Curbing Illicit Financial Flows from Resource-rich Developing Countries: Improving Natural Resource Governance to Finance the SDGs

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Illicit Financial Flows: Concepts and Definition

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Introduction

Countries have committed to 'significantly' reduce 'illicit financial flows' (IFFs) by 2030 (SDG target 16.4). Yet, there is still no agreement on the conceptual and definitional issues surrounding the notion of IFFs. The contours of the definition are still fuzzy, and its inherent coherence is under question. In a 'narrow' sense, IFFs refer to the cross-border movement of money that is "earned, transferred or used" in contravention to existing laws (World Bank 2016, 1). This definition focuses on financial flows across the border associated with illegal activity. In the public narrative, it conflates IFFs with criminal activity. This narrow definition already encompasses several different types of transfers, including those connected with corruption, tax evasion, smuggling and trafficking in goods and people, or the financing of organized crime. The 'broad', or 'normative' definition of IFFs stretches the concept further, by including transactions which are deemed to be unethical, even if they are not technically illegal (High Level Panel on Illicit Financial Flows from Africa 2015, Independent Expert on the effects of debt 2016, UNCTAD 2014). For example, many countries do not have transfer pricing laws, which results in abusive transfer pricing not being technical unlawful under their domestic legal framework (Chowla and Falcao 2016). Domestic law may not be violated; yet, the transaction would still be normatively unacceptable, hence 'illicit', under a broad, normative definition of IFFs.[1]

Beyond the narrow/broad definitional debate (for a review, Forstater 2018a), a few questions remain as to (Erikkson 2017):

1. The type of cross-border transfers that qualify as IFFs – whether money flows or anything with money value, from loans embedded in private contracts to smuggled physical goods;
2. Whether the source, or the use, or the transfer mechanism of a cross-border transfer should be illegal;
3. The normative benchmark used to assess illegality – whether domestic laws or international law, and whether the positive law currently in force or normative principles and standards;
4. The 'degree', or type of illegality that is required – in tax matters, whether fiscal crime, non-criminal tax evasion, 'abusive' or 'unlawful' tax avoidance, or 'grey area' tax avoidance.[2]

The debate points to major divergences and disagreement on all these points. In the end, the definition of IFFs remains clouded in "open questions, uncertainties and inconsistencies" (Erikkson 2017).

On the one hand, this definitional uncertainty amounts to some form of 'constructive ambiguity'. Looking backward, it has been instrumental in building a political momentum around the IFF issue. Building that momentum required emphasis on aggregates, and postponement of technical disagreements about the specifics of the issue at stake. Looking forward, this definitional 'openness' ensures some built-in flexibility in the IFF debate, which is adaptable to the fast pace of legal reform, and to changes in underlying policy perceptions.

On the other hand, lack of clarity and agreement about the basic tenets of the IFF debate prevents constructive dialogue and inhibits policy action. From this perspective, it is a stumbling block to any effort to rigorously gauge the magnitude of IFFs. Furthermore, it hinders the design of effective policy responses to curb IFFs, since regulatory responses require clarity as regards targeted actors, techniques and motives of IFFs. This quest for analytical clarity is frustrated by emphasis on aggregates that conceal key differences in terms of underlying economic and legal dimensions. Hence, there is a need to unpack the IFF definition, disentangle its various threads and expose its inherent ambiguities. The challenge is how to do that, without unravelling the whole fabric.

[1] Likewise, certain tax optimization schemes that make use of offshore structures to get around an inconvenient law may still be technically legal, depending on the reach of domestic anti-abuse rules. The law may not be violated, but the transaction is normatively unacceptable, hence 'illicit', under a normative definition of IFFs (UNCTAD 2014, 172-73; Independent Expert on the Effects of Foreign Debt 2016, 4).

[2] The reader is referred to the following discussion of the distinction between legal and illicit.

This brief contributes to the debate by reviewing and challenging some of its tenets (section 2) and by elaborating on the way ahead (section 3). It firsts rehearses and questions key 'conventional' distinctions in the IFF debate: the distinction between 'illegal' and 'illicit'; between formal and purpose-oriented definitions of IFFs; the 'corrupt'/'criminal'/'commercial' taxonomy of IFFs; and distinctions between aggregate and disaggregate approaches under the IFF agenda. It then outlines an approach that may help to move out of the definitional impasse. It concludes with some summary observations.

1 A Reassessment of the definitional debate

1.1 'Illegal' v. 'illicit'

It is customary in the literature and in the policy debate to distinguish between a narrow and a broad definition of IFFs (for a review, Forstater 2018a, 4-7). The former requires a breach of the law ('illegal' activities). The latter encompasses unethical acts that may still be technically lawful, if unregulated ('illicit' activities). This distinction has gained wide acceptance in the debate on tax-motivated IFFs (on terminology, Box 1). In this context it is widely held that transfers associated with tax evasion (illegal) qualify as IFFs, while tax avoidance schemes (formally compliant with 'the letter of law'), would not, even if immoral (Forstater, 2018a and 2018b). Yet, tax avoidance practices would still fall under a broad, normative definition of IFFs.

Box 1: Tax evasion, (aggressive) tax avoidance and (legitimate) tax planning

The terms 'tax evasion', 'tax avoidance and 'tax planning' are widely used to denote different tax behaviours. UK Treasury Minister David Gauke drew the following distinction during a parliamentary debate in 2010 – a distinction upheld in the UK 2015 government paper on tax avoidance (HM Treasury 2015).

Tax evasion occurs when people or business deliberately do not pay the taxes that they legally owe. They can do so by underreporting income, over reporting expenses, or simply not paying taxes owed. Tax evasion embraces the 'hidden economy', "where people conceal their presence or taxable sources of income" (HM Treasury 2015, at 5).

Tax avoidance involves "bending the rules of the tax system to gain a tax advantage that Parliament never intended" (HM Treasury 2015, at 5). It typically entails "taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability" (European Commission 2017). The practice is sometimes referred to as 'aggressive tax planning' (European Commission), or 'abusive' or 'aggressive tax avoidance', to distinguish it from 'legitimate' tax planning. Tax avoidance here substantially overlaps with 'base erosion and profit shifting' (BEPS) as used in the G20/OECD context.

Tax planning involves "using tax reliefs for the purpose for which they were intended" (HM Treasury 2015, at 5), for example, taking legitimate tax deductions included in the tax code to lower the tax bill. It is sometimes referred to as 'lawful tax avoidance' or 'legitimate tax planning'.

As stated by Treasury Minister David Gauke, tax evasion is always illegal; tax avoidance "involves compliance with the letter but not the spirit of the law"; and tax planning "is a case of acting in both the spirit and the letter of the law" (HC Deb 12 July 2010 c706, reported in Seely 2018).

Based on this distinction, some argue that tax avoidance is legal, and should stay out of the IFF debate.

While this taxonomy brings some theoretical clarity to the debate, the boundaries between tax planning and tax avoidance, and between tax avoidance and tax evasion in reality are somewhat blurred. There is in practice a continuum and much depends on the circumstances of the case. The legal assessment of avoidance practices is not a simple or obvious one, as discussed below.

Source: HM Treasury 2015; Seely 2018.

The distinction between illegal and illicit, and between tax evasion and avoidance, is intuitively clear.[3] Yet, particularly in tax matters, this distinction is less straightforward than it may appear. This is on at several grounds.

First, as extensively elaborated by Professor Sol Picciotto, the distinction overlooks a key feature of the law: the indeterminacy of legal terms and the legal process of interpretation. Legal terms are often indeterminate; their specification is fact-intensive and much depends on the specifics of the case. Eventually, it is incumbent on the judge (and, in some cases, the revenue authority)[4] to categorize the facts to fit them into a particular legal category. It is important to note that this interpretative process is purposively framed by the object and rationale of the law. By interpreting statutes purposively, most courts will not allow a transaction to stand if it merely follows the letter of the law, while frustrating its intention (Box 2). This *per se* problematizes the separation of the 'letter' and 'spirit' of the law, on which the illegal v. illicit distinction largely rests.

Box 2: Statutory interpretation, judicial anti-abuse doctrines and general theories of abuse of law

There are various means by which courts deal with tax avoidance schemes operating "within the letter – but not the spirit – of the law". These techniques include judicial interpretation of statutes, judicial anti-abuse doctrines and anti-abuse theories of law.

Statutory construction and purposive interpretation - In general, courts interpret statutes purposively. They do not apply a strict letter of the law approach, but instead read provisions in terms of the purpose of the statute as a whole. By construing legislation purposively, the courts can apprehend transactions that merely follow the letter of the law but not its intention. However, there are limits to this process. In the United Kingdom, for example, rules of legal interpretation may not permit to stretch statutory language too far, and oblige courts to stick to the wording of the legislation when assessing the objectives of the legislature. Further, the interpretation of tax statues is not straightforward, and it may be difficult to discern a reasonably clear purpose.

Judicial anti-abuse doctrines - Beyond statutory constructs, common law jurisdictions have developed judicial doctrines to counter tax avoidance. This goes beyond the purposive interpretation of statutes. It entails judge-made rules and guiding principles that emerge from the case law. In the United States, for example, courts (and the revenue authority) turn to several doctrines to deal with tax avoidance schemes – for example, 'substance over form', 'sham transactions', 'business purpose', 'economic substance' and 'step transaction' doctrines. Even where a taxpayer carefully engineers its scheme to comply with all technicalities of a particular tax statute, courts could resort to these doctrines to re-characterise the scheme or deny tax benefits. The underlying principle is that technical compliance with the law is not enough, absent substantial compliance. Similar techniques are used in other jurisdictions to void transactions, re-categorize transactions, or collapse a series of connected transactions into a single one.

Abuse of law theories - Finally, some civil law systems have general theories of abuse of law that prevent abuse in theory. In particular, under deeply rooted abuse of law principles, the law cannot be used for purposes contrary to that for which it was provided – i.e. no law can provide for its circumvention.

Second, in tax matters, the reach of statutory law has markedly expanded; the distinction between tax evasion (illegal) and tax avoidance (formerly perceived as legal) is blurring. This reflects the fast pace of regulatory reform in tax law. Over the past five years, the pace and breadth of reform has accelerated and expanded, under the Base Erosion and Profit Shifting (BEPS) agenda. Many jurisdictions have introduced specifically targeted laws – transfer price rules, interest deductibility rules, controlled foreign company (CFC) rules, and anti-hybrid rules[5] – to close regulatory loopholes and redress mismatches that provided opportunities for regulatory arbitrage and abuse. Many have enacted so-called 'catch all' rules, typically in the form of general anti-avoidance rules (GAARs), that at once rule out transactions designed to avoid tax.[6] Most significantly, a GAAR would allow courts to interpret statutes in a manner that furthers the 'spirt of the law', even if that may necessitate a stretched interpretation of the language. These new sets of rules capture the most common cross-border tax avoidance strategies, blurring the line between

[3] It echoes long-standing distinctions in legal theory, between positivist and natural law approaches, and between *lex lata* and *de lege ferenda* perspectives. In legal practice, it hints at some rift between law and justice.
[4] To some extent, special regimes for disclosure of tax avoidance schemes and advance tax rulings shift the interpretative process from the judiciary to the executive (the revenue administration).
[5] Withholding taxes, though not technically anti-avoidance rules, also play a key role as an anti-abuse device.
[6] For examples of domestic approach GAAR, refer to the UK and Indian GAAR. An equivalent tax treaty approach is the 'principal purpose test' (PPT).

tax evasion (illegal) and avoidance (deemed legal). Certainly, business will adjust and find new, more subtle forms of elusion. Targeted anti-avoidance legislation can actually create avoidance opportunities through new loopholes and mismatches. The regulation of tax avoidance typically engenders a 'balloon effect': you squeeze the balloon in one place just to inflate it elsewhere. But the law will follow, like in a cat-and-mouse game of constant pursuit, near captures, and repeated escapes.

Third, 'illegality' is a complex concept. In particular, some actions may be technically unlawful even if they are not criminal. To the contrary, the public narrative tends to conflate illegal and criminal. It goes on to say that tax avoidance is legal, meaning that it involves no criminal activity. This line of reasoning faces objections. As discussed above, tax avoidance can be unlawful, even if not criminal. Take the example of aggressive tax optimization schemes. In the public narrative, these practices are deemed to be technically lawful. Note however that, under some circumstances, the tax authority has the right to challenge the tax planning scheme and levy a tax based on the economic substance of the transaction. In this case, tax avoidance would not amount to a criminal tax offense. Yet, it would be technically unlawful, at least in administrative terms. It is also important to stress that 'criminal' is, per se, a multi-layered and nuanced concept: most jurisdictions provide for different classifications of criminal offense – for example, *crime*, *délit*, and *contravention* in civil law countries, or felony and misdemeanour in Anglo-American law (Box 3). To sum up, what is perceived as 'quasi-legal' or 'technically lawful' is often technically unlawful, even if the conduct only amounts to an infraction not liable to a prison sentence.

Box 3: Criminal tax offenses in Switzerland

In the field of direct taxation, Switzerland's criminal tax law makes a distinction between breaches of procedural obligations (*violations des obligations de procedure*, LIFD Art. 181), tax evasion (*soustraction d'impôts*, LIFD Art. 175) and tax fraud (*usage de faux*, LIFD Art. 186). Tax evasion occurs when the taxpayers does not pay taxes that are due. Minor forms amount to a breach of procedural rules. Tax fraud is a qualified form of tax evasion, which implies the use of forged or falsified documents or other cunning acts to cheat the tax administration. Tax evasion is a minor offense (a contravention) punishable by a fine, which can reach as much as three times the evaded tax. The proceeding, which involves the cantonal tax authorities, is administrative. The requirement of trial by jury does not apply. Tax fraud is a criminal offense that can lead to imprisonment: it is punishable by a term of imprisonment up to three years or a monetary penalty. The procedure is judicial, governed by the provisions of the criminal procedure code. Tax avoidance, or aggressive tax planning, by definition does not entail a formal infringement of tax laws: it exploits regulatory loopholes and mismatches in tax rules across jurisdiction to 'optimize' a group's tax exposure. Switzerland has not enacted specifically targeted anti-avoidance laws or 'catch-all' rules to stem tax avoidance practices. Yet, aggressive tax planning strategies are potentially unlawful (or, in other words, 'legal until proven illegal') under Swiss laws, regulations and tax administration practices. Under certain conditions, the fiscal authorities have the right to reclassify the facts and adjust the tax according to the economic reality. If it is found that tax avoidance practices conceal patterns of tax evasion or tax fraud, the relevant provisions of the LIFD apply.

Source: *Loi federal sur l'impôt federal direct* (LIFD) (RO 1991 1184); Xavier Oberson 2008 and 2016.

Finally, the public narrative tends to mix up two questions that should be kept conceptually distinct: the question of legality in theory, and whether the existing law is being properly applied and enforced. As discussed, tax avoidance is potentially unlawful, at least under those legal orders that have attained a certain level of sophistication. Yet, many cases – undetected – will not come to court. Further, when a case is litigated, there may be a degree of judgment involved in assessing what activities fall on the 'abusive' side of the line, which results in uncertainty as to the outcome of litigation. In these circumstances, many avoidance schemes succeed 'by default' (Quentin 2017). And businesses may deliberately choose risky tax positions since there is a realistic opportunity for success. This explains the mass-marketing in the UK of avoidance schemes with as little as a 50% chance of success if challenged in court (House of Commons Committee of Public Accounts 2013). This risk appetite goes a long way to explain the persistent 'tax gap'[7] even in countries with well-developed legal systems – an estimated £33 billion for 2016/17 in the UK, or 5.7% of total tax liabilities (Seely 2018, at 9).

[7] Defined as "the difference between tax that is collected and that which is 'theoretically due'" (Seely 2018).

These arguments invite to de-emphasize the illegal v. illicit distinction (and the tax evasion v. tax avoidance distinction) in the IFF debate. In the end, it is hard to draw a line between tax evasion and tax avoidance, or between avoidance activities that are unlawful v. technically legal: the legal assessment of tax avoidance practices is a circumstantial process of interpretation, constantly adjusting, in a dynamic and adaptive regulatory environment.

Two observations follow from the above.

First, what is genuinely at stake, today, is not the illegal v. illicit dilemma, but a creeping erosion of the very notion of 'legal certainty': in a fast-moving regulatory environment, what was lawful yesterday may be unlawful today and legality is, increasingly, a matter of judicial and administrative discretion. The much-needed shift from detailed legal drafting towards principles-based and policy-based legislation (for example, GAARs) will likely exacerbate this feature of the legal system.

Second, the illegal v. illicit distinction possibly conceals something different: capacity gaps for tax administration and prosecution, particularly in resource-strained jurisdictions. These gaps may lead to lack of regulation, or weak legal enforcement. A narrow definition of tax-motivated IFFs overlooks the variability of administrative and enforcement capacity across countries. As a result, it biases findings of IFFs to countries with higher tax administration capacity, higher prosecution capacity and more sophisticated legal systems (Chowla and Falcao 2016).

Against this background, it may be expedient to drop distinctions – evasion v. avoidance, unlawful tax avoidance v. legitimate tax planning – that do not bring clarity to the debate. As argued in section 2.1, IFFs should be flexibly defined as cross border flows that contravene national or international law and standards, with reference to the dynamic, evolutive nature of legal processes.

1.2 Formal and purpose-oriented definitions

In an effort to resolve the narrow/broad controversy, some commentators argue for a functional, purposive interpretation of IFFs. They move beyond the question, "what are we measuring?", to the question, "why are we measuring?", arguing that we are not measuring outflows for the sake out outflows, but in relation to the domestic resource mobilization (DRM) agenda.

Pursuant to this substantive approach, the key issue in defining IFFs should be the revenue impact of the flows. More broadly, the key underlying concern is "the impact of illicit financial flows […] on the economic, social and political stability and development of societies" (A/RES/71/213, December 2016). Pursuant to this 'developmental' approach, IFFs are defined as international financial flows that have a negative net impact on sustainable development, when all their direct and indirect effects are taken into account (Blankenburg and Khan 2012; for a review, Miyandazi and Ronceray 2018).

This definitional approach focuses on the revenue (or, broadly, the developmental) impact of the transfer, rather than on the illegality of the transfer. Its central questions is to what extent the flow is damaging for development, irrespective of whether the flow is legal, illegal, or falls in a grey area. This holds two corollaries.

On the one hand, a developmental definition of IFFs encompasses transactions that, although technically lawful (until proven unlawful), have adverse revenue impacts in developing countries. This also covers 'legitimate' tax planning schemes by multinational enterprises that shift profits out of developing countries (refer to Box 1). It has been observed, in this respect, that profit shifting – whether technically unlawful or lawful – leads to annual revenue losses of 100-600 billion USD (refer to the literature review by Cobham and Janský 2017 and 2018). From a development perspective, tax avoidance practices erode the tax base of developing countries and should accordingly constitute an IFF.

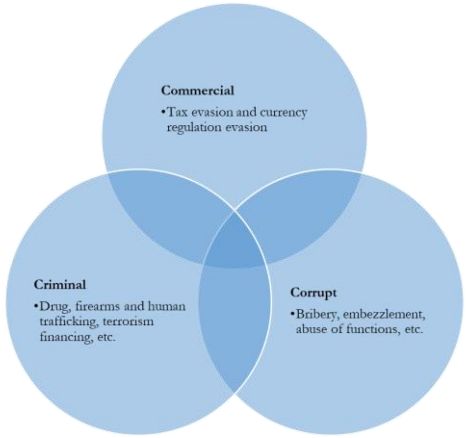
On the other hand, the developmental definition of IFFs excludes flows that, although technically unlawful, have no negative net impacts on sustainable development (Miyandazi and Ronceray 2018). It has been observed, in this respect, that rule-violating transactions are not all equally harmful (Blankenburg and Khan 2012, OECD 2018). For example, informal value transfers are especially important in countries where the formal banking system is too expensive for the poor. Transactions conducted through these informal systems of money transfer do not fit under a developmental definition of IFF, even if illegal under domestic law (Erikkson 2017). Likewise, unreported artisanal mining features a high degree of subsistence-level criminal activity: it provides income for ordinary people lacking credible alternative livelihoods, and the profits may be re-invested in the local economy (OECD 2018). Corruption-related IFFs also require nuanced distinctions. For example, bribes meant to bypass unproductive red tape may enable economic activities, even if they undermine the rule of law (Miyandazi and Ronceray 2018; see also Khan and Andreoni 2018). In specific cases, it is also possible to identify exceptions to the general harmful nature of tax abuses: for example, profit shifting to avoid illegitimate expropriation by a predatory regime in a fragile state may undermine the tax base but also makes investment viable (Blankenburg and Khan 2012, Khan and Andreoni 2018, Miyandazi and Ronceray 2018). Overall, IFFs may be driven by "inappropriate or contradictory formal rules, or low capabilities of firms in developing countries" (Khan and Andreoni, 2018). They may reflect structural drivers that cannot be changed in the short to medium term without hurting the local economy or social set up. Tackling or diminishing these flows could provide difficult and the development impact may be negative in the short to mid-term.

This purposive approach offers a useful policy orientation to the debate. It assists in drawing a line between licit and illicit patterns of conduct under the IFF agenda. Yet, it also introduces a new layer of complexity, which risks making the assessment of IFFs further blurred and indistinct. In particular, a purposive definition of IFF based on the revenue impact of the flows would extend the concept of IFFs to all practices that may erode developing countries' tax base, or otherwise result in a loss of income. The reach of the IFF agenda would stretch to include such issues as business tax incentives, contract and price unfairness, and the allocation of taxing rights under double tax agreements. The revenue impact of these practices is not straightforward. For example, tax incentives may erode a country's tax base, but also attract additional investment: the net revenue impacts should be assessed on a case by case basis (Matteotti 2018). Eventually, a development definition of IFFs has merits as it gives policy relevance to the debate, but comes with a requirement of contextual, factual intensive analysis.

1.3 'Commercial', 'criminal' and 'corrupt' components of IFFs

The public narrative identifies three broad types of IFFs: commercial, criminal and corrupt (High Level Panel on Illicit Financial Flows from Africa 2015, Global Financial Integrity 2017, UNCTAD 2014). This standard taxonomy sheds light on three main sources, or drivers, of IFFs: tax evasion and currency regulation evasion ('commercial' motives); bribes and corruption ('corruption'-driven IFFs); and 'illegal markets', including drug and human trafficking, counterfeiting, contraband, conflict commodities, etc. ('criminal' IFFs).

Figure 1: Conventional breakdown of IFFs



This breakdown of IFFs is useful, in that it divides clusters of activities with different generators and motives. Note however that, in practice, the three categories – commercial, criminal and corrupt – overlap and intertwine.

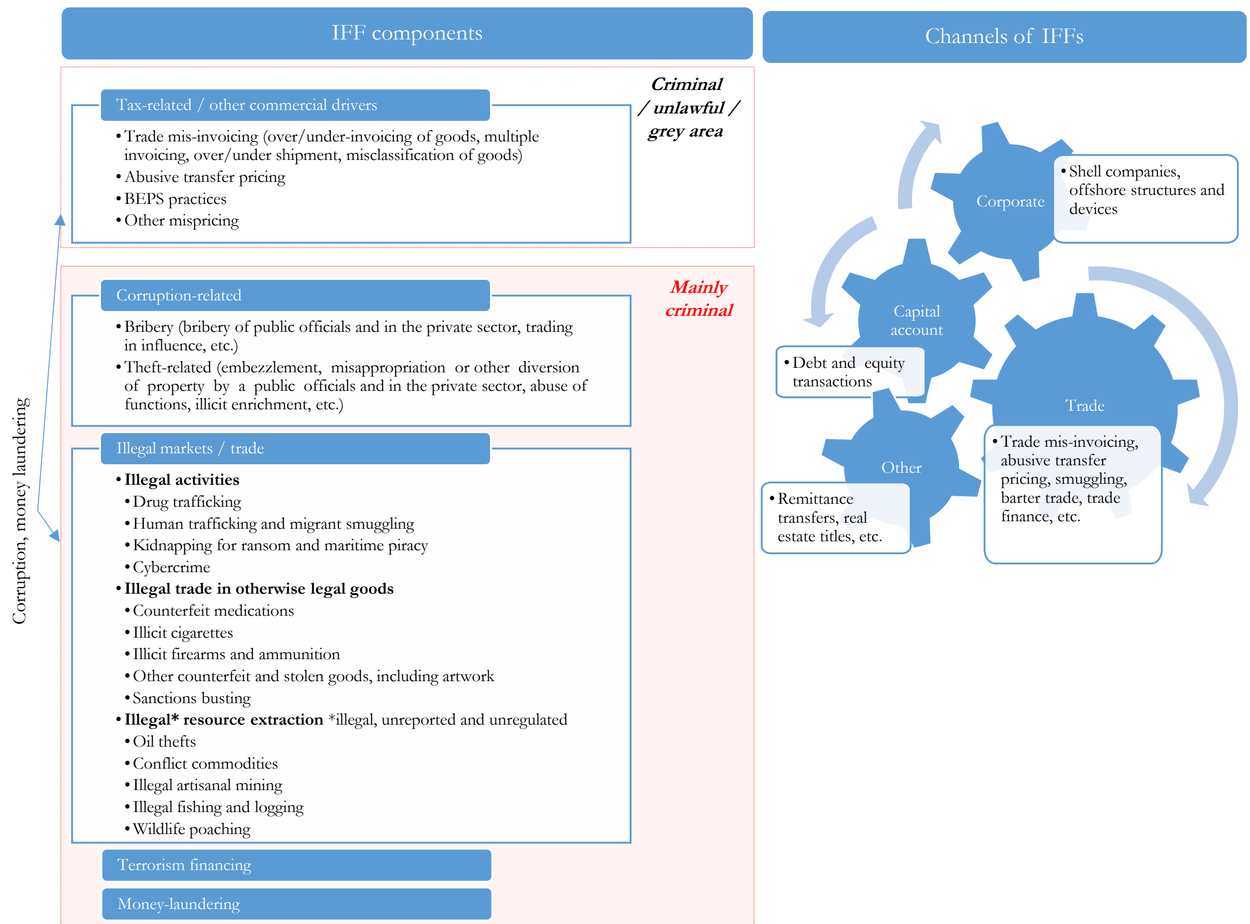
First, it is hard to univocally categorize facts under either the commercial, or criminal or corrupt category. Take the example of tax evasion, the main motive behind the commercial component of IFFs. In most jurisdictions, it is a crime to evade taxes: tax evasion is criminal, liable to a prison sentence. More precisely, some acts would amount to criminal tax evasion, while others would trigger administrative sanctions. Crossing the line typically depends on a number of factors, including 'materiality' thresholds, some subjective test of willfulness, and specific patterns of conduct, such as the use of forged or falsified documents to deceive the tax administration (refer to the previous analysis). In this instance, 'commercial' and 'criminal' are not separate categories: they overlap and entangle. The same holds true for 'corrupt' and 'criminal': bribery, embezzlement, abuse of functions and the like amount to 'crimes' in most jurisdictions.

Second, and in a related vein, the three categories interweave in practice. Large customs fraud and tax evasion schemes, for example, are often entangled with money laundering and corruption [8] Likewise, it has been observed, corruption is not an "additively separable IFF that can be added to tax evasion […] and other IFFs": even if it can be a distinct illicit flow, for instance if politicians conceal their bribes offshore, corruption more typically facilitates IFFs or affects their magnitude and effects (e.g., corruption can affect the tax rate negotiated with MNCs, or their tax assessment) (Khan and Andreoni 2018). In this respect, corruption should not be treated as a separate IFF sub-component, but as a crosscutting issue, or an 'orthogonal' category (Khan and Andreoni 2018).

How, then, to move forward? The existing breakdown of IFFs is a starting point, and may be elaborated further. One option is to refine the labels - for example, by using the phrase 'criminal enterprise', or 'criminal in earning/use' instead of the unqualified term 'criminal'. Beyond these 'cosmetic' changes, it is important to unpack IFF components that lack internal coherence. This is notably the case with the (badly termed) 'criminal' component, a wide category that encompasses several different types of financial transfers, made for different reasons. For analytical and policy purposes, it may be useful to distinguish between funds with a criminal destination, such as the financing of terrorism, and funds that originate from criminal activities. These latter should be broken down into discrete 'thematic' areas based on existing institutional work streams (Figure 2).

Figure 2: IFFs – Components and channels

[8] Key revelations from the 'Paradise Papers' point to the involvement of extractive companies, traders and their agents in opaque transactions and potentially corrupted commodity deals. In customs fraud and large tax evasion schemes, tax evasion is often entangled with money laundering and corruption.



Source: Authors' elaboration from Global Financial Integrity 2017, High Level Panel on Illicit Financial Flows from Africa 2015, IATF 2017, OECD 2014, OECD 2018. The three-part illegal markets/trade typology is based on OECD 2018 ('illegal activities', 'illicit trade in legal goods' and 'illicit resource extraction').

1.4 Aggregate v. disaggregate approaches

Some commentators question the IFF agenda. As pointed out by Reuter, for advocacy purposes it has been useful to aggregate bribe, tax evasion, corporate profit shifting, currency regulation evasion, criminal enterprise earnings etc. under a single umbrella; for policy and research purposes it would be more appropriate to disaggregate (Reuter 2017). The implication is that for analytical and policy purposes, it would be better to disaggregate IFFs in discrete subject matters and treat them separately, rather than to develop an agenda that treats them as a single phenomenon (Reiter 2017). In our view, disaggregation and aggregation are both needed, as discussed below.

Undoubtedly, there is a need to add 'granularity' to the analysis of IFFs. It is important to disentangle the various dimension of the phenomenon, and extricate some key variables:

- The sources of the proceeds – whether bribes, tax evasion or avoidance, corruption, currency regulation evasion, sanctions busting, earnings from criminal enterprises;
- The variety of actors involved – corporate groups, corrupt officials, physical tax evaders, or criminal enterprises;
- The different push and pull drivers that motivate IFFs, including tax differentials, currency controls, or secrecy provisions;

- The geography of IFFs, from source to recipient countries through transit countries;
- The methods or channels though which illicit funds flow, ranging from simple smuggling to elaborate trade-based money laundering techniques.

A circumstantial assessment of these facts is needed to appreciate the governance challenges involved in trying to curb IFFs.

Yet, the notion of IFFs retains its usefulness for policy and research purposes, beyond advocacy reasons. There are at least three sets of arguments that can be made for a broad IFF agenda.

First, a single IFF agenda helps to improve regulatory coordination, between and within countries, across a spectrum of interventions. An agenda that treats IFFs as a single phenomenon is a drive to move forward in a synchronized manner on multiple fronts. It counters the tendency, inherent in legal specialism, towards fragmentation and duplication. Government actions to tackle the several components of IFFs require coordinated responses across different administrations, including revenue authorities, banking supervisors, financial intelligence units, customs agencies, and law enforcement agencies. An integrated agenda highlights the operational interconnectedness of different specialist areas of law that tend to operate in silos: money laundering and banking prudential requirements, anti-bribery laws, customs law and enforcement, reporting and due diligence requirements, including professional standards for the corporate service providers, and multiple exchange of information and transparency requirements.[9] This holistic approach is necessary to properly address avoidance practices by business: specifically targeted interventions will just spur new schemes to circumvent them (the 'balloon effect'); an integrated package of coordinated policy interventions may eventually burst the balloon.

Second, IFFs differ, but they tend to use similar techniques and facilities: abusive offshore structures and devices, secrecy systems, and a host of facilitators, including the legal profession (Cobham and Janský 2017, Picciotto 2018a and 2018b). A single IFF agenda may converge and heighten regulatory attention on these 'nerve centres' of the IFF architecture. Regulatory efforts directed at these hot spots would likely have multiplier effects across the whole spectrum of IFFs, since offshore structures, secrecy and facilitators cater for different IFFs at once: they are used to conceal or launder the proceeds of corruption or the earnings from criminal enterprises, and they facilitate tax avoidance schemes (Picciotto 2018a and 2018b).

Third, the IFF agenda filters into other discourses, leading to cross-fertilization and mutual reinforcement of public narratives and work programmes. For example, there are 'distinct areas of direct overlap' between the Domestic Resource Mobilization (DRM) agenda and the IFFs agenda (World Bank, 2017). Furthermore, the IFFs agenda serves to inform and deepen the emerging debate on Sustainable Finance (SSF). Overall, there is some confluence in current development discourse: DRM and IFFs, as well as SSF and IFFs, are interlinked at critical junctures. These different strands of work come together to support comprehensive reform strategies. Cutting off a part of the discourse would weaken the whole fabric.

The arguments above suggest that we keep a broad, flexible definition of IFFs, under a single agenda. Which brings us back to the initial question: how to add 'granularity' and operational significance to the IFF work programme, without unravelling the whole IFF agenda?

2 The way forward

The way forward lies in a broad, but pragmatic, agenda. As outlined below, the tactics chosen is to keep a broad, flexible definition of IFFs, and work it out when needed, for specific analytical or policy purposes. Further, a

[9] These latter include, for example, exchange of information between tax authorities, whether automatic or on request; disclosure of tax avoidance schemes and exchange of advance tax rulings; country by country reporting; and the development of beneficial ownership registries.

pragmatic approach should inform the breakdown of the IFFs agenda into workable modules and the choice of indicators.

2.1 A flexible 'umbrella' definition

As discussed in section 1.4, a brad IFF agenda is a powerful engine for systemic change. This argument invites to keep a broad, 'umbrella' definition of IFF. What is needed is some convergence around the basic tenets of a broad definition (IATF 2017).

There is wide convergence around the core concept of cross-border financial transfers that are deemed illicit due to the origin or destination of the funds, or the transfer mechanism (for a review, Forstater 2018a, Chowla and Falcao 2016, Miyandazi and Ronceray 2018).[10] The working definition of IFFs as international transfers of illicitly earned, sourced or transferred finance (or capital) can be retained as the 'common denominator definition' (IATF 2017) for separate work streams for each IFF sub-component. However, two important qualifications, or caveats, are in order.

First, as discussed, narrowly legalistic definitions of IFFs should be avoided (refer to section 1.1). However, it is important to anchor the definition of IFFs to legal constructs – rather than ethics, in order to avoid subjective controversies about moral values. This invites to steer a middle course in between purely legalistic and purely normative approaches. Along these lines, 'illicitness' should be flexibly construed with reference to national or international law *and standards*, with a view to the dynamic, evolutive nature of legal processes. In tax matters, this implies reference to a critical mass of soft law engagements, legal principles and statutory enactments that collectively challenge the widely held assumption that tax avoidance is legal but tax evasion is not. The previous analysis has drawn attention to lines of judicial reasoning, judicial doctrines and statutory enactments aimed at countering abuse of law and tax avoidance (section 1.1). From this wealth of legal material, it is possible to extract general principles – for example, 'substance over form' – to which the debate on tax-motivated IFFs can refer. As regards soft law legal instruments, reference is specifically directed to the standards developed under the G20/OECD Base Erosion and Profit Shifting Project (BEPS), the UN Committee of Experts on International Cooperation in Tax Matters, the Platform for Collaboration on Tax and other standard setting bodies in international tax matters. Reference is here to the core principles, assumptions and overriding tests that inform and frame these standards, not to the specific techniques and methodologies that the standards set to pursue their underlying objectives. For example, a key reference norm is to realign taxation with economic substance and value creation – the aim of the BEPs objective. Interestingly, such overriding BEPS principle very much echoes the doctrines of 'economic substance' and 'substance over form' – which have long been a part of the tax law of many countries. In some respects, soft law legal instruments are integrating long-standing anti-abuse principles into the 'mainstream' policy discourse. In turn, these principles set norms that inform law-making. Such construction of 'illicitness' (and IFFs) tends to blur the distinction between soft and hard law.[11] Most importantly, by referring to

[10] This definition is, to some extent, tautologist. Yet, it also sets bounds and limits. It frames the issue at stake, in at least four respects. First, it relates to finance or money matters (cash flows and bank transfers). Some variants broaden the definition to include capital flows (equity and debt) and the monetary value embedded in goods (for example, smuggled gold). Second, it relates to flows - transfers, not stocks. Third, the money (or assets) must cross the border: domestic activities and transactions do not matter, unless the resulting proceeds are transferred beyond the border. Fourth, the flows - more precisely, either the transfer, or the origin, or the use of the proceeds – must be 'illicit'.

[11] What is at stake here is the "hardening" of soft law initiatives in the context of peer-review processes and auditing procedures that put significant standard-compliance pressure on countries. Unlike laws and regulations, standards are not legally binding, unless stipulated in legislation or in contracts. Yet, they are legally relevant: they assist in interpreting existing rules, including in the context of arbitral proceedings, and contribute to the gradual formation of new rules through the political law-making process. The BEPS principles, in particular, set an inescapable normative reference in tax matters. A de facto implementation duty exists concerning these standards, since non-compliance carries the risk of being placed on "black" or "grey" tax haven list. The sense of 'blurring boundaries' is heightened by the pace and breadth of legal reform, which is 'hardening' soft law commitments into hard law (refer to the analysis in section 1.1).

international standards and principles of law, it would level the playing field between countries with different regulatory and law enforcement capacity to seize and sanction tax avoidance.

Second, and in a related vein, the 'umbrella' definition of IFFs should be, in principle, broadly encompassing and aspirational. This invites a move beyond a formalist, static conception of IFFs, towards a more purposive interpretation, which links IFFs to efforts to mobilize domestic resources for development. As discussed, an approach that focuses on the revenue impacts of IFFs, rather than on the legality of the transaction, introduces a new layer of complexity in the assessment of 'illicitness'. At the same time, it makes the assessment meaningful and policy relevant. Reference is here to the 2030 Agenda for Sustainable Development and the Sustainable Development Goals (SDGs)[12] and the Addis Ababa Action Agenda,[13] which explicitly anchor IFFs in the DRM. Note that the AAAA example explicitly includes tax avoidance under the IFF agenda. The political commitments enshrined in the 2030 Sustainable Agenda and other soft law texts are legally significant as 'soft law'. They assist in interpreting existing rules and contribute to the gradual formation of new rules through the political law-making process.

So qualified, the definition of IFFs can accommodate different and competing definitional approaches. It provides an umbrella definitions for separate work streams for each IFF sub-component. Definitional details should not attract too much attention. Note that other major reform packages, such as the BEPS programme, lack clear definition of relevant concepts. Countries did not need to agree on what was meant by "value creation" to endorse the BEPS standards (John Peterson 2018). The definitional uncertainty surrounding the term did not prevent the adoption of specific practical actions. The same type of constructive ambiguity should play a role in the IFF definitional debate. The meaning of the definition can still be specified and eventually narrowed for specific policy or analytical purposes.

2.2 Tailored working definitions

The broad definition above is put forward as a 'common denominator definition' (IATF 2017). For specific policy and research purposes, it may be necessary to add granularity to the definition, by spelling out what is in and what is out of scope with reference to actors, transfer mechanisms, or origin. This 'scoping' process is largely discretionary: drawing a line between what is in scope and what is out is an arbitrary exercise, framed by reasons of methodological convenience and political sensitivity. For example, setting the boundaries of the notion 'commodity trade-related IFFs' is, to a large extent, a matter of definitional discretion (Box 4).

Box 4: Commodity trade-related IFFs – Possible components

'Commodity trade-related IFFs' are illicit financial flows associated with commodity trade. The term conflates distinct dimensions that should be kept analytically distinct: the cross-border commercial practices that contribute to illicit flows, the underlying activities that generate illicit flows, and corruption-related flows in the commodity economy.

Commercial cross-border practices

A first component covers commodity trade transactions conducted so as to manipulate customs duties, income taxes, excise taxes, VAT taxes, or other sources of government revenue (tax-motivated IFFs). The boundaries of the definition are not firmly set. The definition primarily captures IFFs that arise through trade mis-invoicing and abusive transfer pricing. The notion may be further expanded to cover outright smuggling and price unfairness.

Trade mis-invoicing covers the fraudulent mispricing of goods traded between independent parties. It involves exporters and/or importers deliberately mis-stating the value, quantity, or nature of goods or services in a trade transaction (Forstater, 2018). It may

[12] United Nations Sustainable Development Summit, New York, 25 - 27 September 2015, *Transforming Our World: The 2030 Agenda for Sustainable Development*, UN GA Res. 70/1 (*adopted* on 25 September 2015), downloadable at http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/70/1.

[13] Third International Conference on Financing for Development, Monterrey, N.L., Mexico, 8-22 March 2002, *Addis Ababa Action Agenda*, UN GA Res. 69/313 (*adopted* on 27 July 2015), downloadable at http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/69/313&Lang=E.

entail over/under-invoicing of goods, multiple invoicing, over/under shipment, misclassification of goods. Such practices amount to customs or tax fraud. They are outwardly illegal, when not criminal.

Illicit outflows of funds may also originate from the manipulation of transfer prices within a multi-national corporation (*abusive transfer pricing, or transfer price manipulation*). For example, by under-invoicing mineral sales to an affiliate in a low-tax jurisdiction, multinationals can shift profits to low-tax countries and save taxes. Likewise, a related party marketing hub in a low tax jurisdiction may charge or receive disproportionate service fees or discount on the price of commodities purchased or sold, so as to shift profits to the low tax jurisdiction. Under international tax rules, these practices amount to unlawful tax evasion or avoidance.

Questions arise as to whether the analysis of commodity trade-related IFFs should also capture *outright smuggling*. Smuggling is a form of customs and tax fraud, like trade mis-invoicing. It is carried out, among other, for tax evasion purposes. In this respect, it shares the same rationale as other tax-motivated IFFs. Yet, smuggling involves goods flows, rather than cross-border financial flows. Its inclusion under the IFF agenda is certainly justified, but significantly expands the subject matter of IFFs – from money to financial capital to the monetary value embedded in physical goods.

Even less straightforward is the case where revenue losses for commodity exporting countries arise from *specific pricing arrangements*. Take the example of a metals streaming agreement whereby a future mine output is sold to a foreign buyer at below-market prices in exchange for an upfront capital payment. Traders may buy commodities at below their market value in the context of complex arrangements that include trade credit agreements, prefinancing, commodity prepays or tolling arrangements (Pirrong 2014).[14] These arrangements, if abusive, may involve mispricing. The key issue at stake is price and contract transparency and fairness. The question is whether or not the notion of IFFs should address such issues as transparency and fairness of contract terms and pricing methods.

Underlying activities

A second research component focuses on the underlying activities that generate illicit flows in the commodity economy. There are several often overlapping illegal trade enterprises operating in the commodity economy.

A prominent category relates to illicit resource extraction, harvesting or capture. It includes illegal mining, illegal fishing and logging, and wildlife poaching. As discussed, some of these enterprises (for example, artisanal mining) feature a high degree of subsistence-level criminal activity and offer income strategies for ordinary people lacking credible alternative livelihoods (OECD 2018). They tend to generate illicit revenue, more than losses. Demonizing these essentially informal economies as a whole under the IFF agenda can be a 'misstep' (OECD 2018).

Related sets of illegal activities are associated with 'conflict commodities', sanctions busting, contraband commodities, and oil-theft operations. These activities are likely to play into local power hierarchies and tend to lead to insecurity, violence and conflict (OECD 2018).

Corruption

As discussed (section 1.3), corruption facilitates IFFs and affects their magnitude and direction. In this respect, it should be treated as a crosscutting dimension in the IFF debate, more than a separate IFF sub-component. However, particularly in large commodity projects, it can give rise to distinct illicit flows, for instance if politicians conceal their bribes offshore.

Source: r4d IFF project.

Eventually, different stakeholders may use different working definitions of IFFs, tailored to specific analytical or policy purposes, under a single umbrella definition. Working definitions are fashioned, manipulated; they come with a policy agenda attached to them (Miyandazi and Ronceray 2018). But that is hardly contentious, as far as stakeholders are conscious of, and explicit about methodological choices and policy objectives. The imperative is to spell out methodological constraints that dictate definitional choices.[15] It is also important to spell out the

[14] International traders often act as financial intermediaries for their customers through complex transactions that bundle financing, risk management and marketing services (Pirrong 2014).

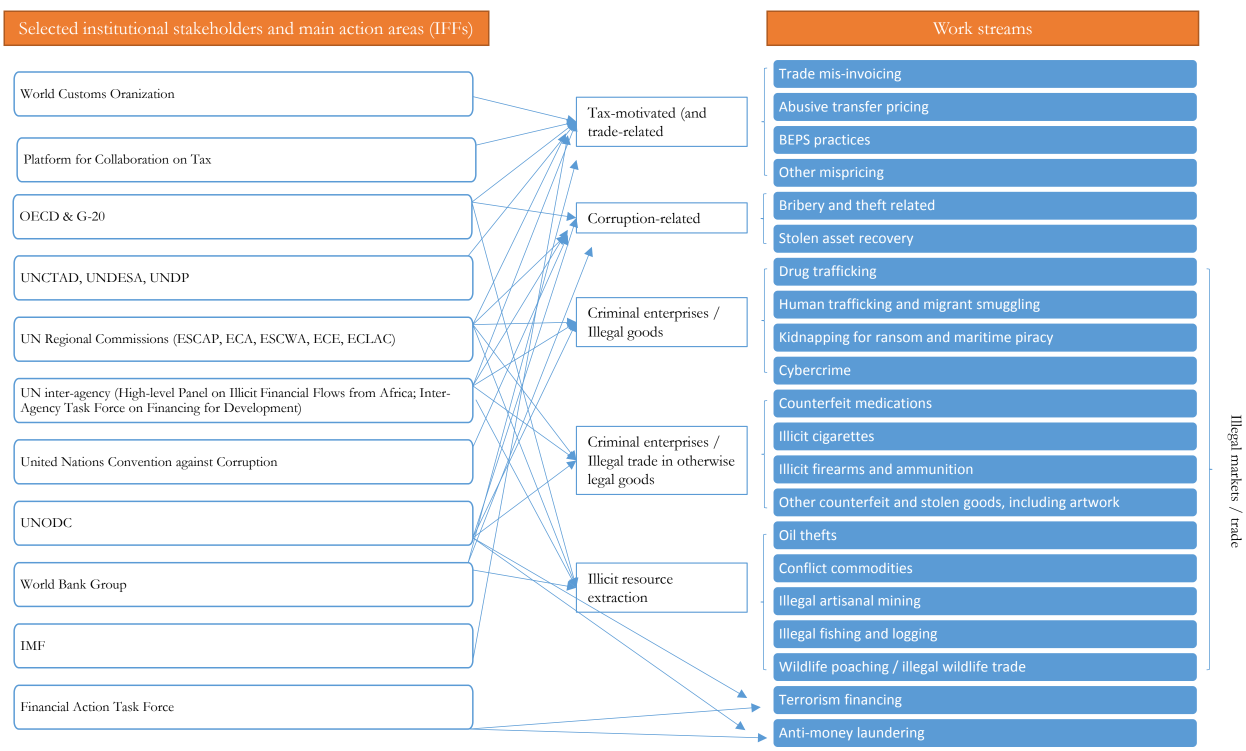
[15] For example, quantitative methodologies (e.g. trade gaps or price filter analysis) to ascertain the volume of IFFs may not fully gauge smuggling, which can be better researched through qualitative research methods.

normative assumptions that frame a specific IFF definition, alongside the policy implications that the definition carries.[16]

2.3 Types of IFFs

Some degree of expediency may also play a role when breaking down IFFs into a taxonomy suitable and distinctive enough for measurement, or into workable 'thematic' modules. Here it is important not to start from scratch, but to build on existing operational work streams. In other words, the taxonomy/categorization exercise should move backward from what exists, in terms of work streams and institutional frameworks in the UN system and in related fora (Figure 3). These work streams include the Stolen Asset Recovery Initiative, the Conference of the States Parties to the United Nations Convention against Corruption, UNODC-related thematic areas, operational frameworks on countering money-laundering and the financing of terrorism, and so on. The starting point should be a stocktaking of existing IFF-related work streams, conducive to an exhaustive inventory of IFF-related thematic areas, with a mapping of the responsible agencies (see Miyandazi and Ronceray 2018). The IFF agenda may then build on these thematic areas, spurring strategic alignment and close collaboration in task teams across agencies that have distinct client engagement (IMF, World Bank, OECD, and several UN and UN-affiliated agencies).

Figure 3: IFFs – Main action areas



Source: Authors' elaboration. For an in-depth review of initiatives targeting IFFs at the African and EU level, refer to Miyandazi and Ronceray (2018).

[16] For example, if the analysis of commodity trade-related IFFs extends to 'in-kind payments' and other 'unconventional' mineral sales - swap sales, pre-payment deals, commodity-backed loans etc. – the normative focus is on issues price and contract transparency and fairness.

2.4 Indicators

Finally, in setting or fine-tuning indicators for SDG target 16.4, it is important to take into account existing data sources, and structure indicators in a way that may inform and guide policy reform. This involves splitting the SDG indicator on IFFs,[17] which aggregates all IFF. As acknowledged by the UN constituency, "the separate analysis of channels or components is more beneficial in designing policy responses to prevent illicit flows" (A/RES/72/207). Different indicators should capture different types of IFFs, by component and channel. Some even argue for a 'modularity' of IFF indicators, so as to factor-in the context-specific revenue and development impacts of IFFs, and for 'politically actionable indicators', allowing for targeted anti-IFFs strategies in specific local contexts (Khan and Andreoni 2018). Splitting the SDG indicator into different sub-indicators may amount to a refinement or a revision, depending on whether small or substantive changes are involved. While refinements of SDG indicators do not require formal adoption by the United Nations Statistical Commission (UNSC), revisions will be considered twice, in March 2020 and in March 2025, for formal adoption by the UNSC after global consultation.

When refining or revising IFFs indicators, it is important to align to established concepts and standards from economics and accounting. Likewise, it is important to take into account the recent development of legal or procedural mechanisms that introduce new transparency frameworks. These disclosure frameworks generate newly available data may allow precise measurement of particular aspects of illicit flows. For example, the exchange of non-resident financial account information with the tax authorities in the account holders' country of residence generates data on offshore tax evasion. As discussed by Cobham and Janský, this data can be used to construe a specific 'undeclared offshore assets indicator'.[18] Payment to government disclosure laws, disclosure of tax avoidance schemes and exchange of advance tax rulings, country by country reporting, and the development of beneficial ownership registries shed light on relatively opaque practices. The OECD country-by-country reporting data, in particular, may be used to construe an -indicator of misaligned profits.[19] It is worth considering to what extent national authorities may build on these transparency frameworks and procedures to feed such indicators (Musselli and Bürgi Bonanomi 2019). The analysis will need to take into account built-in limits to this use: stringent standards on confidentiality, data safeguard and proper use of the information that strike the normative balance between transparency concerns and taxpayers' rights (Box 5).

Box 5: Transparency frameworks and use of data

Disclosure frameworks	Information	Area of relevance	Constraints on public use
Exchange of information on request (EOIR)	Bank information Accounting/transaction level information Ownership information	Tax evasion and avoidance (undeclared offshore accounts; transfer price manipulation; mis-invoicing)	Yes (stringent standards on confidentiality, data safeguard and proper use of the information)
Automatic exchange of information (AEOI)	Bank information	Tax evasion and avoidance (undeclared offshore accounts)	Yes (stringent standards on confidentiality, data safeguard and proper use of the information)
Spontaneous exchange of information (tax rulings)	Accounting/transaction level information	Tax evasion and avoidance (transfer price manipulation; mis-invoicing)	Yes (stringent standards on confidentiality, data safeguard and proper use of the information)

[17] SDG Indicator 16.4.1 "Total value of inward and outward illicit financial flows, in current United States dollars".
[18] Defined as "the excess of the value of citizens' assets declared by participating jurisdictions under the OECD Common Reporting Standard (CRS), over the value declared by citizens themselves for tax purposes to their tax authorities" (Cobham and Janský 2018)
[19] Calculated as "the total excess profits declared in jurisdictions with a greater share of profits than would be aligned with their share of economic activity" (Cobham and Janský 2018)

Country-by-country reporting (CbCR) *(local and master files)	Accounting/transaction level information	Tax evasion and avoidance (transfer price manipulation; mis-invoicing)	Yes ((stringent standards on confidentiality, data safeguard and proper use of the information)
EITI	Payments made & revenue received	Revenue transparency (corruption and accountability)	Public
Payment to Government (PtG) laws	Payments made	Revenue transparency (corruption and accountability)	Public
Sustainability reporting and due diligence laws	Payments made; corporate social responsibility	Revenue transparency (corruption and accountability); illegal trade	Public

Source: r4d IFF project, stocktaking 1 (transparency in tax matters).

Conclusions

A broad IFF agenda is a powerful engine for systemic change. It counters the tendency, inherent in legal specialism, towards fragmentation and duplication; fosters regulatory coordination across a spectrum of interventions; and promotes policy interventions that have multiplier effects across the whole spectrum of IFFs.

Stakeholders should converge around a broad, flexible 'umbrella definition' of IFFs in which all parties can read their own meaning of the terms. The working definition of IFFs as international transfers of illicitly earned, sourced or transferred finance (or capital) can be retained as the 'common denominator definition'. It provides an umbrella definition for separate work streams for each IFF sub-component. Under each work stream, the meaning of the definition can be specified and eventually narrowed for specific policy or analytical purposes.

An excessive focus on legalistic distinctions is not helpful. 'Illicitness' should be flexibly construed with reference to national or international law *and standards*, including the BEPS standards and those set by other standard setting bodies in international tax matters. Though not formally binging, multilaterally agreed standards are legally relevant and point to the direction in which the law is evolving. By benchmarking illicitness against well-defined standards and legal principles, the IFF debate would remain anchored to (soft) law, while integrating evolutive elements.

A developmental, or revenue-impact approach offers a useful policy orientation to the IFF debate. Linked into the sustainable development agenda, it assists in drawing a line between licit and illicit financial flows. Yet, it comes with a requirement of contextual, factual intensive analysis.

For specific policy and research purposes, it may be necessary to add granularity to the definition, by spelling out what is in and what is out of scope with reference to actors, transfer mechanisms, or origin. The process is bound to be discretionary, framed by reasons of methodological convenience and political sensitivity. Eventually, different stakeholders may use different working definitions of IFFs, tailored to specific analytical or policy purposes, under a single umbrella definition. The imperative is to spell out methodological constraints that dictate definitional choices, alongside the policy implications that each working definition carries.

A pragmatic approach should inform the breakdown of the IFFs agenda into workable modules and the choice of indicators. The starting point should be a stocktaking of existing IFF-related initiatives, conducive to an exhaustive inventory of IFF-related thematic areas, with a mapping of the responsible agencies. The IFF agenda may build on these thematic areas, spurring strategic alignment and close collaboration in task teams across agencies that have distinct client engagement. The SDG indicator on IFFs should be split into sub-indicators. To the extent possible, this should be construed as a refinement of the indicator, rather than a revision, in order to avoid cumbersome consensual procedures. When refining IFF indicators, it is important to align to established concepts and standards from economics and accounting. It is also important to consider new disclosure frameworks (AEOI, CbCR, etc.). These frameworks generate newly available data that may allow precise measurement of particular aspects of illicit flow. Yet, there are built-in limits to this use, including stringent standards on confidentiality, data safeguard and proper use of the information.

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