



Illicit Financial Flows from Developing Countries: 2002-2006

Executive Summary

The objective of this study is to estimate the volume and pattern of illicit financial flows exiting the developing world through application of existing economic models using the most recent macroeconomic data available. **Illicit financial flows in the context of this report includes the proceeds from both illicit activities such as corruption (bribery and embezzlement of national wealth), criminal activity, and the proceeds of licit business that become illicit when transported across borders in contravention of applicable laws and regulatory frameworks (most commonly in order to evade payment of taxes).** This paper does not link illicit financial flows with the underlying activities (whether legal or illegal) that generated the capital to transfer abroad.

Official statistics on illicit financial flows do not exist because these outflows escape the detection of regulatory agencies. Since a country's official statistics do not directly record the outflows of illicit capital, researchers have developed a number of proxy measures to study the phenomena. All of these proxy measures, based on economic models, have a limited capacity to reflect the actual volume of illicit financial flows. Therefore, if anything, the estimates of illicit financial flows for developing countries presented in this paper are likely to be understated.

Principle Findings

- 1) In 2006, the most recent year of the GFI study, developing countries lost an estimated \$858.6 billion – \$1.06 trillion in illicit financial outflows.
- 2) Even at the lower end of the range of estimates, the volume of illicit financial flows coming out of developing countries increased at a compound rate of 18.2 percent over the 5 year period analyzed for the study.
- 3) On average, for the five-year period of this study, Asia accounts for approximately 50 percent of overall illicit financial flows from all developing countries.
- 4) Due to a large volume of illicit financial flows from mainland China, Asia was the dominant region in overall illicit financial flows from developing countries.
- 5) On average, Europe ranks second in the share of overall illicit financial flows from developing countries, accounting for approximately 17 percent of the total.
- 6) The share of illicit financial flows from the Middle East and North Africa (MENA) region and the Western Hemisphere region are each approximately 15 percent of total illicit financial flows from developing countries.
- 7) The smallest share of illicit financial flows is from the Africa region at approximately 3 percent of the total. However, there are strong reasons to believe that the share would have been higher if more complete and reliable data were available.



- 8) Over the five-year period of this study, illicit financial flows grew at the fastest pace in the MENA (49.4 percent) region followed by Europe (25.4 percent), Asia (15.7 percent), and the Western Hemisphere (2.8 percent) in that order. Illicit financial flows from Africa actually declined (-2.9 percent) but this decline is more the result of incomplete data than supportive economic or political factors.
- 9) The nearly 50 percent compound rate of growth in illicit financial flows from the MENA region reflects the phenomenal growth of the current account surplus and external debt of many oil producing countries in the region, rather than the flight of capital through trade misinvoicing.

Methods of Estimation

The estimates of illicit financial flows presented in this paper are based on three economic models — the Hot Money, World Bank Residual, and Trade Mispricing—which have been widely used by economists. These methods provide estimates of illicit financial flows from all developing countries broken down by various regions of the world making use of large-scale macroeconomic databases maintained by international organizations such as the IMF and the World Bank. The paper provides recent estimates of illicit financial flows from developing countries, which should be welcome by both researchers and policy makers alike given that there have been very few such comprehensive studies.

The main methods of estimating illicit flows in this paper involve a combination of the World Bank Residual model and the Trade Mispricing model. The former is intuitively appealing in that source of funds (inflows of capital) which are not matched by recorded use of funds (outflows or expenditures of capital) are considered to be illicit financial flows. Source of funds include types of capital inflows such as increases in net external indebtedness of the public sector and the net flow of foreign direct investment.

This paper also utilizes two alternative measures of net external indebtedness of the public sector, one based on changes in the stock of external debt (CED) and the other on the net debt flows (NDF). Use of funds includes the current account deficit (that is financed by the capital account flows) and additions to reserves. In this broad macroeconomic framework, outward illicit flows exist when the source of funds exceeds the use of funds, and vice-versa for inward illicit financial flows. The second method attempts to capture illicit flows through trade mispricing. Researchers have long recognized trade mispricing as a major conduit for illicit financial flows. By over-invoicing imports and under-invoicing exports wealth can be accumulated outside the jurisdiction where it was earned (i.e. illicit financial flows).

The data showing exports to and imports from a particular country are derived from partner-country trade data reported to the IMF by its member countries for publication in the *Direction of Trade Statistics (DOTS)*. The DOTS is a unique database on global trade flows which allows researchers to estimate an important component of illicit financial flows which occurs through the misinvoicing of international trade.

Economic model estimates are “normalized,” or filtered, which yields the lower end of a range of estimated illicit financial flows. The normalization process subjects the entire list of developing countries (for which data are available) to pass through two filters: (i) capital outflows must be seen in at least three out of the five years studied and, (ii) capital outflows must exceed a minimum of 10 percent of the country’s exports, the assumption being that lower levels are likely due to data problems rather than genuine illicit financial flows. In contrast, the “non-normalized” method of deriving illicit financial flows for a country includes all cases where estimates of illicit financial flows were encountered, no matter how small and even if only for one year out of the five studied. The non-normalized method yields the higher end of a range of estimated illicit financial flows volumes.