

Fernando Cantu-Bazaldua via factipanel.org

1:42 AM (21 hours ago)

to Stephen, info@factipanel.org, Anu

Dear colleagues,


Following my message from last week, please find attached the final draft of the UNCTAD-UNODC Conceptual Framework for the Measurement of Illicit Financial Flows. It presents the definition and scope of measurement of IFFs in the context of SDG indicator 16.4.1, and it was created in consultation with the Task Force on the Statistical Measurement of IFFs, an UNCTAD/UNODC initiative involving representatives from national statistical offices and other official data providers, as well as international organizations. This document is the basis for ongoing methodological development of the SDG indicator. We are currently developing methodological guidelines based on this framework, which will be further developed during pilot testing that are already taking place and will continue in the coming years. We will inform the FACTI panel of any progress in this front in due course.

In the meantime, if you have any questions about the conceptual framework or you require any additional information on the development of SDG indicator 16.4.1, please let us know.

Thank you and best regards,



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From: Fernando Cantu-Bazaldua

Sent: Tuesday, 26 May 2020 16:25

To: info@factipanel.org

Cc: Anu Peltola <Anu.Peltola@unctad.org>

Subject: UNCTAD/UNODC Conceptual Framework on the statistical measurement of illicit financial flows

Dear colleagues,

I hope this message finds you well. I am writing from the Development Statistics and Information Branch of UNCTAD. As custodians of SDG 16.4.1 on illicit financial flows, we keep working on the statistical development of this indicator and the challenges around measuring the different components and channels of illicit financial flows.


This afternoon we had a meeting of the Task Force on the Statistical Measurement of IFFs, established by UNCTAD and UNODC to advance this work. At this meeting, we had a final round of discussions on a draft Conceptual Framework, establishing the definition and scope of measurement of IFFs for statistical purposes and in the context of the SDG indicator. We will incorporate the final comments received and we will send it by the end of this week for consideration of the FACTI Panel.

Apologies for missing the deadline of 24 May (of the call for comments from stakeholders), but we wanted to make sure to send you a final version of the Conceptual Framework.

Many thanks and best regards,

Fernando

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UNCTAD-UNODC Conceptual Framework for the Measurement of Illicit Financial Flows

May 2020

1. Executive summary

The 2030 Agenda for Sustainable Development (A/RES/70/1) identifies the reduction of IFFs as a priority area to build peaceful societies around the world. Combatting IFFs is a crucial component of global efforts to promote peace, justice and strong institutions, as reflected in target 16.4 of the 2030 Agenda, i.e. *“by 2030, significantly reduce illicit financial flows and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organised crime”*.

In July 2017, the United Nations General Assembly adopted the indicator framework for the monitoring of progress towards SDGs (A/RES/71/313). Indicator 16.4.1, *total value of inward and outward illicit financial flows*, was selected as the indicator to measure progress towards target 16.4. At the time, there was no universal agreement on what should be included within the scope of IFFs or how the component parts could be measured.

As different understandings of IFFs can be found and many of these flows are deliberately hidden, measuring them is an extremely difficult task. Reflecting this complexity, the indicator has two custodians: UNODC leading the work on crime related IFFs and UNCTAD leading the development of methods to measure IFFs related to taxes and trade. This document reflects the results of international work on statistical definition of IFFs and concepts to enable their measurement.

The custodian agencies joined forces to develop common statistical definitions and methods for the measurement of different types of IFFs in one indicator. During 2017-2018, UNCTAD and UNODC held expert consultations and, at their recommendation, established a joint statistical Task Force to develop methodologies for the measurement of IFFs. Arising from this work, a conceptual framework, statistical definitions, typology and methodologies have been prepared.

This approach identifies the main types of IFFs to be measured and lays out a framework based on existing statistical definitions, classifications and methodologies, in line with the System of National Accounts (SNA) and the balance of payments (BoP). A disaggregated and bottom up measurement approach is proposed in line with these frameworks and following international efforts to measure non-observed or illegal economic activities.

Illicit financial flows refer to activities considered as criminal offences, also some non-illegal behaviours related to tax and commercial practices. The International Classification of Crime for Statistical Purposes (ICCS) provides definitions of activities generating IFFs. Four main types of activities can generate IFFs: 1) tax and commercial activities, 2) corruption, 3) theft-type activities and financing of crime and terrorism, and 4) illegal markets. IFFs can emerge at two different stages:

- Illicit income generation, which includes the set of transactions that either are performed in the context of the production of illicit goods and services or generate illicit income for an actor during a non-productive illicit activity.

- Illicit income management, which refers to transactions that use illicit income to invest in financial and non-financial assets, to shift income or assets across borders, or to consume goods and services.

IFFs are multi-dimensional, comprising several different kinds of activities, including flows originating from illicit activities, illicit transactions to transfer funds that have a licit origin, and flows stemming from licit activity being used in an illicit way. Not all illicit financial flows stem from illegal activity. For example, the indicator includes aggressive tax avoidance as an illicit financial flow, as it can be considered detrimental to sustainable development in many countries, even though such activities are generally not illegal.

In October 2019, at the 10th session of the Inter-Agency and Expert Group on Sustainable Development Goals Indicators (IAEG-SDGs) in Addis Ababa, the expert group reviewed the methodological proposal jointly submitted by the custodian agencies. At that meeting, the IAEG-SDG reclassified the indicator from Tier III to Tier II, meaning the indicator is conceptually clear and has set out internationally established standards, but data are not yet regularly produced by countries.

This document further details the conceptual framework for measuring IFFs. The framework and specific measurement methodologies are tested in ongoing and new pilot activities. The methods in relation to selected illegal markets have been tested in Latin America as well as at the sub-regional level for selected activities (wildlife goods and drug trafficking). Preliminary findings show the feasibility of the developed measurement approaches.

2. Introduction to IFFs

Every year organized crime and trade with illegal goods (such as, drug trafficking or trafficking in firearms) and illegal and illicit tax and commercial practices generate billions of dollars of illicit flows. Proceeds of crime may be channelled abroad, often to safe havens. They may also be laundered and re-cycled into legal markets. Large-scale organized crime, and the related illegal economies, weakens state institutions by fuelling corruption and violence, and undermines the rule of law. It discourages public and private investment and deprives the licit economy from resources that are needed for sustainable development across all its dimensions. IFFs stemming from illegal activity such as crime and corruption erode the functioning of criminal justice systems, reduce state revenues, erode the tax base, and weaken state institutions.

Other illicit financial flows originating in the legal economy may also divert resources for development, erode the tax base, hamper structural transformation and sustainable economic growth.

The ability to achieve the SDGs remains fragile when undermined by IFFs. Indeed, the 2030 Agenda underscores the need for an increased mobilization of financial resources dedicated to sustainable development, including through the improved capacity for revenue collection, and more resources dedicated to investment. IFFs undermine this effort. The Addis Ababa Action Agenda [paras 23 and 24] on financing for development also calls for a redoubling of efforts to substantially reduce IFFs, with a view to eventually eliminating them.

Progress towards target 16.4 of the 2030 Agenda, which aims to “*significantly reduce illicit financial flows*” is to be measured by SDG indicator 16.4.1, the “*Total value of inward and outward illicit financial flows (in current United States dollars)*”. The SDG indicator focuses on cross-country flows to

assess the size of financial flows entering or leaving a country, thus, reducing funds for development or driving the financial system of a country.

In 2017, when the United Nations General Assembly adopted the SDG indicator framework, there was no consensus on what precisely was meant by IFFs nor on how they could be measured. UNCTAD and UNODC, the two co-custodians of indicator 16.4.1 started methodological work and broad consultations to develop statistical definitions and methods to measure IFFs.

3. Statistical challenges

Lack of consistent statistics on IFFs causes uncertainty about how large illicit flows are, how and where they originate and their impact on development. IFFs can be generated by a wide variety of different activities, such as crime, corruption, illicit tax practices and others. IFFs can markedly differ across countries and regions, but the lack of a common framework makes their measurement impossible.

3.1 Conceptual challenges

A review of research shows that there are different understandings of what IFFs constitute and how they can be measured, ranging from estimates of money laundering schemes that rely on the banking system to disguise the illicit origin of funds, to macroeconomic measures that compare mirror trade statistics between countries. The absence of a common understanding hampers policy action to combat IFFs in the national context and internationally to agree on common policy goals.

For instance, some quantitative studies equate IFFs with trade misinvoicing only. While trade-based money laundering is a method to move money illicitly, it is not the only IFFs, and these measures related to trade misinvoicing typically do not consider illicit flows transiting through the financial system or the physical movement of money.

By definition, IFFs only include illicit flows. However, statistical studies carried out to date show that it is empirically challenging to separate some practices, like tax evasion (illegal) and borderline practices, such as aggressive tax avoidance (generally legal, but often considered illicit in the academic literature). It is not always straightforward to determine the point at which lawful tax planning becomes aggressive or harmful. It may only be possible to measure a range as the border between lawful and aggressive tax planning may be methodology specific.

3.2 Ensuring validity and soundness of estimation methods

IFFs are deliberately hidden and, as they take many forms and use varying channels, their measurement is challenging both conceptually and in practice. The challenges of measuring and countering IFFs differ across countries. Consequently, their practices and approaches to measuring the illegal, non-observed or informal economic activities that may generate IFFs differ. Therefore, space for country-specific solutions and flexible application of methods is necessary.

At the same time, statistics need to be based on definitions that can be applied in a similar fashion across countries to enable comparability. For instance, crime statistics are based on a globally agreed classification of crimes consisting of types of actions and behaviours to be measured regardless of what is considered a crime by the national legislation of each country. From a practical perspective, statistics cannot be based directly and exclusively on legal considerations since legal frameworks are

not consistent across jurisdictions and are often reactive (e.g., there may be significant time lags before new types of activities are declared illegal) leading to differential treatment across countries and time.

Transactions of an illicit nature¹ can take place in several guises and at various stages of economic activity. For example, funds can be used for cross-border imports of illicit goods and then for their further sale to another country. The activities that generate IFFs need to be analysed carefully and placed in a framework that can identify the various components that give rise to illicit activity. IFFs need to be classified using a discrete, exhaustive and mutually exclusive statistical classification aligned with existing statistical frameworks and principles.²

Many illicit activities are intertwined, such as, bribery related to drug trafficking or trade mispricing. To avoid duplication, separate accounting for income generation and income management is needed consistent with the System of National Accounts (SNA). The measurement should also be based on an exclusive statistical classification that separates as far as possible, for instance, corruption from other illicit activities

3.3 Availability and limitations of data

National statistical systems already have some of the data needed for the measurement of IFFs, but these data are scattered across a range of authorities and statistical domains. For instance, existing national accounts and balance of payments statistics, produced by national statistical institutes and central banks, including estimates of illegal economic activities³ and the non-observed economy⁴, provide a good starting point for the measurement of IFFs.

Other relevant data may be held by the police and ministries of justice, councils of justice, financial intelligence units and other government agencies collecting information on seizures and criminal offences. In addition, tax authorities typically collect relevant data for assessing tax gaps and exchange country-by-country reporting data on multinational enterprises, although these data are often collected for purposes other than statistical analysis (e.g. risk assessment). Statistics on international trade in goods and services can provide useful information on commercial IFFs. However, while data on merchandise trade collected by customs cover all commodities, with only small gaps in terms of goods not going through customs, often countries do not have a single or harmonised data source to

¹ The Balance of Payments Manual 6th edition defines illegal transactions as those that are forbidden by law, and only when the institutional units involved enter the actions by mutual agreement. Otherwise, they are other flows. Illegal transactions are treated the same way as legal actions in the balance of payments statistics.

² The OECD glossary of statistical terms offers some good advice on what makes a good classification. See <https://stats.oecd.org/glossary/detail.asp?ID=350>.

³ According to the 2008 SNA there may be no clear borderline between the non-observed economy and illegal production. By definition, illegal production comprises (1) the production of goods or services whose sale, distribution or possession is forbidden by law; (2) production activities which are usually legal but which become illegal when carried out by unauthorised producers, e.g., unlicensed medical practitioners (SNA 6.30); (3) production which does not comply with certain safety, health or other standards could be defined as illegal. (SNA 6.35); and (4) the scope of illegal production in individual countries depends upon the laws in place, e.g. prostitution. Transactions on unofficial markets must also be included in the accounts, whether such markets are actually legal or illegal.

⁴ According to OECD (2012). *Measuring the Non-Observed Economy: A Handbook* "The groups of activities most likely to be non-observed are those that are underground, illegal, informal sector, or undertaken by households for their own final use. Activities may also be missed because of deficiencies in the basic statistical data collection programme."

capture trade in services.⁵ Unfortunately, trade in services is very challenging to measure in general. As they seem to offer an important potential as a large carrier of IFFs, special efforts will be required to measure and analyse these flows. However, due attention is needed to interpret information from trade statistics, especially when using methods such as mirror statistics: several components should be taken into account when assessing discrepancies between data produced by origin and destination countries, the existence of IFF being only one of them.

According to a recent IMF survey⁶ on the measurement of informal economy, over 60 per cent of national statistical offices collate relevant data on the underground, illegal and informal activities using surveys, administrative sources, mirror statistics, international studies and expert assessment. While informal activities are largely domestic, many of them generate cross-border flows, and while the statistical sources may not cover all kinds of IFFs, they typically focus on those flows that are most relevant to a country. There are also systematic data collections on crime and related IFFs; UNODC, for instance, compiles statistics on drugs as reported directly by countries, including detailed data on demand, supply, prices, drug characteristics, seizure data, etc. It is likely, however, that some countries will need to identify additional sources of information to measure IFFs consistently.

Compiling statistics on IFFs requires access to many data sources held by different authorities. Central banks, tax authorities and national statistical offices often have the strongest mandate to collect and access such data. National statistical offices, as the coordinator of the national statistical system and as the focal point for coordinating the compilation of SDG indicators, should lead the work to bring the necessary stakeholders together to measure IFFs.

4. Main steps taken to develop the measurement of IFFs

To progress with the challenging measurement task, UNCTAD and UNODC are undertaking a series of coordinated actions and consultations to develop the statistical measurement of IFFs. The initial steps involved analytical studies and background research⁷ on IFFs and a review of the measurement methods applied by various researchers and organisations, which provided substantive input to subsequent activities.

During 2017-2019, UNODC and UNCTAD held a series of expert consultations⁸ to take stock of current research, knowledge and experience regarding different types of IFFs. The expert consultations included contributions from national statistical offices, financial intelligence units, tax authorities, academia, non-governmental organisations, international organisations and other IFF experts. In

⁵ Some countries, however, have introduced advanced systems for the reporting and monitoring of services trade. For instance, since October 2012 Brazil requires Brazilian legal entities and individuals to report on all services taken or rendered abroad as import or export of services to the Integrated System of Foreign Service Trade (SISCOSERV). It includes information on services, intangibles and other transactions that may generate changes in the net worth in Brazil.

⁶ International Monetary Fund (2018). *Preliminary Report of the Task Force on Informal Economy*. Available at <https://www.imf.org/external/pubs/ft/bop/2018/pdf/18-10.pdf> (accessed 10 February 2020).

⁷ The background research includes the work of custodian agencies UNODC and UNCTAD and the findings by consultants, among others, Alex Cobham, Petr Janský, Kathy Nicolaou-Manias, Mushtaq Khan and Antonio Andreoni.

⁸ For more information on the UNCTAD and UNODC expert consultations on indicator 16.4.1, see <https://www.unodc.org/unodc/en/data-and-analysis/statistics/expert-consultation-iff.html> and <https://unctad.org/en/Pages/MeetingDetails.aspx?meetingid=1864>.

addition, UNCTAD and UNODC collected expert advice and insights at various fora.⁹ The meetings highlighted an urgent need to agree on concepts and definitions and recommended further engagement with national statistical authorities, including central banks, customs and tax authorities.

To this end, UNCTAD and UNODC established a joint statistical Task Force¹⁰ on the measurement of IFFs in January 2019 to define concepts; assess data availability; develop statistical methods; and review country-level activities for the measurement of IFFs.

The Task Force's work is based on analytical studies that provided a thorough overview of the aspects to be addressed in developing a method for SDG indicator 16.4.1. Consultations with national and international organisations have been critical to generating broad consensus on the statistical concepts and definitions. The Task Force started with a review of previous research and with an analysis of the outcomes of expert consultations. The statistical definitions and methods, thus, build on previous work on IFFs and related statistical activities¹¹.

Following the review of current methods, the Task Force held several conference calls and one face-to-face meeting in Geneva on 16-17 July 2019, leading to a common understanding on the statistical scope and definitions for measuring SDG 16.4.1. Based on this work, the custodian agencies presented the proposal to the IAEG-SDGs in October 2019. The IAEG-SDG endorsed the direction taken, and reclassified indicator 16.4.1 from Tier III to Tier II, meaning that the indicator is conceptually clear and based on internationally established standards, but data are not yet available from countries.

Despite this reclassification, the work to develop statistical methods and guidance for the measurement of the indicator continues. Methodologies are currently being pilot tested as part United Nations Development Account (UNDA) projects in coordination with UNECA and ECLAC. These projects, with a regional focus on Africa and Latin America and the Caribbean, aim to develop countries' capacity to compile and disseminate statistics on IFFs. The activities have provided important insights into the feasibility of measurement and current capacity gaps and will feed into refining the measurement framework. In 2020, another UNDA project was launched in the Asia and the Pacific region in cooperation with ESCAP.

The joint Task Force will continue to guide pilot testing, refine the statistical methods based on the results of pilots and prepare a comprehensive statistical framework for the measurement of IFFs.

⁹ These included, but were not limited to, the UNCTAD Session on Multinational Profit Shifting and Illicit Financial Flows at the World Statistics Congress in Kuala Lumpur (August 2019), UNODC Side Event on Measuring Illicit Financial Flows from Crime in Vienna (April and May 2019), UNECA Inception Meeting: Preventing Trade Mis-invoicing in Selected African Countries in Addis Ababa (April 2019), ESCWA International Conference on 'Financing Sustainable Development - Curbing Illicit Financial Flows in Beirut (November 2018), UNODC Technical Meeting on the Measurement of Illicit Financial Flows in Mexico City (November 2018), and FTC/ICRICT Pan-Continental Dialogue and Forum on Illicit Financial Flows in Nairobi (November 2018) etc.

¹⁰ The Task Force is composed of statistical experts from Brazil, Finland, Ireland, Italy, Peru, South Africa and the United Kingdom representing national statistical offices, central banks, customs or tax authorities. The Task Force also includes experts from international organisations with recognised expertise in this field. Eurostat, IMF, OECD, UNECA and UNSD, in addition to UNCTAD and UNODC, are represented

¹¹ This includes work carried out previously by Eurostat, Global Financial Integrity, IMF, OECD, UNECA, UNSD World Bank, UNCTAD and UNODC, as well as the findings of many academic studies.

5. Definition of IFFs

For the purpose of SDG indicator 16.4.1 IFFs are defined as:

Financial flows that are illicit in origin, transfer or use that reflect an exchange of value and cross country borders.

Thus, IFFs have the following features:

- **Illicit in origin, transfer or use.** A flow of value is considered illicit if it is illicitly generated (e.g. originates from criminal activities or tax evasion), illicitly transferred (e.g. violating currency controls) or illicitly used (e.g. for financing terrorism). The flow can be legally generated, transferred or used, but it must be illicit in at least one of these aspects. Some flows that are not strictly illegal may fall within the definition of IFFs, e.g. cross-border tax avoidance which erodes the tax base of a country where that income was generated.
- **Exchange of value,** rather than money or purely financial transfers. Exchanges of value include not only currency exchanges, but also exchanges of goods and services, and financial and non-financial assets. For instance, illicit cross-border bartering, meaning the illicit exchange of goods and services for other goods and services, is a common practice in illicit markets and it is considered as IFF.
- IFF measure **a flow of value over a given time** - as opposed to a stock measure, which would be the accumulation of value.
- **Flows that cross a border.**¹² This includes assets where the ownership changes from a resident of a country to a non-resident, even if the assets remain in the same jurisdiction.

SDG indicator 16.4.1 calls for the measurement of the “total value” of IFFs. While this is useful as an indication of the overall size of the IFF problem and for advocacy purposes, it has limited applicability in guiding policy. A more granular measurement of IFFs, in line with a finer typology, would help to identify and separate, as necessary, the main sources and channels of IFFs and also provide some guidance for national and international interventions targeting them. Such a finer typology would also enable disaggregation of those IFFs that are legal from those that are not.

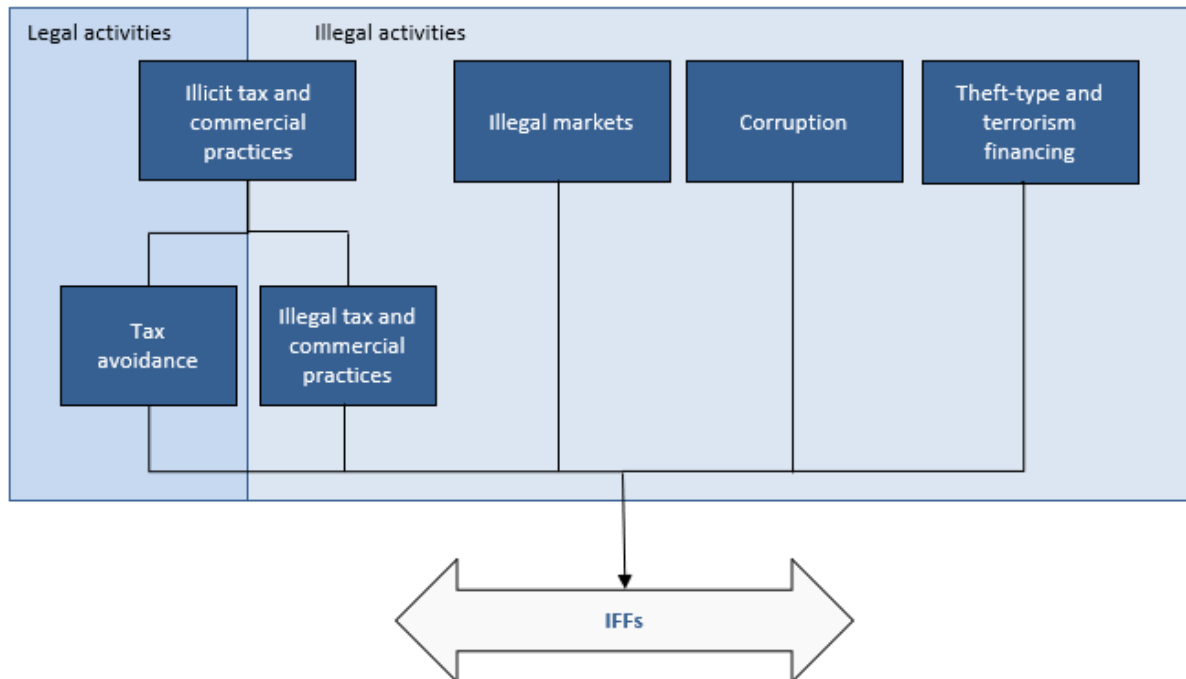
IFFs originating from illegal economic activities can be laundered and subsequent transactions can appear as legal. It should be emphasised that flows of capitals of illegal origin should be considered as illicit financial flows when crossing a border, since the origin of the funds is in illicit activities. However, it can be very challenging to determine the illicit origin of certain financial flows as the distance from the illicit origin increases. On the other hand, IFFs can also originate from legal economic activities, but become illicit when financial flows are managed and transferred, for instance, to evade taxes or used to finance illegal activities.

IFFs can be classified from many angles: their sources, channels, impacts, actors involved, motives, etc. The typology should prioritize the policy perspective to enable effective policy action to curb IFFs.

¹² The proposed bottom-up measurement approach described below considers domestic illicit financial flows as part of the illegal economy too. These flows would not fall under the definition of IFF for SDG 16.4.1, but are of high relevance to understand organised cross-border illicit flows.

The typology of IFFs is, therefore, linked to the main activities from which they arise (figure 1). Figure 1 looks at the types of activities that generate IFFs, i.e. the underlying activities rather than IFFs themselves.

Figure 1. Categories of activities that generate IFFs



Source: UNODC and UNCTAD.

According to this typology, four main categories of IFFs are distinguished.

- **Illicit tax and commercial IFFs.** This category includes illicit practices by legal entities and arrangements and individuals with the objective of concealing revenues, reducing tax burden, evading controls and regulations and other purposes. This category can be divided into two components:
 - **Illegal tax and commercial IFFs.** These include illegal practices such as tariff, duty and revenue offences, tax evasion, corporate offences, market manipulation and other selected practices. Some activities that are non-observed, hidden or informal¹³ or part of the so-called shadow¹⁴, underground¹⁵ or grey economy may also generate IFFs.

¹³ The IMF uses the following working definition of informal economy: “[T]he informal economy comprises (i) the production of goods and market services of households; and (ii) the activities of corporations (illegal; underground) that may not be covered in the regular data collection framework for compiling macroeconomic statistics. This scope of the informal economy considers not only the domestic activities, but also the cross-border transactions of resident units [...]” IMF (2019), *Final Report of the Task Force on Informal Economy*, available at <https://www.imf.org/external/pubs/ft/bop/2019/pdf/19-03.pdf> (accessed 2 March 2020).

¹⁴ According to the IMF (2018). *Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?*: “The shadow economy includes all economic activities which are hidden from official authorities for monetary, regulatory, and institutional reasons.”

¹⁵ In the SNA, “underground production consists of activities that are productive in an economic sense and quite legal (provided certain standards or regulations are complied with), but which are deliberately concealed from public authorities for the following reasons: a) to avoid the payment of income, value added or other taxes; b) to avoid payment of social security contributions; c) to avoid meeting certain legal standards such as minimum wages, maximum hours, safety or health

Related activities included in the International Classification of Crime for Statistical Purposes (ICCS) comprise tax evasion, tariff, duty and revenue offences, competition offences, import/export offences, acts against trade regulations, restrictions or embargoes and investment or stock/shares offences.

- **IFFs related to tax avoidance.** Illicit flows can also be generated from legal economic activities through what is sometimes called harmful or aggressive tax avoidance (see box 1 for more detail on the distinction between legal and illegal illicit flows). Aggressive tax avoidance can take place through a variety of forms, such as manipulation of transfer pricing, strategic location of debt and intellectual property, tax treaty shopping, the use of hybrid instruments and entities and other tax avoidance schemes. For the purposes of the measurement of the indicator, these flows need to be carefully considered, as they generally arise from licit business transactions and only the illicit part of the cross-border flows belongs within the scope of IFFs.
- **IFFs from illegal markets.** These include trade in illicit goods and services, when the money flows generated cross country borders. Such processes often involve a degree of criminal organisation aimed at creating profit. They include any type of illegal trafficking of goods, such as drugs and firearms, or services, such as smuggling of migrants. IFFs are generated by the flows related to international trade of illicit goods and services, as well as by cross-border flows from managing the illicit income from such activities.
- **IFFs from corruption.** The United Nations Convention against Corruption defines acts considered as corruption and those are consistently defined in the ICCS. These include bribery, embezzlement, abuse of functions, trading in influence, illicit enrichment and other acts. When the economic returns from these acts, directly or indirectly, generate cross-border flows, they are considered IFFs.
- **IFFs from theft-type activities and financing of crime and terrorism.** Theft-type activities are non-productive activities that entail a forced, involuntary and illicit transfer of economic resources between two actors. Examples include theft, extortion, illicit enrichment, and kidnapping. In addition, terrorism financing and financing of crime are illicit, voluntary transfers of funds between two actors with the purpose of funding criminal or terrorist actions. When the related financial flows cross country borders, they constitute IFFs.

standards, etc; or d) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.”

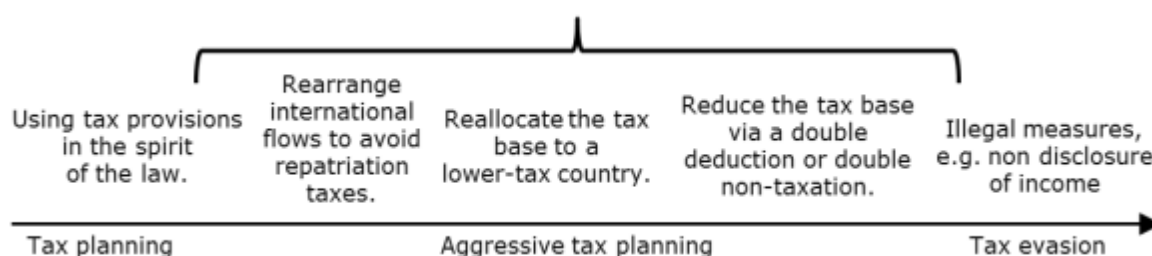
Box 1: Aggressive tax avoidance and IFFs

A specific conceptual challenge is to specify what kinds of activities should be designated to be illicit or licit. This issue is particularly challenging in the area of tax avoidance). It is noteworthy that SDG 16.4 refers to ‘illicit’ instead of ‘illegal’ financial flows. Aggressive tax avoidance, including by MNEs, can have similar economic consequences to illegal financial flows and can drain resources from countries and thus can be considered illicit.

The inclusion of tax avoidance in the definition of IFFs creates some challenges, as it blurs the line between legal and illegal activities. For example, while aggressive tax avoidance can be considered detrimental to sustainable development in many countries, particularly in developing countries, tax avoidance generally involves activities that are not illegal. For the purposes of the indicator, aggressive tax avoidance is included as an illicit financial flow, while noting that these activities are generally legal.

Noting that the boundary between what are legal and illegal tax practices may be unclear, the European Commission (2017)¹ describes a continuum of activities from legal tax planning to illegal tax evasion (see figure 2). They describe aggressive tax planning as “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.”

Figure 2. Boundaries of aggressive tax planning



Source: European Commission (2017), Working Paper No 71. *Aggressive tax planning indicators. Final Report.*

Activities considered as aggressive tax avoidance, and therefore considered to be included within IFFs for the purposes of this indicator, are considered in detail in OECD (2013)¹, and can include base erosion and profit shifting (BEPS) through interest payments, strategic location of intangible assets, abuse of tax treaties, artificial avoidance of permanent establishment and transfer pricing manipulation.

In this area, important progress has been made by the Inclusive Framework on BEPS, which brings together over 135 jurisdictions to work on an equal footing to tackle tax avoidance. The BEPS package, which was released in October 2015 by OECD and G20 countries, delivers solutions for governments to close the gaps in existing international rules that allow corporate profits to be artificially shifted to low or no tax jurisdictions where companies have little or no economic activity. Work to address outstanding BEPS issues by the Inclusive Framework is ongoing (OECD, 2020)¹.

Progress has also been made by the Inclusive Framework on BEPS in improving the availability of data to support the measurement of MNE tax avoidance,¹ including through the forthcoming public release of aggregated and anonymised Country-by-Country Report Statistics, which can be drawn upon for the purposes of this indicator.

In the SNA, each transaction that satisfies the principle of “mutual agreement” between parties is to be included within the production boundary i.e. as a productive activity, whether or not it is legal. While only productive activities generate value added, non-productive activities can also transfer value from one actor to the other.¹⁶ Illegal markets and theft-type activities clearly include, respectively, productive and non-productive activities. Corruption, on the other hand, comprises different activities, which may or may not involve mutual agreement. Some of these activities, e.g. bribery or trading in influence, are characterised by mutual agreement and, therefore, are considered productive, while others, such as embezzlement, misappropriation or other diversion of economic resources, are non-productive.

With national laws and country practices differing, and with IFF measurement being a statistical exercise rather than an audit or judicial one, it is not possible to define the scope of activities for measurement directly in terms of their legality. The indicator is, therefore, constructed based on a typology of behaviors, events and activities generating IFFs. This approach is in line with the ICCS and crime statistics in general. The ICCS provides a list and definitions of activities many of which may also generate IFFs, such as theft-type activities and terrorism, illicit trafficking and corruption, as well as many activities related to tax and commercial malpractices.¹⁷ Table 1 provides examples of such activities and how to link the main categories of IFFs to activities that generate them.¹⁸

Table 1. Examples of activities generating IFFs from crime, by ICCS categories

<i>Categories of IFFs</i>	<i>Examples</i>
Tax and commercial practices	08041 Tariff, taxation, duty and revenue offences 08042 Corporate offences including competition and import/export offences; acts against trade regulations 08045 Market manipulation or insider trading, price fixing
Theft-type activities and terrorism financing (parts of sections 02, 04, 09)	020221 Kidnapping 020222 Illegal restraint 020223 Hijacking 020229 Other deprivation of liberty 0204 Trafficking in persons 0205 Coercion 0401 Robbery 0501 Burglary 0502 Theft 09062 Financing of terrorism
Illegal markets	ICCS includes a long list of activities, including for example drug trafficking (060132), firearm trafficking (090121), illegal mining (10043), smuggling of migrants (08051), smuggling of goods (08044), wildlife trafficking (100312)

¹⁶ Many illegal actions are crimes against persons or property that cannot be considered as transactions under “mutual agreement”, e.g. theft. These are not recorded in the SNA, unless thefts, or acts of violence (including war), involve significant redistribution, or destruction, of assets. These would then be treated as other flows or transfers (i.e. changes in the value of assets and liabilities), not as transactions.

¹⁷ https://www.unodc.org/documents/data-and-analysis/statistics/crime/ICCS/ICCS_English_2016_web.pdf

¹⁸ It is important to note that not all IFFs would map onto this framework, as IFFs related to tax avoidance may not be covered in the ICCS.

Corruption (section 0703)	07031 Bribery 07032 Embezzlement 07033 Abuse of functions 07034 Trading in influence 07035 Illicit enrichment 07039 Other acts of corruption
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Source: UNODC.

Note: This list is only intended to provide some examples and it is not exhaustive.

The ICCS describes the actions and behaviours relating to each category and provides examples of the types of activities concerned. The above listed activities are also sources of IFFs. It would be useful to link the categories of IFFs and their source activities to their transmission channels. This requires further consideration since similar financial flows may apply to a variety of channels, such as trade in goods, related party lending or borrowing, inward-outward investment, etc. Data availability and the selection of statistical methods are likely to depend on the type of activity generating IFFs and the channels used.

Moreover, while ICCS considers illicit activities, such as acts against public revenue provisions and acts involving behaviour that is regulated or prohibited on moral or ethical grounds (0804), it focuses on actions and behaviours that are attributable to different types of crime. A classification will be needed also to cover all IFFs related to tax and commercial activities.

6. The statistical approach for measuring IFFs

There is a relevant stream of literature that proposes methods to measure IFFs from illegal economic activities, and illicit tax and trade-related practices. The methods proposed can be crudely grouped in to two different approaches:

- (1) **Top-down methods** attempt to measure IFFs by interpreting or modelling inconsistencies in different types of aggregated data, such as currency demand, international trade, and capital account of balance of payments.¹⁹ Methods, such as mirror statistics, can be useful as a source of information on some tax and trade related IFFs that are generated as part of licit economic activities, but are transferred in an illicit way.
- (2) **Bottom-up approaches** attempt to measure IFFs starting from the analysis of a given illicit activity, defining the set of flows that can be identified as IFFs and then producing estimates for each of them.²⁰ Overall IFFs estimates are obtained by aggregating estimates at a lower level, e.g. by IFF type or source. For instance, Eurostat (2018)²¹ has defined a framework to

¹⁹ Top-down approaches can be clustered based on the type of the informative set where inconsistencies are investigated. Currency Demand Approach (Tanzi, 1996; Schneider, 2011; Schneider and Williams, 2013; Ardizzi et al., 2016) ground on the comparison between the actual demand for currency and the amount of money that should be demanded based on observable economic indicators. Hot Money Method and Residual Approach use discrepancies in financial accounts to estimate the amount of flows connected with non-observed economy (Kar, Cartwright-Smith and Hollingshead, 2010; Kar and Freitas, 2011). Discrepancies in mirror trade statistics may provide a measure of illicit flows connected with international trade (Gara et al., 2016). Gravity models (Walker, 1995; Unger et al., 2006) focus on attractiveness to determine the extent to which financial flows between countries can be supposed to be illicit.

estimate illegal economy within the framework of national accounts and balance of payments statistics using such a bottom-up approach.

Consistently with the statistical framework presented here, where different types of IFFs are defined in relation to the activity generating them, a bottom-up and direct measurement approach is proposed. Bottom-up methods estimate IFFs in relation to each underlying activity.²²

An important distinction is made between two different stages where IFFs can be generated, which reflect two different finalities²³:

- **IFFs linked to income generation**, as the set of cross-border transactions that are performed in the context of the production of illicit goods and services or the set of cross-border operations²⁴ that directly generate illicit income for an actor during a non-productive illicit activity.
- **IFFs linked to income management**, as the set of cross-border transactions finalised to use the (illicit) income for investment in (legal or illicit) financial and non-financial assets or for consuming (legal or illegal) goods and services.

Following this, IFFs can occur when criminal acts generate illicit income. When illicit goods and services are sold, a flow of value comes from the buyer to the seller. Likewise, successful extortion generates income for the extorter. Inward or outward IFFs occur during income generation when the operation in question is performed across a border (e.g., when a shipment of illicit drugs is sold from a resident of one country to a resident of a different country).

IFFs can also take place by illicit income management, which refers to the use of illicit income for investment or consumption, or the illicit management of income generated in legal economic activity, e.g. to reduce the tax base. If spent abroad, the operation is an outward IFF. If the income stems from illicit activity taking place outside a jurisdiction but is spent in the domestic jurisdiction, then an inward IFF is generated.

In sum, IFFs can be attributed to four different types of flows: inflows and outflows from illicit income generation and inflows and outflows from illicit income management. The following sections describe the relevance of these flows with respect to the four typologies of IFFs.

²² The measurement approach presented here is consistent with Eurostat (2018). Handbook on the compilation of statistics on illegal economic activities in national accounts and balance of payments. <https://ec.europa.eu/eurostat/documents/3859598/8714610/KS-05-17-202-EN-N.pdf/eaf638df-17dc-47a1-9ab7-fe68476100ec>

²³ This basic typology is also coherent with the main concept of national accounts. Indeed, income generation refers to the set of operations that in national accounts relate to production account, and generation and distribution of income account, while income management refers to the set of operations that in national accounts refer to capital and use of income account.

²⁴ An operation is defined as an exchange between parties, independent from a possible agreement among them

6.1 IFFs related to income generation

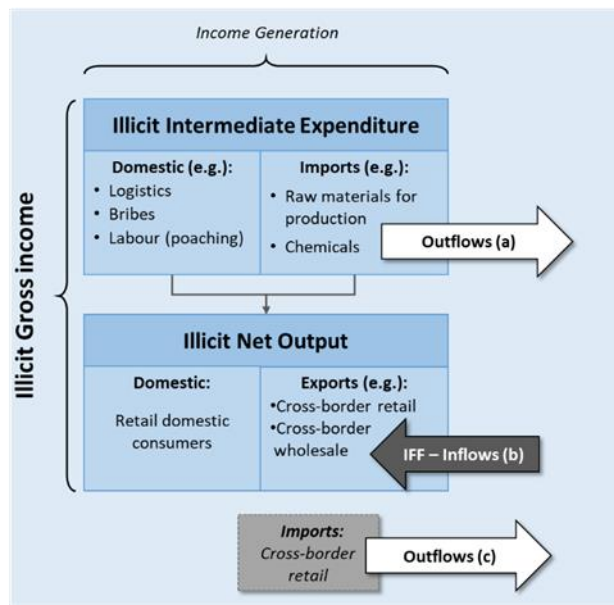
IFFs from income generation mainly relate to goods and services provided in illegal markets as transactions that are aimed at carrying out unlawful productive processes for making profits. As every productive process, income generation can be represented by three main aggregates: gross output, intermediate expenditure (or intermediate costs) and value added (which also represents the net income for the actors).

- **(Illicit) gross income/(illicit) gross output** refers to the value of the illicit goods or services produced in a given period. The value is determined as quantity-times-price (where the price is, for example, the retail price in the domestic market, or the export price if goods are exported).
- **(Illicit) intermediate expenditure** refers to the value of (licit and illicit) inputs acquired to produce illicit goods and services over a given period. The value of inputs is determined as quantity-per-price (where the price is, for example, the domestic price if the good is bought from a resident, or the import price if the good is bought from a non-resident).
- **(Illicit) value added/(illicit) net income** is the economic result of the productive process. It is determined as gross output minus intermediate expenditure. It also represents the net income (income after accounting for costs) earned by all actors carrying out the illicit activity.

Inward IFFs occur when illicit goods and services are exported abroad. These products can be either for final consumption (e.g. an online dealer sells synthetic drugs directly to a consumer in another country) or they are (licit or illicit) intermediate inputs to illicit productive processes in a foreign country (e.g. morphine is exported to another country to produce heroin or transportation services bought by a non-resident trafficker to ship cocaine). Outward IFFs occur when intermediate inputs are imported against payments from abroad (e.g. drugs imported for further domestic sale) or when final illicit goods and services are imported.

In a similar fashion, this type of IFFs occur when a foreign business entity bribes a public official to facilitate the granting of a procurement contract or the permission to extract natural resources. The unlawful service provided by the corrupt public official can be seen as a productive activity – i.e. the result of a mutual agreement – that generates an IFF from the country where the business entity is located to the country of the public official.

Figure 3. IFFs in income generation (illegal markets)



Notes: Outflows (a) correspond to the import of illicit goods and services that are used for generating illicit final products. Inflows (b) correspond to the export of final goods and services. Outflows (c) correspond to the import of illicit final goods and services that have been produced in a different country (e.g., self-imported ivory or illicit drugs ordered on-line).

IFFs from income generation can also be generated by non-productive activities, such as theft-type activities and corruption, and they equal the aggregated value of all funds and goods that move between resident and non-resident entities (for example when cross-border extortion is committed)²⁵.

Intermediate costs for non-productive activities are considered as “operational costs” (in the SNA, they are implicitly accounted for as final consumption).

The direction of the flow depends on the residence of the actors: if the sender (e.g. victim of a theft-type activity) is resident and the recipient (e.g. extortioner) is non-resident, then non-productive activities generate outward IFFs; whereas if the sender is non-resident and the recipient is resident inward IFFs emerge.

Box 2. Measuring illicit financial flows in illegal markets

In pilot activities, UNODC tested in collaboration with Member States methods to estimate IFFs emerging from illegal markets. In such markets, IFFs emerge at various stages of illicit activities, relating to different actions and exchanges. The estimation process follows the basic distinction of transactions based on their purpose, i.e. income generating transactions and income management transactions. The estimation followed three basic steps: measuring the overall illicit income generated (including domestically generated income), illicit financial flows from income generation transactions and IFFs from income management transactions.

²⁵ When illicit income from ‘domestic’ theft-type activities (e.g. extortion or kidnapping between resident entities) is transferred abroad it refers to the income management phase.

The pilot activities looked at 4 different illicit markets: drugs, smuggling of migrants, trafficking in persons and illegal mining. The following presents examples on smuggling of migrants and drugs.

IFFs related to smuggling of migrants in Mexico

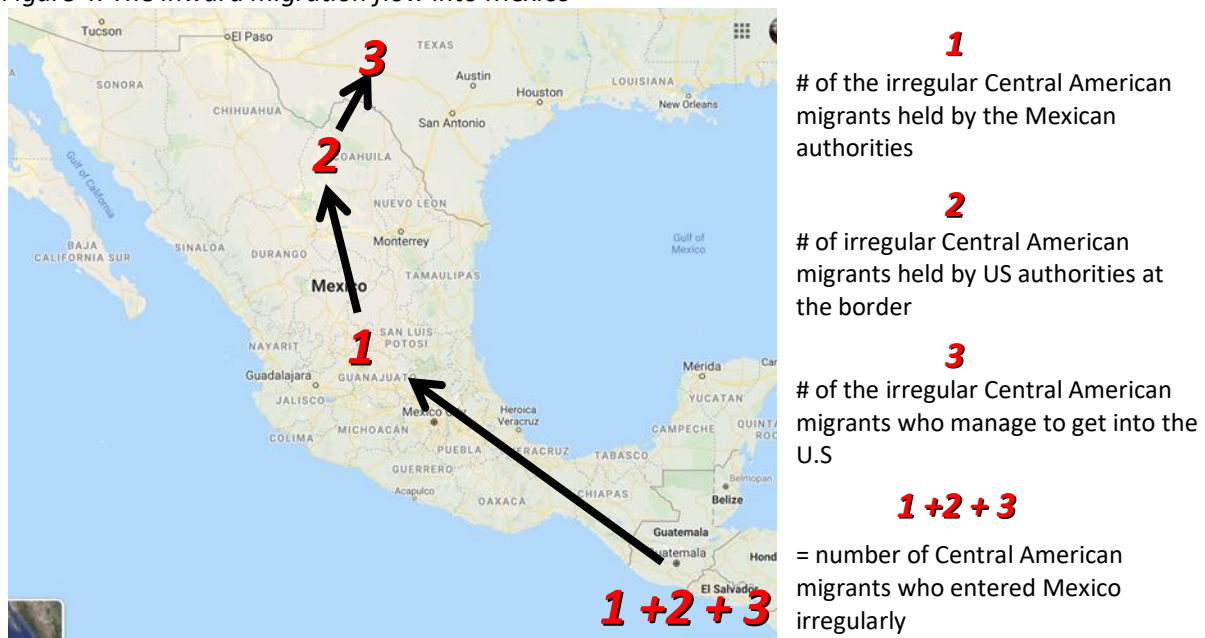
Smuggling of Migrants (SoM) is defined as “facilitating the illegal entry of a person into a State Party of which the person is not a national or a permanent resident for the purpose of obtaining, directly or indirectly, a financial or other material benefit”.²⁶ Illicit financial flows from SoM describe the value illicitly generated, transferred or utilised that is moved from one country to another in transactions related to SoM.

In a pilot study of estimating IFF from SoM in Mexico a bottom-up approach is used, which approximated IFF on the basis of estimates pertaining to the number of migrants smuggled and the respective fees paid. From the perspective of Mexico, inward IFFs during income generation are the fees paid by non-resident migrants to resident smugglers:

$$\text{Inward IFFs} = \# \text{ of non-resident migrants smuggled by resident smugglers} \times \text{fees}$$

Similarly, outward IFFs are calculated in relation to outgoing financial flows. IFFs were assessed based on estimates on irregular migrants who entered Mexico (see Figure 4.), the average fees paid to migrant smuggles and the proportion of migrants that use smugglers (final results are expected to be published at end of 2020). Using these data, estimates of in- and outflows in the phase of income generation could be calculated.

Figure 4. The inward migration flow into Mexico



Income generation from Afghan opiate economy

Afghanistan is the by far the world's largest producer of opium, and a substantive share of global heroin production, a derivative of opium, originates in that country.

By combining estimated prices and amounts produced, imported and exported,²⁷ the illicit gross income of the Afghan opiate economy was estimated at USD 1.2-2.2 billion in 2018 (USD 4.1-6.6 billion in 2017). This corresponded to 6 to 11 per cent of the country's GDP in 2018 and exceeded the value of its officially recorded exports of goods and services (estimated at 4.3 per cent of GDP).

Income generation inflows are obtained from the value of exported opiates, which was estimated to be between USD 1.1 – 2.1 billion. The manufacture of heroin required imported precursor substances, being worth some USD 88 - 184 million, creating corresponding illicit financial outflows.

The above examples demonstrated that illicit income generation IFFs can be successfully approximated by using data on the extent of an illicit activity and corresponding, international price data. Illicit financial flows from income management, however, have been more challenging to measure. Direct measurement methods (e.g., based on identifying illicit transactions) are difficult to employ as the money laundering process is clandestine in nature and extremely difficult to capture from data collections in place. In the current phase of pilot activities various approaches to measure income management IFFs are being tested.

6.2 IFFs from income management

IFFs can result from the use (management) of illicit income generated by any of the four types of activities. It generates IFFs when it is transferred abroad for investment or consumption.

Outward IFFs emerge when resident illicit funds are used to buy goods and services from abroad (other than those that have been accounted for as intermediate costs) or to acquire foreign financial or non-financial assets. Symmetrically, inward IFFs are generated if non-resident illicit funds (e.g., generated by drug trafficking in another country) are used in the country of interest. These flows are difficult to measure and are not easy to link to a specific illicit activity.

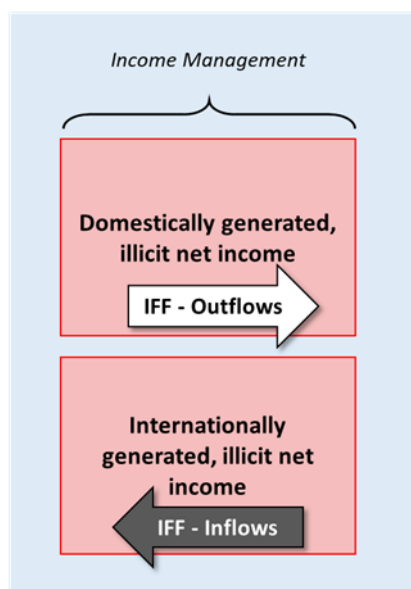
The size of income management related outward IFFs is directly related to the domestically generated (licit or illicit) net income. The size of income management related inward IFFs depends on other factors, such as the attractiveness of the country for money laundering, inter-country difference in tax rates and rules and regulations, the likelihood of nationals living abroad sending home illicitly generated income, and the internal structure of multinational and other firms with a global presence. IFFs from income management can also refer to income generated from licit (or illicit) economic activities that is illicitly transferred abroad.

²⁷ Government of the Islamic Republic of Afghanistan and UNODC, Afghanistan opium survey reports 2002 – 2018; see <https://www.unodc.org/unodc/en/crop-monitoring/index.html>

BEPS activities can be related to tax and trade IFFs as part of income management. These BEPS activities can take a variety of forms (OECD, 2018; Beer et al, 2019²⁸). This can include strategic location of debt and intangible assets, manipulation of transfer pricing, artificial avoidance of permanent establishment and other strategies. Estimates of BEPS range between (USD 100bn and over USD 600bn (Bradbury, Hanappi and Moore, 2018²⁹).

IFFs can also occur when funds are shifted out of a jurisdiction for the purposes of evading (not avoiding tax). This includes illegally concealing income or assets from tax authorities. **Corporate structures** with no real economic activity can be used as part of tax evasion strategies, and for the concealment of corrupt funds by public officials, and criminal behaviours, such as money laundering. They can provide a vehicle to transfer and conceal trade profits in lower-tax jurisdictions and reduce tax liabilities or to conceal the beneficial owner or the ultimate investor to avoid paying taxes over investment income. Moreover, chains of such corporate structures with misreporting or non-reporting of beneficial owners, also called “anonymous ownership vehicles”, aim to benefit from routes with tax advantages, thus potentially generating IFFs.

Figure 5. IFFs in income management



7. Conclusion

This note has set out the statistical definition and scope of IFFs for the purposes of measuring SDG indicator 16.4.1. These important first steps have been endorsed by the IAEG-SDG. The next steps will be to develop and test a range of statistical methodologies consistent with the definitions above and the SNA and balance of payments statistics. Countries already collect data on a number of illegal activities and other statistics that can contribute to the measurement of SDG indicator 16.4.1. Some aspects of IFFs are more readily measurable, for instance IFFs originating in trade of illegal goods and

²⁸ Beer, S. Mooij, R. and Liu, L. (2019). *International Corporate Tax Avoidance: A Review of the Channels, Effect Sizes, and Blind Spots*, Journal of Economic Surveys, doi:[10.1111/joes.12305](https://doi.org/10.1111/joes.12305).

²⁹ Bradbury, D., T. Hanappi and A. Moore (2018), "Estimating the fiscal effects of base erosion and profit shifting: data availability and analytical issues", *Transnational Corporations*, vol. 25/2, <https://doi.org/10.18356/e1d7a8b4-en>.

services (e.g. illicit drugs markets, smuggling of migrants and prohibited wildlife products), where national and international data on supply, demand, trade flows and prices are collected in a systematic manner.

The framework presented in this paper has been proven useful for assessing IFFs from trade of illegal commodities, as demonstrated by tests in pilot countries. The distinction between income generation and income management allows the use of statistics and estimates on illicit markets, such as supply, demand, price and seizure data, to approximate IFFs. A different set of information need be used to analyse how income is used. This means that IFFs can be assessed to varying degrees of comprehensiveness, depending on data availability.

Clearly, some types of IFFs are more challenging to measure in practice, such as those related to bribery, abuse of functions, illicit enrichment and illicit tax practices. Data on these activities remain scattered. Furthermore, methods to avoid double counting will be needed e.g. in case of bribery paid to facilitate unlawful cross-border activities in illegal markets. Therefore, further work is needed to develop practical methods to measure the various types of IFFs separately, starting from the ones for which more data are available in countries. Furthermore, in practice it may be necessary to estimate separately some of the IFF categories with the highest uncertainties, for instance, IFFs from tax and commercial activities.

It will be important to put efforts into building capacity to improve data collection and compilation for the measurement of IFFs. UNCTAD and UNODC, with partner organizations, will support countries in improving their statistical capacity to understand and estimate IFFs. The results of ongoing pilot studies will be used to refine the conceptual framework and to develop practical guidance on statistical methods to measure different types of IFFs.

The production of estimates on inward IFFs appears as very challenging from a country perspective, as it is difficult to identify and estimate the amounts of financial flows of illicit origin that enter a given country. In the longer term, disaggregation of outward IFFs by country of destination could also enable the compilation of inward IFFs by aggregating outward IFFs as estimated by countries of origin.

The joint Task Force will continue its work to support countries in national data collection and compilation with a view to developing a *Practical Compilation Guide for the Measurement of Illicit Financial Flows* based on this conceptual framework. This will include a full classification of activities generating IFFs, linked to the types and channels of IFFs, with recommended methods to measure them. Further work will also aim at developing a more nuanced measurement of IFFs to support policy action. In the future, the measurement of IFFs as a satellite account taking into consideration national accounts concepts and definitions, including IFFs from productive and non-productive activities, could be worth exploring.