

Executive Summary

This is a study of illicit financial flows and capital flight (consisting of both licit as well as illicit capital) from Brazil, which we have undertaken for three main reasons. First, existing studies on capital flight from Brazil are dated. Second, there are no studies that focus on outflows of illicit capital from Brazil, let alone over a long time span. Finally, Brazil is a large exporter of illicit capital. Global Financial Integrity's latest annual report, *Illicit Financial Flows from Developing Countries: 2002-2011*, published in December 2013, found that the country illegally transferred abroad on average US\$19.3 billion per annum over the decade ending 2011, the seventh highest of such outflows from the developing world.

Outflows of illicit capital totaled US\$401.6 billion from 1960 through 2012. Illicit outflows increased from an annual average of 1.49 percent of GDP in the 1960s to 1.71 percent of GDP in the 1980s before receding to 1.54 percent of GDP in the last decade ending 2009. Outflows have continued at roughly 1.47 percent of GDP in the most recent three-year period, 2010-2012, for which data are available. Most illicit outflows occur through trade misinvoicing rather than via balance of payments leakages. The deliberate under-invoicing of exports rather than the over-invoicing of imports is the preferred method to transfer illicit funds from Brazil.

In terms of magnitude, Brazil lost a total of US\$590.2 billion during the period (or about 2.2 percent of GDP on average) through broad capital flight, which consists of illicit as well as licit funds. Capital flight increased sharply from the 1960s through the 1990s, although the pace of outflows declined somewhat over the last decade ending 2009. There is no doubt that serious macroeconomic shocks related to hyperinflation and near-debt defaults triggered the continued increase in capital flight in the 1990s. Starting at about 2.6 percent of GDP on average during the 1960s, capital flight fell to 1.9 percent of GDP in the last decade ending 2009 before increasing to 2.1 percent of GDP in the last three years, 2010-2012.

We developed models to estimate the size of the underground economy and to explore the factors driving both capital flight and illicit flows from Brazil over the period 1965-2011. One of the most interesting findings is that illicit financial flows both drive and are driven by Brazil's underground economy. Moreover, the models confirm that the underground economy had a significant negative impact on investment, implying that, as the underground economy grew, it tended to divert resources away from the official economy. Likewise, we found that even broad capital flight, consisting of a mix of licit and illicit flows, is driven mainly by governance-related factors such as illicit flows. This is not surprising given that, on average, illicit flows comprise some 68 percent of capital flight.

We found that broad capital flight behaved in a more predictable manner than illicit outflows in response to macroeconomic crises. This is to be expected because the licit component of broad capital flight tends to be more sensitive to macroeconomic shocks than the illicit component, where

the primary motivation is sheltering illicit assets from regulatory scrutiny and confiscation even in the best of times. In general, capital flight seems to increase in the immediate aftermath of a crisis, perhaps in proportion to the severity of the crisis.

Econometric model tests provided several insights into how macroeconomic conditions and the overall state of governance impact both capital flight and illicit flows, as well as how they impact the “above-ground,” or official, economy. The salient findings can be summarized as follows.

Capital flight and illicit financial flows tend to drive each other. This is the first study where a definite link between the two has been established through the use of a structural equations model. We found that a 1.0 percent increase in illicit financial flows is correlated to a 0.83 percent increase in broad capital flight.

We also examined the link between economic growth, income inequality, and capital flight. While the lack of an unbroken series on the Gini coefficient prevented its inclusion in our model, regression analysis with a shorter time period (1970-2011) showed that worsening income inequality also seems to drive capital flight, although the relationship is only significant at the 90 percent level. A possible explanation is that rising income inequality implies a larger number of high net worth individuals (HNWIs). It is the HNWIs rather than the common man that can finance capital flight and take advantage of the world’s shadow financial system to shelter wealth.

Drawing upon the results of the model, we examine the legal and policy environment in Brazil, and conclude with suggested policy measures to curtail capital flight and illicit flows from Brazil. Our finding that illicit flows through trade misinvoicing comprise the largest proportion of capital flight from Brazil suggests that curbing capital flight will require strong customs and tax enforcement and oversight. Brazil has also long struggled with corruption, and our finding of the persistent size of Brazil’s underground economy—38.9 percent of the official economy per year on average over the period of the study—suggests that the country faces much broader governance issues. Finally, while Brazil has made great strides in recent years towards bringing its anti-money laundering regime in line with international standards, these legal changes have not necessarily been accompanied by effective enforcement.

No set of policy changes is capable of completely eliminating illicit financial flows or capital flight, but we recommend several measures designed to substantially curtail such flows, guided by two main principles: greater transparency in domestic and international financial transactions, and greater cooperation between governments to shut down the channels through which illicit money flows. These include taking stronger legal measures against trade misinvoicing, instituting transparency of company ownership, and building the technical and human capacity needed to effectively utilize the data that will be shared under emerging tax information exchange arrangements.

Overall, Brazil has an established financial infrastructure, a strong commitment to democratic governance, and many of the laws and procedures needed to curb illicit financial flows and rein in the underground economy already in place. However, these advantages must be coupled with the capacity and political will to fully implement and enforce such measures. Curtailing illicit financial flows must become a priority throughout the Brazilian government.