Funding the Future

Up to 44% of illicit flows from developing countries ma...

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In December 2008 Global Financial Integrity produced its analysis entitled “Illicit Financial Flows from Developing Countries: 2002-2006.” It showed that some $850 billion to $1 trillion a year was disappearing from poorer countries as proceeds of bribery and theft, criminal activity, and commercial tax evasion. That analysis utilized established economic models, namely the World Bank Residual Method and IMF Direction of Trade Statistics. And the estimate is considered to be quite conservative, as it does not include illicit flows generated through smuggling and some forms of trade mispricing.

The question then arose: Where are these financial flows absorbed? There are no established economic models providing analytical tools to answer this question. It is in fact easier to analyze outflows from developing countries with weak statistical capacities than it is to analyze inflows into developed countries with much stronger statistical capacities. The greater part of illicit flows departing one country and arriving in another country are transferred as cash through the shadow financial system, resulting in deposits in accounts outside countries of origin. But such money does not remain as cash on deposit; instead much of it gets withdrawn and put into securities, real estate, consumption, or other uses.

Withdrawal data are not reported. End-of-period deposit data are reported. As such it is possible to examine the change of annual end-of-period deposits and compare this to outflow data. For each country, the Bank for International Settlements (BIS) compiles data on the total of private deposits outside countries of origin. Normally, such external deposit data is provided globally, not broken down by country of deposit. At the request of Global Financial Integrity however, the BIS made available regional breakdowns of such deposit data.

Growth of external deposits by region compared to estimated illicit outflows provides a basis for analyzing where such global illicit outflows ultimately arrive. With additional analytical techniques it is possible to estimate how much is deposited in offshore financial centres versus developed country banks.

The resulting work from GFI demonstrates that developed countries are the largest absorbers of cash coming out of developing countries. Developed country banks absorb between 56 percent and 76 percent of such flows, considerably more than offshore financial centres.

It is clear as a result that the problem of absorption of illicit financial flows is one that rests primarily with Europe and North America, rather more so than with tax havens and secrecy jurisdictions.

The policy implication is also clear. While developing countries need to implement policies to curtail illicit financial flows, efforts to alleviate poverty and contribute to sustainable growth will be thwarted as long as developed countries permit their banks and cooperating offshore financial centres to facilitate the absorption of illicit funds.

Nothing else will do if the poor of the world are to see their poverty alleviated.

Now is the time for action.