

## ***Illicit Financial Flows: Defining and Estimating Them***

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Illicit Financial Flows (IFFs or IFF) are a pervasive and growing problem for the countries of Africa. Due to their nature, the exact magnitude of IFFs are not known, but they have been estimated by the Global Financial Integrity (GFI) NPO to have averaged 25% of developing country trade in the decade 2006-2015. Although proportionately more prevalent in Sub-Saharan Africa than in North Africa, and among extractive exporters than non-extractive exporters, they nevertheless present a continental problem and one that will need to be addressed both as a developmental issue and a regulatory and governance issue. The loss to the continent in terms of capital flight is substantial, especially in the context of capital shortages in many parts of the continent.

A first step in combatting this scourge is to understand its nature. This involves defining what financial flows qualify as 'illicit' before addressing the issues around attempted identification and estimation of these flows. By their very nature, illicit financial flows defy conventional means of measurement. Therefore, before one can attempt to understand (or address) the magnitude of the problem relating to these flows, various measurement and estimation techniques need to be used in order to build a data set. This will be tackled after first overviewing the definitional aspects.

IFFs are generally defined as illegal financial flows across sovereign borders, however the definition is sometimes broadened to include activities that violate the spirit of the law. IFFs have various components, including:

- Trade mispricing/misinvoicing and transfer pricing: Trade mispricing is when unrelated ('arms-length') entities conduct trade at prices that deviate significantly from market prices, in order to shift profits either away or towards the seller. This misinvoicing (of goods at prices that are either above or below the fair market price) leads to capital transfers either out of (outflows) or into (inflows) a country.
- Transfer pricing is when a multinational corporation conducts trade with its own units across borders at prices significantly different from market prices, in order to shift resources.

Other forms (or sources) of IFFs include money laundering, corruption, financing of subversion, human trafficking and commodity smuggling.



## Methodologies for estimating IFFs

Various techniques have been developed in order to attempt to estimate IFFs. These techniques and approaches lead to estimates of varying accuracy and so are sometimes given in 'high' estimates vs 'low' estimates.

The so-called 'aggregate' approach to measurement is most often followed by researchers and makes use of aggregate bilateral trade data. The two sources of this data are the IMF Direction of Trade Statistics (DOTS) and the United Nations Comtrade data. A notable caveat with aggregate data concerns the interpretation of discrepancies, which appear as illicit flows. It is not possible to tell whether an aggregate discrepancy in fact represents a single large illicit flow or the sum of multiple smaller price discrepancies.

IFFs are classified as either inflows or outflows, depending on whether the mispricing event results in a net financial inflow by the home (developing) country or a net financial outflow. A rigorous definition is given in a recent report by GFI<sup>1</sup>, what follows here is a verbose definition of the same concepts:

- Imports by the developing country from the trade partner, which are valued *c.i.f.* are adjusted downwards by a given factor (10%) to make them comparable with *f.o.b.* valued exports from the trade partner. This difference between these values gives the import discrepancy (ID).
- The export discrepancy (ED) is calculated similarly: the partner country's imports from the developing country are adjusted downward by the compensating factor to make them comparable with the *f.o.b.* valued exports from the developing country.

A negative value for ID indicates import under-invoicing, which is interpreted as an illicit inflow whereas a positive value indicates import over-invoicing, which is interpreted as an illicit outflow. A negative value for ED indicates export over-invoicing, which is interpreted as an illicit inflow, whereas a positive value indicates export under-invoicing, which is interpreted as an illicit outflow.

The above methods, while being the best available methods of estimating IFFs, are nonetheless *estimates* and will deviate from the true value of IFFs for several reasons. Firstly, the adjustment factors to convert *c.i.f.* to *f.o.b.* may not be entirely accurate and may quantify part of these trade margin differences as IFFs.

Secondly, the true quantum of IFFs include smuggling and criminal activities conducted off the financial grid. Also, if the trade invoices contain mispricing at both the exit and the entry ports, the extent of the deviation from market value will not be detected by the aggregate method (although the more inaccessible transactional approach will still be representative). There are also other reasons for trade mispricing that are not related to IFFs; for example, statistical errors or entrepôt trade. The latter refers to the flow of trade through intermediates, or trade hubs such as Hong Kong, Singapore and Rotterdam.

On balance and due to their nature, the limitations in estimation of IFFs should lean towards conservative rather than generous estimates of the true magnitude of the flows. This tendency towards underestimation is preferable, however, to that of overestimation. In all cases however, the inherent limitations of the estimation of IFFs should be born in mind when evaluating any quantitative study involving this data. A forthcoming tralac working paper attempts to identify the *drivers* of IFF in Africa and makes use of the approach using the aggregate DOTS data. A forthcoming tralac blog article will also take a look at the problem with a focus on some of Africa's worst IFF offenders; including South Africa, Nigeria and Zambia.

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<sup>1</sup> Global Financial Integrity. 2017. *Illicit Financial Flows to and from Developing Countries, 2005-2014*, p.41. Washington, DC. <http://bit.ly/2qYKhmT>