The "Mexico: Illicit Financial Flows, Macroeconomic Imbalances, and the Underground Economy" report from Global Financial Integrity is EMBARGOED until Sunday, January 29, 2012 at 13:01 CST / 14:01 EST / 19:01 GMT. Contact Clark Gascoigne (cgascoigne@gfintegrity.org, +1 202 293 0740 x222) to request advance copy of the report.

Tip Sheet: Mexico: Illicit Financial Flows, Macroeconomic Imbalances, and the Underground Economy: *New study from Global Financial Integrity analyzes illicit financial flows out of Mexico from 1970 through 2010.*

Report Background: Each year, Global Financial Integrity (GFI) releases a global overview of illicit financial flows out of all developing countries, and one in-depth, country-specific study on the drivers and dynamics of illicit financial flows from a particular developing nation. This year, Global Financial Integrity's country-specific study examines Mexico.

The report measures and tracks the amount of illicit money (the proceeds of crime, corruption, and tax evasion) that left the country illegally over the 41 years between 1970 and 2010. It's important to note, though, that GFI's models cannot pick up transactions that are settled in cash, which tend to be things like drug trafficking, human trafficking, etc., so these are extremely conservative estimates. Were cash transactions able to be captured in the model, the numbers would likely be much higher.

Report Findings include:

- **Over the period 1970-2010, cumulative illicit financial flows from Mexico amounted to a massive US$872 billion.**
- **The outflow of illicit capital has grown significantly from around US$1 billion in 1970 to US$68.5 billion in 2010 after reaching a peak in 2007 when the value was close to US$91 billion.** Average outflows of illicit capital per annum increased sharply throughout the four decades. They were US$3.0 billion in the 1970s, US$10.4 billion in the 1980s, US$17.4 billion in the 1990s, and US$49.6 billion in the decade ending 2009.
- **Flows of illicit money averaged 5.2 percent of GDP** over the 41-year period 1970-2010. The peak year for illicit flows as a percentage of GDP was 1995 when it reached 12.7 percent. As a percentage of GDP, **illicit flows increased from an average of 4.5 percent of GDP in the period before NAFTA was implemented in January 1994 to an average of 6.3 percent of GDP in the 17 years that followed**.
- IFFs as a percent of Mexico's external debt increased from 15.0 percent in 1970 to 28.7 percent in 2010, averaging 16.8 percent over the period 1970-2010. Most of the sharp increase in this ratio came after NAFTA was implemented in 1994;
- Baring a few significant jumps, IFFs as a percent of Mexico's exports declined from 74.4 percent in 1970 to 23.0 percent in 2010 mostly as a result of increasing oil exports over time;
- **There is a stable relationship between the volume of illicit outflows and the onset and aftermath of Mexico's macroeconomic crises** during the 41-year period. With reference to the six crises studied, illicit outflows increased in the crisis year compared to the two years preceding the crisis. Specifically, in the:
    - 1973 oil price shock, illicit outflows were 4.4 percent of GDP, which was almost four times higher than the average of 1.15 percent per annum during the two years before the crisis;
    - 1976 balance of payments crisis, illicit flows were 5.6 percent of GDP, which was well above the average of 3.2 percent per annum recorded during 1974-1975;
    - 1982 debt crisis, outflows were 5.3 percent compared to an average of 3.5 percent during 1980-81;
    - 1986 oil price shock, illicit flows were 8.1 percent of GDP, which was significantly higher than the average of 5.1 percent of GDP seen over 1984-85;

- 1994 peso crisis outflows were 3.8 percent of GDP which was almost three times the average rate of 1.3 percent over the period 1992-93; and
- global economic crisis of 2007, illicit flows were 8.8 percent of GDP compared to an average annual rate of 5.5 percent over 2005-06.

Illicit Outflow Drivers, Trends:

- **Trade mispricing accounted for 73.7 percent of total illicit flows** over the period 1970-2010. (5) Moreover, the report found that **increasing trade openness since 1994 when NAFTA was implemented led to more trade mispricing**.
- The report finds that **illicit outflows drive the underground economy and contribute to the deterioration of economic governance**. Likewise, **growth in the underground economy also drives illicit flows**. Therefore, curtailing illicit financial flows will have a positive impact in reducing corruption and criminal activity throughout the country. The link between the underground economy and illicit flows is consistent with the case study on India which GFI conducted last year.

Implications

Over the past decade, illicit outflows have averaged about 6% of GDP—a massive amount of money for any developing nation to lose. These illicit flows rob Mexico of much needed funds to foster economic development, and they reduce the tax revenue the government needs to finance schools, hospitals, infrastructure, poverty alleviation and the fight against the drug cartels.

Policy Recommendations:

Almost three-quarters of total illicit flows over the period 1970-2010 were generated through trade mispricing (Appendix Table 6). This would strongly suggest that policy should be focused on curtailing trade mispricing. The report recommends three policy measures to reduce trade mispricing:

- Require the utilization of computer software to detect export and import prices that are clearly out of line with international norms; (49)
- Require that the parties conducting a sale of goods or services in a cross-border transaction sign a statement in the commercial invoice certifying that no trade mispricing in an attempt to avoid duties or taxes has taken place and that the transaction is priced using the OECD arms-length principle; (51) and
- Undertake additional measures to curb abusive transfer pricing. (51)

In addition to policy action to curtail trade mispricing, the report recommends four additional policy actions to reduce illicit capital flight from Mexico:

- expand double tax avoidance agreements; (53)
- require automatic cross-border exchange of tax information on personal and business accounts; (54)
- pursue macroeconomic stability; (56)
- improve overall governance in order to reduce the propensity to pay bribes and kickbacks; (57) and
- take steps to reign in the role of offshore financial centers (OFCs) and banks. (59)