016), footnote 19, pg. 103.

The 2015 report of the High Level Panel on Illicit Financial Flows from Africa[16] takes a different approach to many of the above papers. The paper formally defines IFFs as "money illegally earned, transferred or used" but goes on to include tax avoidance as a type of IFF:

"IFFs originating from commercial activities have several purposes, including hiding wealth, evading or aggressively avoiding tax, and dodging customs duties and domestic levies. Some of these activities, especially those linked to taxation, are described from a more technical perspective as 'base erosion and profit shifting' especially within the ambit of the OECD. The various means by which IFFs take place in Africa include abusive transfer pricing, trade mispricing, misinvoicing of services and intangibles and using unequal contracts, all for purposes of tax evasion, aggressive tax avoidance and illegal export of foreign exchange."[17]

The European Parliament[18] has also sought to bring the tax avoidance aspect into the definition of IFFs within the European Community . For example, a June 2015 report on tax avoidance and tax evasion as challenges for governance, social protection and development in developing countries, passed in the run-up to the Third International Conference on Financing for Development in Addis Ababa, defines IFFs as "all unrecorded private financial outflows involving capital that is illegally earned, transferred or utilized", but then goes on to say that they "typically originate from tax evasion and avoidance activities, such as abusive transfer pricing, against the principle that taxes should be paid where profits have been generated ."[19]

Similarly civil society publications have also taken a wider perspective on IFFs. For example, the discussion by Alex Cobham, then at the Center for Global Development and writing for the Copenhagen Consensus Center, defines IFFs to have four components: market and/or regulatory abuse, tax abuse, abuse of power, and the laundering of the proceeds of crime.[20] It describes tax abuse as "including both that by individuals and companies related to hidden assets and income streams, and that of multinational groups related to profit shifting." Similar definitions that discuss tax avoidance as being against the spirit of the law can be found for example in discussions on illicit flows and gender[21], illicit

[16] The report was commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development and published by the United Nations Economic Commission for Africa in February 2015. It can be found at http://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf.

[17] High Level Panel on Illicit Financial Flows from Africa (2015), p.24.

[18] The European Parliament is not a regulating body. The normative body within the European Community is the Commission. The Parliament makes proposals for modification of the European legislation, some of which are accepted by the Commission and others which are not.

[19] European Parliament (2015) "Report on tax avoidance and tax evasion as challenges for governance, social protection and development in developing countries", 2015/2058(INI), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2015-0184+0+DOC+PDF+V0//EN.

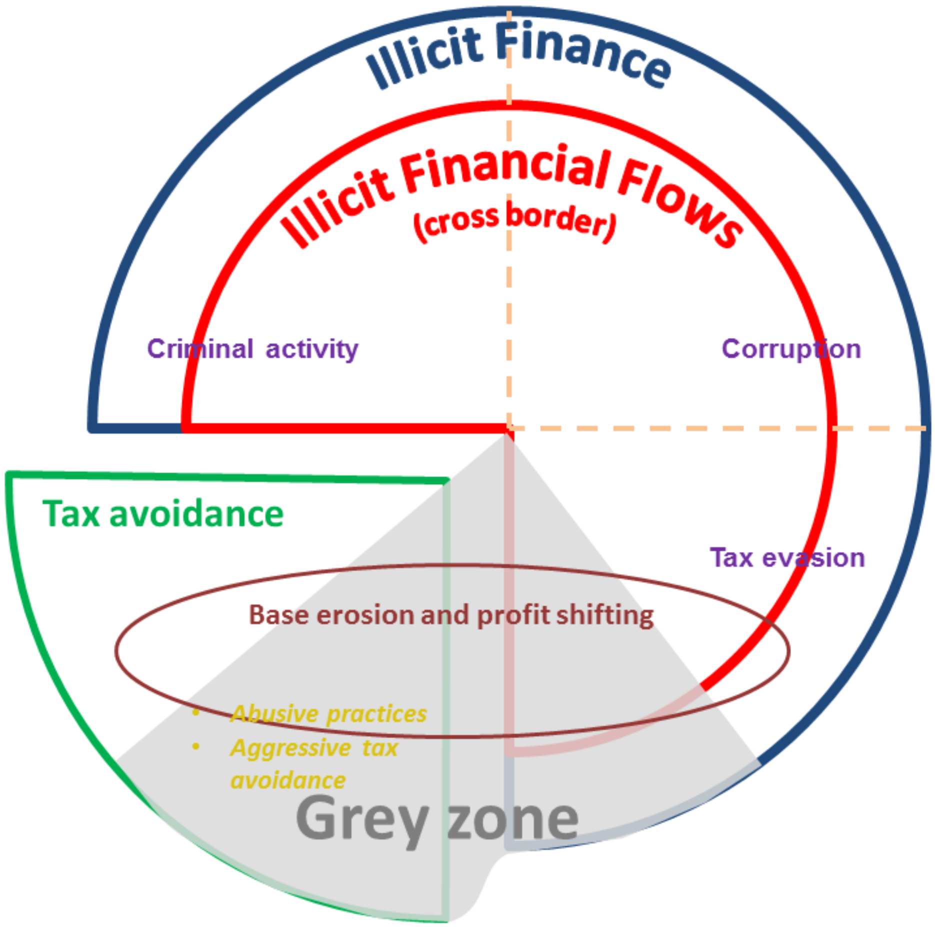
[20] Cobham, Alex (2015) "Illicit Financial Flows Assessment Paper: Benefits and Costs of the IFF Targets for the Post-2015 Development Agenda", Copenhagen Consensus Center, 4 August 2015, http://www.copenhagenconsensus.com/sites/default/files/iff_assessment_-_cobham_0.pdf.

[21] Grondona, Veronica, Nicole Bidegain Ponte and Corina Rodríguez Enriquez (2016) "Curbing Illicit Financial Flows and dismantling secrecy jurisdictions to advance women's human rights", http://www.taxjustice.net/wp-content/uploads/2013/04/IFF_Gender-Grondona_Bidegain_Rodriguez.pdf.

financial flows in Africa[22], and illicit flows in Argentina[23]. However, civil society is diverse, with some sticking to a definition that only includes illegal activities. For example, Global Financial Integrity, which produces widely cited estimates of IFFs, "classifies such flows as illicit if the funds crossing borders are illegally earned, transferred, and/or utilized".[24]

[22] Bokosi, Fanwell Kenala and Tafadzwa Chikumbu (2015) "Tackling Illicit Financial Flows From and Within Africa", African Civil Society Circle, March 2015, http://www.francophonie.org/IMG/pdf/afrodad.pdf.
[23] Rua, Magdalena Belén (2014) "Fuga De Capitales v. Argentina, 2014: Los 'Facilitadores' y Sus Modos de Acción", CEFID-AR, Working paper 60, August 2014, http://www.cefid-ar.org.ar/documentos/DT_60-Version_web..pdf.
[24] Kar, Dev and Joseph Spanjers (2015) "Illicit Financial Flows from Developing Countries: 2004-2013", Global Financial Integrity, December 2015, http://www.gfintegrity.org/wp-content/uploads/2015/12/IFF-Update_2015-Final-1.pdf.

Figure 2: A common working definition of IFFs



Source: Authors' elaboration

Notes:

- *The diagram is not scaled by the size or value of transactions.*
- *Tax evasion and tax avoidance can be conducted both by individuals and by enterprises. In practice individuals involved in evasion and avoidance often use shell corporations in their arrangements.*

Most definitions highlight the need for there to be a cross border transfer of financial capital that contravenes national or international law. Moreover, the funds must have either a criminal origin or a criminal destination; or be made by, to or for entities subject to financial sanctions; or seek to evade anti-money-laundering measures. As shown in figure 1, there is a large grey zone corresponding to the absence of clear defining lines between tax avoidance and tax evasion. Some commentators find the drawing of a distinction between the two practices as arbitrary, and there are problems with classifying some transaction as potentially abusive or aggressive. Section three discusses the classification of tax avoidance in more detail.

The activities most commonly associated with illicit financial flows include: Tax evasion,[25] money laundering,[26] corruption,[27] bribery[28] trade mispricing,[29] and terrorist financing.[30] The least cited examples are: fraud,[31] conflict financing,[32] counter-terrorist financing,[33] smuggling,[34] trafficking drugs, people or wildlife,[35] financing of organized crime,[36] counterfeiting[37] and tax avoidance.[38]

The most disputed aspect of the definition currently (and in face of the ongoing discussion on base eroding and profit shifting practices), is whether the term should also cover tax avoidance techniques. The inclusion of tax avoidance in the term IFFs is discussed further in the next section.

International instruments establishing legal obligations

At UN level, the key instruments which establish legal obligations in the field of illicit flows are:

- *United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances 1988* (Vienna Convention). This includes provisions on money laundering and international cooperation.
- *United Nations Convention against Transnational Organized Crime 2000* (Palermo Convention). This requires countries to criminalise money laundering, and includes frameworks for extradition, mutual legal assistance and law enforcement cooperation.
- *International Convention for the Suppression of the Financing of Terrorism 1999* – requires states to criminalise the financing of terrorism, and adopt powers to freeze and seize funds intended to be used for terrorist activities.
- *United Nations Convention against Corruption 2003* (Merida Convention) – requires measures to prevent and criminalise corruption, provide international cooperation and asset recovery on corruption cases.
- In addition a number of *UN Security Council Resolutions* have introduced measures to counter illicit financial flows, in particular by establishing targeted financial sanctions regimes applied to Al Qaida and other terrorist groups.

Additionally, the Financial Action Task Force (FATF) was created as an intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing, which are two of the crimes covered within the concept of illicit financial flows. as will be demonstrated in the next section.

[25] UN 2016 (1), UN 2016 (2), WB 2016, OECD 2015, OECD 2014 and OECD 2013.
[26] UN 2016 (1), OECD 2015, OECD 2014 and OECD 2013.
[27] UN 2016 (1), UN 2016 (2), WB 2016, and OECD 2015.
[28] UN 2016 (1), OECD 2015, and OECD 2014.
[29] OECD 2014.
[30] UN 2016 (1), OECD 2015, and OECD 2014.
[31] UN 2016 (1), and OECD 2014
[32] UN 2016 (1), and OECD 2015.
[33] UN 2016 (1), and OECD 2015.
[34] WB 2016 and OECD 2014.
[35] WB 2016.
[36] WB 2016.
[37] OECD 2014.
[38] WB 2016 and OECD 2013 (indirect mention)

3. Illicitness, illegality, and taxation

As section two made clear, despite the lack of official agreement on the definition of IFFs, the majority of working definitions used amongst international institutions and their staff are highly aligned. Yet this alignment belies the wider sentiment when considering civil society actors and public perception particularly in relation to the inclusion of tax avoidance in the term IFFs.

A central principle is that taxes should be paid to the Governments of countries where economic activity occurs and value is created. This was formulated and endorsed by G20 leaders in 2013 as "profits should be taxed where economic activities deriving the profits are performed and where value is created."[39] The G20 endorsement drove the base erosion and profit shifting (BEPS) project at the OECD, which finally largely concluded in 2015, pending some further work on some areas. The G20's statement led to universal international endorsement, in the Addis Ababa Action Agenda, of the statement "We will make sure that all companies, including multinationals, pay taxes to the Governments of countries where economic activity occurs and value is created, in accordance with national and international laws and policies."

In many instances tax avoidance is generally referred to as the practice whereby a taxpayer takes advantage of a gap in the tax legislation, or a mismatch between the law of two countries, and uses that opportunity in order to reduce his domestic tax burden, by either reclassifying income or re-allocating it to a different jurisdiction. It therefore tends to refer to a legal arrangement used to lower a taxpayer's tax liability by (i) contradicting the original intent of the law; (ii) benefitting from a gap in the tax legislation; (iii) making use of a mismatch in the legislation of two or more countries; (iv) interposing legal entities in low tax jurisdictions with the sole objective of obtaining a tax reduction. That is provided the domestic law of the State does not capture the practice and cover it through the anti-avoidance provision. To the extent a practice is covered in the anti-avoidance legislation, it becomes illegal and unauthorized under the legal framework of the jurisdiction concerned.

Tax avoidance tends to be used to reference legal tax planning and is a practice that has often relied on tax competition between States. A country's openness to tax planning opportunities may be related to its desire to attract foreign direct investment. While tax avoidance is not regarded to be illegal, it is considered to be an abusive tax practice to the extent it goes against the original intent of the legislator.[40] A multinational enterprise that has avoided paying taxes by making use of a mismatch between the rules of two (or more) countries' tax rules resulting in double non-taxation or unduly low taxation, may not have committed any illegal act. The OECD has, through the BEPS program, increasingly referred to such transactions as abusive transactions (tax arbitrage is in fact covered by BEPS Action Plan 2). However abusive, the practice may not yet in itself be illegal, a pre-requirement for consideration as an illicit financial flow under the common definition described in section two.

The World Bank has recently written:

---

[39] G20 St Petersburg Summit Declaration

[40] Christensen, John (2009). Africa's Bane: Tax Havens, Capital Flight and the Corruption Interface, Working Paper 1/2009, Real Instituto Elcano, 2009, available from http://www.realinstitutoelcano.org/wps/portal/rielcano_eng/Content?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/sub-saharan+africa/dt1-2009/

> "7. **There is an ongoing debate on which commercial activities should be considered as part of IFFs**. What constitutes IFFs within the context of international trade, especially in relation to tax avoidance and tax fraud, is still being debated. For example, tax can be avoided through activities such as legal tax planning and optimization. This is different than IFFs that arise through the fraudulent mispricing of goods traded between independent parties, illegal transfer pricing within a multi-national corporation, or fictitious transactions.
>
> 8. **The WBG understands the term 'IFFs' to cover both the flow of illicit funds and assets across borders and the underlying activities that generate the flows**. Money and activities that have a clear connection with illegality – corruption, illegal natural resource exploitation, smuggling and trafficking, money laundering, tax evasion and fraud in international trade – fall under IFFs. Tax avoidance activities, such as legal tax planning and optimization, do not belong to IFFs. The WBG is committed to addressing the tax avoidance issue, and this is dealt with primarily through the WBG's work on international tax policy and domestic resource mobilization. The principle adopted by the WBG is that cross-border movement of financial assets are considered illicit only when they are associated with activities that are deemed to be illegal in the local jurisdiction."[41]

A question this paper wishes to address is whether the term IFF should be considered in a broader sense. Activities might be any combination of illegal and/or immoral. The more conservative approach, which has been adopted by most intergovernmental institutions, has been to only include within IFFs those activities which are illegal disregarding other considerations. This section discusses three complications with excluding tax avoidance from the definitions of IFFs: the role of fairness, the conflict between economic terms and legal concepts, and the administrative and legal capacity constraints in many countries.

Fairness and illicitness

As mentioned above, there are questions about whether "illicit" is synonymous with "illegal" and the implications this has on efforts to measure and/or reduce IFFs. Yet, the importance of fairness in taxation has been a continued refrain in both political discourse and in intergovernmental agreements. A wide literature has been published on the importance of trust as one of the determinants of the level of tax compliance.[42] This trust in the tax authorities relates very strongly the perceived fairness of the tax system. While legal and judicial systems can sometimes be characterised as dealing with questions of fact in order to reach findings of guilt or innocence, the entire system is predicated on generating fair outcomes. Elected legislatures, in theory, write laws to create fair systems that are supported by the majority of people, while still respecting the rights of the minority.

It also is immediately clear that linguistically the term "illicit" is not restricted to a definition about legality. The Oxford English Dictionary includes a definition of "improper, irregular; esp. not sanctioned

---

41 World Bank, *The World Bank Group's Response to Illicit Financial Flows: A Stocktaking,* March 22, 2016, pg. 2.
42 See for example the literature reviewed and the theoretical framework elaborated in: Kirchler, Erich, Erik Hoelzl, and Ingrid Wahl. "Enforced versus voluntary tax compliance: The 'slippery slope' framework." *Journal of Economic Psychology* 29.2 (2008): 210-225.

by law, rule, **or custom**" [emphasis added][43]. Merriam-Webster includes a definition of "involving activities that are not considered morally acceptable".[44] The same dual usage can be seen in French, with Larousse indicating "that which is forbidden by morality or law".[45] The papers in the World Bank staff-edited volume on IFFs also make this point, with Everest-Phillips specifying that an illegal activity is one prohibited by law, whereas an illicit act is one which is morally detrimental to society or to a State and its governing body.[46]

Morality plainly plays a part in the popular discourse and everyday public understanding of the laws. Policy makers, particularly in political systems that afford citizens the chance to vote for elected representatives, are considered to have a duty to reflect the wishes of those they represent. Political representatives including ministers and legislators are not necessarily economists or accountants; though in some jurisdictions they may more frequently be trained lawyers.[47] It is impossible to know precisely their intent when using the term themselves and when accepting its use in intergovernmental agreements such as the 2030 Agenda and the Addis Ababa Action Agenda, therefore they could have been envisaging a broader interpretation than that related to strict legality.

However, the distinction is more than a semantic one based on the dictionary definition of word illicit. Van Schendel and Abraham[48] make two critical points that bear repeating at length:

> "Both law and crime emerge from historical and ongoing struggles over legitimacy, in the course of which powerful groups succeed in delegitimizing and criminalizing certain practices. But their success always falls short of either winning full popular consent or fully suppressing criminalized practices. As a result, licit and illicit practices coexist in social life and are together imbricated in state processes. Students of illicitness must start from the assumptions that states cannot simply be equated with law and order, and that illicit practices are necessarily part of any state." (p. 7)
>
> "At the global scale … because of inconsistent definitions of crime across different jurisdictions and the absence of a sovereign international authority, it may not always be possible to attribute a single category of 'legal' or 'illegal' to practices and flows that cross

[43] http://www.oed.com/view/Entry/91445

[44] http://www.merriam-webster.com/dictionary/illicit

[45] In French "Qui est défendu par la morale ou par la loi", http://larousse.fr/dictionnaires/francais/illicite/41546

[46] M. Everest-Phillips, *The Political Economy of Controlling Tax Evasion and Illicit Flows, in Draining Development? Controlling Flows of Illicit Funds from Developing Countries World Bank Publication, Chapter 3, (Peter Reuter, editor), 2012, pg. 71, available at: https://openknowledge.worldbank.org/bitstream/handle/10986/2242/668150PUB0EPI0067848B09780821388693.pdf.*

[47] For example in a survey of the 114th US Congress, of the 535 members in both the House of Representatives and the Senate, only 10 listed themselves as accountants, and no mentions were made of being an economist, while 202 listed their previous profession as "law". See Manning (2016) "Membership of the 114th Congress: A Profile", Congressional Research Service, CRS Report R43869, retrieved from https://www.fas.org/sgp/crs/misc/R43869.pdf.

[48] Van Schendel, Willem, and Itty Abraham. "Introduction: The making of illicitness." Illicit Flows and Criminal Things: States, Borders, and the Other Side of Globalization (2005): 1-37.

> national boundaries. When we shift our nomenclature to the distinction between 'licit' and 'illicit,' we refer less to the letter of the law than to social perceptions of activities defined as criminal." (p. 18)

Social perceptions in relation to tax avoidance activities are also likely to have changed over the last 10 years. This is in part due to the response to the 2008 financial crisis, with many States curtailing expenditure while increasing taxation and citizens feeling that the corresponding reduction in public services and higher tax incidence for ordinary citizens unjust.[49] However, the balance of public opinion varies by country, and likely over time, with some contemporaneous cross-country surveys showing big differences even across relatively similar countries in Europe.[50]

Economic vs. legal practice

A larger complication with the conception of IFFs being only illegal is that of how the statistics on IFFs are recorded by the different institutional stakeholders. If one accepts the assumption that illicitness is synonymous with illegality, there may, counterintuitively, not be much volume of IFFs or be need to estimate IFFs. This is because in most legal systems there is a presumption of innocence and illegality can only be proven after the completion of a formal process.

The presumption of innocence is a long-standing legal practice that has been dated back to Roman imperial era and is also described in Islamic jurisprudence. This principle is actually enshrined in the UN Declaration of Human Rights, where article 11 states: "Everyone charged with a penal offence has the right to be presumed innocent until proved guilty according to law in a public trial at which he has had all the guarantees necessary for his defense."[51] This principle is a cornerstone of legal protections of people against arbitrary detention or punishment and constitutes a fundamental and inviolable right.

Using a definition of IFFs that equates illicitness to illegality means that activities cannot legally be construed as tax evasion unless they have been found to be so by court or competent authority. As a result the estimated massive scale of international crime and the suspected large volumes of corruption cannot formally be considered illicit until after due process. Then determining the size of IFFs would simply be a matter of summing the value of activities that have had such guilty verdicts.

Of course it would be farcical to make such a calculation and pass this figure off as the total size of IFFs. It is well understood that criminal activity, for example manufacture and sale of banned narcotics, is widespread and ongoing. Similarly some economic studies for estimation of tax avoidance and tax

[49] See for example official survey data from the UK at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/500203/Exploring_public_attitude_to_tax_avoidance_in_2015.pdf; public survey data from the USA at http://www.people-press.org/2015/03/19/federal-tax-system-seen-in-need-of-overhaul/;

[50] https://yougov.co.uk/news/2013/06/29/tax-avoidance-acceptable-when-legal/

[51] http://www.un.org/en/universal-declaration-human-rights/index.html

evasion show that there are widespread discrepancies between expected tax revenue, assuming no base erosion or profit shifting, and reality and that would point out to an institutional problem.[52]

An additional complication in the realm of measuring tax avoidance and tax evasion is that administrative challenges to the tax practices of individuals and corporate entities do not always result in civil liability and only very rarely result in criminal legal proceedings. For example, the United States Internal Revenue Service estimated that its annual average gross tax gap for 2008-2010 was $458 billion, with a further $52 billion paid through enforcement and late payments, resulting in a net tax gap of $406 billion.[53] In 2010, the IRS identified almost 8 million new delinquent accounts and launched 2.27 million new investigations and served over 1 million federal tax liens. This involved 37 million civil penalties valued at $28 billion, far below the estimated tax gap and only about half of the actual $52 billion recovered. In the same year the IRS only initiated 4,706 criminal investigations, while securing 2,184 criminal convictions.[54]

The practice of estimating crime data is somewhat analogous, but there are important differences. Crime estimates are prepared before due process is complete, and are thus based on activity that is not formally found to be illegal. It is increasingly common that crime data is based on either official records of crime or victimization surveys.[55] However, United Nations guidance on the development of systems of criminal justice statistics notes that "official data on crime are fraught with systematic and random error. These data give account only of those crimes that are reported to the police and recorded by the authorities, thus representing an incomplete account of crime committed in society."[56] In the case of IFFs the lack of an individual victim to report the activity or to complete a survey, provide an important difference between the basis of criminal justice statistics and the kind of estimates of IFFs that could be made with a strict definition IFFs referring only to illegality.

Administrative and legal capacity constraints

One further complication in the consideration of illicitness versus illegality is the variability of administrative and enforcement capacity. Even in some developed economies, the reduction in budgets for tax administrations has led to worries about the efficiency and comprehensiveness of enforcement. Yet, the skills and capacity gaps are large in the tax authorities of many developing countries, though not uniformly so.[57] Developing countries, particularly smaller ones, have fewer administrative staff, lower

[52] See for example: OECD (2015) Measuring and Monitoring BEPS, Action 11: 2015 Final Report; and Crivelli, Ernesto, Ruud De Mooij and Michael Keen (2015) "Base Erosion, Profit Shifting and Developing Countries", IMF Working Paper WP/15/118.
[53] IRS (2016) Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008–2010, https://www.irs.gov/pub/irs-soi/p1415.pdf.
[54] IRS (2011) Internal Revenue Service Data Book 2010, https://www.irs.gov/pub/irs-soi/10databk.pdf.
[55] UNODC (2016) "Compiling and comparing International Crime Statistics", available at https://www.unodc.org/unodc/en/data-and-analysis/Compiling-and-comparing-International-Crime-Statistics.html
[56] United Nations (2003) Manual for the Development of a System of Criminal Justice Statistics, ST/ESA/STAT/SER. F/89.
[57] IMF, OECD, UN and World Bank (2011) "Supporting the Development of More Effective Tax Systems: A Report to the G-20 Development Working Group".

levels of digitization and information technology resources, and potentially less experience in auditing complex financial transactions.

An additional further constraint is that some smaller or developing countries, particularly smaller or less well-resourced ones, may have outdated, incomplete or vague legal codes. In such cases of legal ambiguity, which are more likely to be found in the legislation of smaller or poorer countries, it is not clear that all tax practices, even abusive or aggressive tactics that are manifestly unfair or that result in large profit shifting, could be considered illegal and thus considered part of IFFs in the more restrictive definition. For example, many countries in Africa do not have laws on transfer pricing, which results in transfer mispricing not being technical illegal under national legislation.[58] Countries with more capacity to negotiate with taxpayers are going to have a natural advantage over those countries with less negotiating experience.

A definition of illicitness requires authorities to prove illegality will bias findings of illicitness to countries with higher capacity tax administration and legal systems. That could lead to IFFs being considered a problem of rich countries, as quantification of IFFs based on legal judgements would naturally lean towards jurisdictions with the greatest capacity for prosecution.

Implications of these contradictions

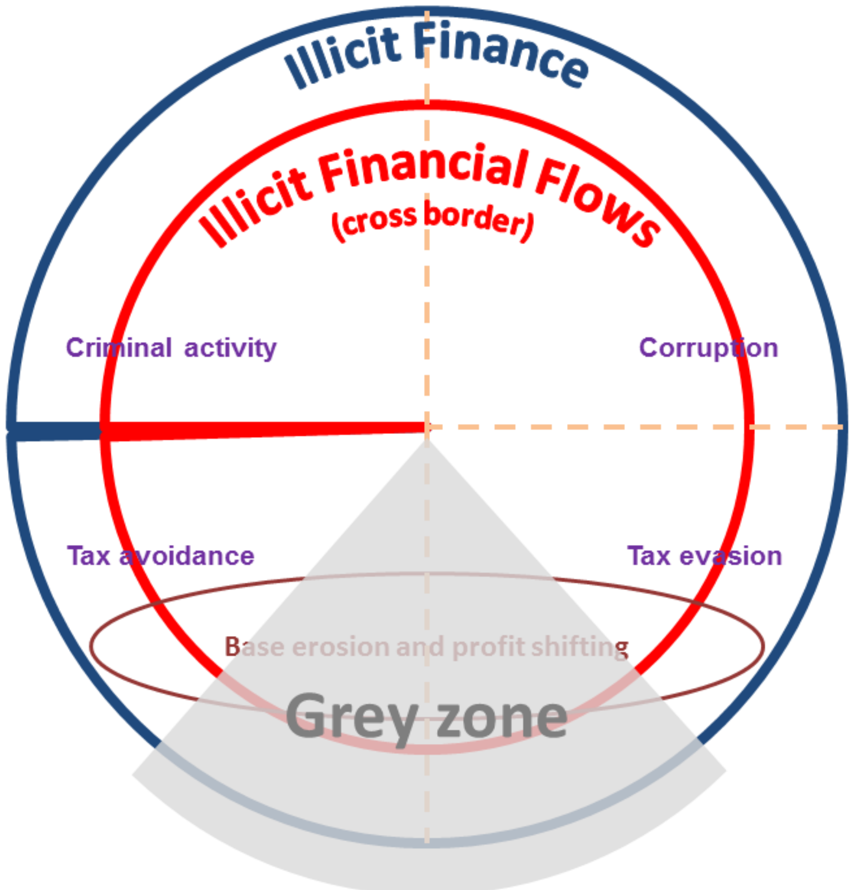
Given the above described contradictions in the term and definitions, it is clear countries should work on better common parameters in which to estimate IFFs A formal definition of IFFs might facilitate the production of better data.

Additionally, the definition or estimates of IFFs in relation to taxation might try to find a way to more closely align with the central principle of the Addis Agenda that taxation should align with economic activity and value creation. While that principle is not fully clear, such as how to weight value creation vis-à-vis economic activity, it can guide efforts to estimate IFFs. Access to sufficient country information, and greater tax transparency- would facilitate production of estimates related to tax avoidance and evasion, following some of the models pioneered by the OECD and IMF.

An alternative conception for the definition of IFFs is represented in figure 3, which includes tax avoidance as a part of IFFs. A key difference with the alternative approach would be what constitutes tax avoidance. Further work would need to be done to distinguish the legal activities that keep taxpayers compliant with tax laws, and thus not part of IFFs, and those aggressive and abusive activities which are labelled as tax avoidance and considered a part of IFFs. Checking whether the activity results in taxes being paid (or profit being declared) in a separate jurisdiction from economic activity or value creation might be used as an indicator to distinguish tax compliance from aggressive or abusive tax avoidance.

[58] Curits, A and Ogniana Todorova (2012) "Spotlight on Africa's transfer pricing landscape", PwC, available at https://www.pwc.com/gx/en/tax/transfer-pricing/management-strategy/assets/pwc-transfer-pricing-africa.pdf

Figure 3: Alternative definition of IFFs



Source: Authors' elaboration

An advantage of such an approach is that it is closer to popular perception and actual dictionary definition of the term “illicit.” The disadvantage is that this definition is not widely accepted by the existing institutional stakeholders and would probably be subjected to a higher degree of scrutiny from States and Intergovernmental organizations. It would also require an objective definition for “tax avoidance” or for “illegal and immoral action,” a term which is open to subjective assessment.

4. Conclusions

To the extent countries fail to agree on a formal definition for IFFs, the issue is likely to persist.

Two basic options are available:

1) A common denominator definition can be chosen that closely aligns with the literature review described in section two. A definition for illicit financial flows that is less contentious among international institutions would leave tax avoidance out of the working IFF definition. This would not preclude approaches to reducing tax avoidance – such as anti-avoidance rules, transparency

measures anti-BEPS measures, amongst others – nor efforts to estimate the scale and impact of tax avoidance. But it would keep any estimates separate from IFF estimates. Then some consideration would still need to be given to dealing with the contradictions described in section three.

2) A wider definition that encompasses both tax evasion and tax avoidance is used on a working basis, with clear communication that illicitness is not the same as illegality. This would not obligate any agency or Government to work or not work in a particular area, but would resolve some of the contradictions described. Efforts could be unified under a single umbrella.

An important consideration is the idea of working with a definition that meets the needs of Member States and accomplishes their goals. Either approach will find vigorous detractors among the United Nations' Member States. However, an informal agreement could avoid prolonged debates in the context of the 2030 Agenda or Addis Agenda follow-up and review process, particularly in the work of the Inter-agency Task Force for Financing for Development.