Accompanying note for the revised version of the Report - *Trade Misinvoicing in Primary Commodities in Developing Countries: The cases of Chile, Côte d'Ivoire, Nigeria, South Africa and Zambia*

(date of issuance: 23 December 2016)

An early version of the UNCTAD report ***Trade Misinvoicing in Primary Commodities in Developing Countries: The cases of Chile, Côte d'Ivoire, Nigeria, South Africa and Zambia*** published in July 2016 generated substantial interest and contributed to the debate on the broader issues of transparency in international trade statistics and fairness in the distribution of gains from globalization. The reactions to the report also revealed some areas of confusion in the interpretation of the results and inadequate understanding of the key concepts used in the analysis. The revised report provides a more detailed exposition of the methodology and the concepts used while further stressing the main messages from the analysis.

In the revised report, the concept of trade misinvoicing is explained in greater detail, including its origin in the literature and the estimation methodology. Trade misinvoicing consists of either perverse discrepancies or excessive normal discrepancies in partner trade statistics derived from the comparison of the value of exports as reported by the exporter to the value of imports as reported by the importer. Perverse discrepancies refer to situations where the value of imports is significantly less than the value of exports plus the cost of transport, insurance and duties. This reflects either export overinvoicing or import underinvoicing. Excessive normal discrepancies pertain to the situation where the value of imports exceeds that of exports by an amount that is substantially higher than the reasonable value of the costs of transport, insurance and duties. This situation reflects export underinvoicing or import overinvoicing. Trade misinvoicing is due to factors pertaining to the origin or the destination of trade flows or both. It is therefore not possible to assign *a priori* the respective share of responsibility on the basis of the estimates of trade misinvoicing alone.

Given that the data on the cost of transport, insurance and duties are not readily available for most countries the report follows the tradition of using 10 percent of exports as a proxy for these costs. In the case of South Africa, one of the only two African countries (the other country is Zimbabwe) that publish imports in f.o.b. and c.i.f. values, the average ratio of the two series over the 1980-2014 period, is 11 percent. Obviously this ratio is likely to vary across countries and products. Therefore if the estimates of trade misinvoicing are low, it may be argued that the discrepancies reflect the gap between the proxy and true value of c.i.f. But when the scale of the estimated trade misinvoicing is substantially large as is the case in the sample of countries and products considered in this report, such an explanation is not plausible.

Comments on the report revealed the frequent confusion with regard to the implications of trade misinvoicing for capital flight. Capital flight consists of unrecorded outflows of capital from a country to the rest of the world through various mechanisms, one of which being trade misinvoicing. However, not all trade misinvoicing generates capital flight. Specifically, capital flight occurs in the cases of export underinvoicing and import overinvoicing. However, in the case of technical import underinvoicing (under-reporting of the value of imports) or pure import smuggling, there is no resulting capital outflow. Moreover, import underinvoicing or import

smuggling does not constitute a total loss for the country as the goods enter into the country. However, the government loses customs duties on these imports, and the goods must be paid for in foreign exchange.

Another area of confusion arises from the conflation of trade misinvoicing with transfer pricing. The two phenomena are different and this report is **not** about transfer pricing. In the case of transfer pricing there are no discrepancies between recorded exports and recorded imports because the same price is used and reported on both sides of the transaction. Abusive transfer pricing consists of inflating prices as a means of shifting profits across territories to take advantage of differences in taxation regimes. While transfer pricing may constitute an illicit financial flow, it is not a mechanism for capital flight because the outflow is recorded. Transfer pricing results in tax revenue losses, but, as in the case of recorded profit repatriation, the transferred profit itself does not constitute capital flight. Instead, transfer pricing can be regarded as a tax-minimizing form of profit repatriation. Moreover, ascertaining the legality of transfer pricing is challenging due to the difficulty of establishing consistent benchmarks for market prices especially for trade in services. The literature on capital flight has not explored the issue of legality of the flows; it has been concerned with the fact that the flows are unrecorded. The literature on illicit financial flows has expanded the analysis in that direction and thus has made a substantial contribution to the policy debate.

A number of comments on the first version of the report have centered on the issue of quality of bilateral trade statistics. In addition to potential problems relating to measurement of the costs of transport, insurance and duties mentioned above, comments have also been raised about the timing of the recording of imports and exports, classification of goods, and the reporting of the destination of trade. It may be argued that the observed perverse or excessive normal discrepancies could be due to discrepancies between the data in official national statistics and the data in the databases compiled by international institutions such as COMTRADE. Such discrepancies are likely to be minimal given that these international institutions receive the data from national sources.

It has been argued that excessive normal and perverse discrepancies may arise from inconsistent classification of products across partners and over time. The case of gold exports from South Africa has been referred to as an illustration of this phenomenon. In national statistics, gold exports are split between monetary and non-monetary gold. The analysis in the UNCTAD report focused on non-monetary gold which is reported by both South Africa and its trading partners in Comtrade, thus enabling comparison of similar products as reported on both sides. Contrary to some criticisms of the first version of the report, the series of non-monetary gold exports reported in Comtrade are similar to those in national statistics, as expected, at least up to 2010. This is shown in Table 12 of the revised report using data from South Africa's Department of Trade and Industry (DTI). However, the values reported show large discrepancies between data from South Africa and its trading partners (see Table 12 in the revised report), which may reflect inconsistencies in classification of gold. A comparison of partner data on non-monetary gold exports with the combined values of monetary and non-monetary gold provided by South Africa still exhibits large discrepancies: South African values are higher in most years up to 2010 and the situation is reversed starting from 2011. Curiously, starting from 2011, all gold exports appear under non-monetary gold in DTI statistics. This change in reporting further complicates the comparison of data from South Africa with that of its trading partners.

It may be argued that the observed abnormal discrepancies may be due to lags in data recording. This would be a concern when there are large year-to-year variations in imports and exports, and if the lags are also variable in length. This issue is not likely to be significant in annual data, given that the current year's unreported imports that are carried over to the following year will be more or less compensated by the previous year's imports which are carried over to this year. This would have minimal effects on estimated statistical discrepancies in annual import and export series.

Another possible source of abnormal discrepancies could be inconsistencies in recording of the origin and destination of products. While such inconsistencies may affect trade misinvoicing estimates at the product-partner level, their effect on estimates of total misinvoicing at the national level, which are incorporated in the estimation of capital flight, is likely to be negligible. Understanding the causes and mechanisms of the observed large discrepancies in bilateral trade statistics requires further analysis at the disaggregated level; i.e., at product and transaction level.

The issue of transit trade may also be an explanation of the large discrepancies between exporting and importing countries' commodity trade records. In the context of the much broader issue of transparency, however, this raises the question of why exports should be recorded as destined to a country when they are not shipped to that country. Clearly, if a commodity is just "transiting" in a country, it should not be recorded as an export to this country. The evidence presented in the UNCTAD report whereby export commodities end up not being tracked from the origin to their ultimate destination should be considered as a matter of concern. This practice undermines the global efforts to ensure a fair distribution of the gains from trade especially on behalf of producers in developing countries. When the true destination of exports is not disclosed and when intermediaries fail to report the values of the transactions, it becomes impossible to establish whether the producer is earning a fair share of the market value of the exported commodities.

The interest in the issue of trade misinvoicing is, indeed, driven by the important consequences, both direct and indirect, that such a phenomenon has on national economies, especially those of developing countries. Trade misinvoicing carries direct costs in the form of foreign exchange that is not repatriated and surrendered to exporting countries' authorities, lost government revenues from the taxes and other levies not paid on the associated exports and imports, or from export tax credit issued on inflated values of exports. An important dimension of the indirect costs of trade misinvoicing is the associated unfair distribution of the gains from trade.

It is understood that the measurement of trade misinvoicing remains imperfect, as is the case with any area of economic analysis relying on statistical data. However, this does not diminish the urgency of addressing trade misinvoicing, a problem that negatively affects the development prospects of commodity-dependent developing countries. Improvements in the quality of trade data and the methodologies used to estimate commodity trade misinvoicing are therefore much needed to advance academic research that feeds into the policy debate. This is particularly important in the context of the current global agenda on development financing where stemming illicit financial flows has been considered as one of the strategies to mobilize resources. In research on trade misinvoicing, as in any research agenda, there is no such thing as the right and

wrong 'lampposts' under which the search for solutions should be confined. No stone should be left unturned. Moreover, it is important to emphasize that trade misinvoicing is only one of the mechanisms that facilitate capital flight and illicit financial flows. Stressing the importance of trade misinvoicing must not be interpreted as underestimating the relevance of other mechanisms of capital flight and illicit financial flows.