



No.87
JULY 2021

POLICY BRIEF

Key points

- The new conceptual framework developed by UNCTAD and the United Nations Office on Drugs and Crime can provide clarity on how to define illicit financial flows. In 2021, some countries in Africa will test the suggested methods for measuring illicit financial flows, using guidelines provided by the task force.
- Trade in high-value, low-weight commodities, particularly gold, is an important source of illicit financial outflows from Africa. To curb such flows, countries should collect more and better trade data, close loopholes in tax treaties and strengthen regulatory frameworks.
- New opportunities for curbing illicit financial flows can arise through the use of better methodologies for customs fraud detection and improved resource governance with regard to metals that will be in high demand for low-carbon technologies.

Embracing a new conceptual framework for the statistical measurement of illicit financial flows

Economic Development in Africa Report 2020: Tackling Illicit Financial Flows for Sustainable Development in Africa argues that tackling illicit financial flows is essential in order for countries in Africa to strengthen domestic resource mobilization, boost hard and soft infrastructure investment and achieve the Sustainable Development Goals. Illicit financial flows from Africa are large and growing: in 2010–2018, Africa lost at least \$220 billion linked to the export of extractive resources, compared with \$40 billion in 2000–2009. The lack of internationally comparable data and conceptual clarity as to what constitutes illicit financial flows and how to measure them have been major challenges in designing policies to curb such flows. This policy brief examines illicit financial flows linked to the export of extractive resources from Africa, methodologies to measure them and their relationship to the new conceptual framework for the statistical measurement of illicit financial flows as part of the measurement of progress towards Goal 16, target 16.4. It highlights opportunities to curb illicit financial flows using improved methodologies for customs fraud detection and to enhance resource governance with regard to metals that will be in high demand for the battery-storage technology needed in the transition to a low-carbon future.

The size and scope of illicit financial flows from Africa

Economic Development in Africa Report 2020 uses the UNCTAD and United Nations Office on Drugs and Crime definition of illicit financial flows as cross-border financial flows that are illicit in origin, transfer or use.¹ Illicit financial flows related to the export of extractive resources (\$40 billion in 2015) are the largest component of such flows from Africa. Estimates of such flows are significant, but understate the problem, since only 41 out of 54 countries on the continent report trade data to the United Nations and data for some large commodity exporters are not available. UNCTAD and the United Nations Office on Drugs and Crime are custodian agencies of Sustainable Development Goal indicator 16.4.1 under target 16.4, aimed at, by 2030, significantly reducing illicit financial and arms flows, strengthening the recovery and return of stolen assets and combating all forms of organized crime.

¹ UNCTAD, 2020a, *Economic Development in Africa Report 2020: Tackling Illicit Financial Flows for Sustainable Development in Africa* (United Nations publication, Sales No. E.20.II.D.21, Geneva); UNCTAD and United Nations Office on Drugs and Crime, 2020, *Conceptual Framework for the Statistical Measurement of Illicit Financial Flows* (Vienna), available at <https://unctad.org/webflyer/conceptual-framework-statistical-measurement-illicit-financial-flows> (accessed 22 June 2021).

Against this background, a new conceptual framework has been developed that classifies illicit financial flows according to the activities through which they are generated. These include criminal activities related to the following: illegal markets; corruption; exploitation-type activities and the financing of terrorism; and illicit tax-related and commercial practices, such as tax evasion through trade misinvoicing and profit-shifting to lower tax jurisdictions.² Data on activities generating illicit financial flows are scarce, fragmented across different national agencies and often lacking in international comparability. Therefore, researchers have had to observe the channels through which such flows move abroad. Funds may be moved through the following: financial transactions such as bank payments (that is, trade in services); trade transactions such as customs invoices (that is, trade in goods); and the physical smuggling of value across borders (that is, cash couriers). The method used in *Economic Development in Africa Report 2020* analyses macro-level trade data on the eight key extractive resources critical to the export potential of Africa and aims to measure this subset of global illicit financial flows. This method does not permit distinguishing between the activities generating illicit financial flows, as these can vary, from tax evasion to trade-based money laundering.

Comparing trade flows between countries

The partner-country trade gap method used in *Economic Development in Africa Report 2020* is based on comparing trade data from bilateral trade partners for the same product in the same year.³ Export underinvoicing, or the fraudulent understatement of value on customs invoices, is a common practice in moving resources or money abroad in a clandestine manner. The stylized mechanism for export underinvoicing given in the table shows that it is a practice that not only lessens tax contributions in country A but also deprives the country of capital and foreign exchange inflows.

Stylized mechanism for export underinvoicing			
	Country A	Country B	Trade gap
Documented trade flows	\$8 million in gold exports	\$10 million in gold imports	\$2 million
Actual trade flows	\$10 million in gold exports		
Corresponding financial flows	Receipt of \$8 million	\$8 million to country A and \$2 million to offshore accounts	

Source: UNCTAD.

The advantage of the partner-country trade gap method is that it allows for a broad coverage of countries and products, yet there are significant limitations. Namely, there may be valid logistical reasons for exports by country A to country B to not match the imports reported by country B for the same product, and asymmetries in bilateral trade flows cannot be directly attributed solely to export underinvoicing. Asymmetries in bilateral trade flows may be driven by commodity-specific value chains and trading practices, such as transit trade, storage in bonded warehouses and value-added processing in duty-free zones, as well as different national trade-recording practices.⁴

Estimates in *Economic Development in Africa Report 2020* help to account for some of these asymmetries (with 41 out of 54 countries in Africa covered by the analysis). The report makes explicit links to the valuation of trade and the recording of international trade statistics, and attempts to address issues that arise due to the merchandising, processing and trading of commodities along value chains, to account for some of the asymmetries in bilateral trade flow statistics. The partner-country trade gap is added for all trading partners, aimed at correcting some degree of destination mismatch, and similar products are grouped together to correct for some degree of product misclassification. The report finds that illicit financial flows from Africa linked to the export of extractive resources are large and growing. It is estimated that in 2010–2018, there were at least \$220 billion in losses from the continent due to the export underinvoicing of extractive resources, compared with \$40 billion in 2000–2009 (figure 1).⁵

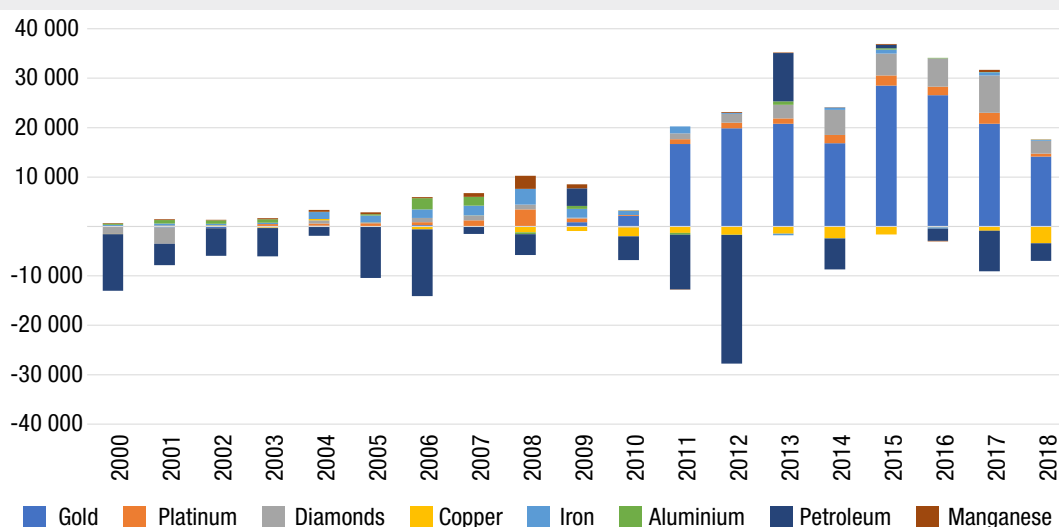
² UNCTAD and United Nations Office on Drugs and Crime, 2019, Concept note, prepared for the task force meeting on statistical methodologies for measuring illicit financial flows, 16 and 17 July, available at <https://unctad.org/meeting/task-force-meeting-statistical-methodologies-measuring-illicit-financial-flows> (accessed 22 June 2021).

³ The partner-country trade gap method has been highlighted by the UNCTAD and United Nations Office on Drugs and Crime task force on the statistical measurement of illicit financial flows as one of the two methods suitable for estimating trade-related illicit financial flows.

⁴ UNCTAD, 2020b, *Handbook of Statistics 2020* (United Nations publication, Sales No. E.21.II.D.1, Geneva).

⁵ UNCTAD, 2020a.

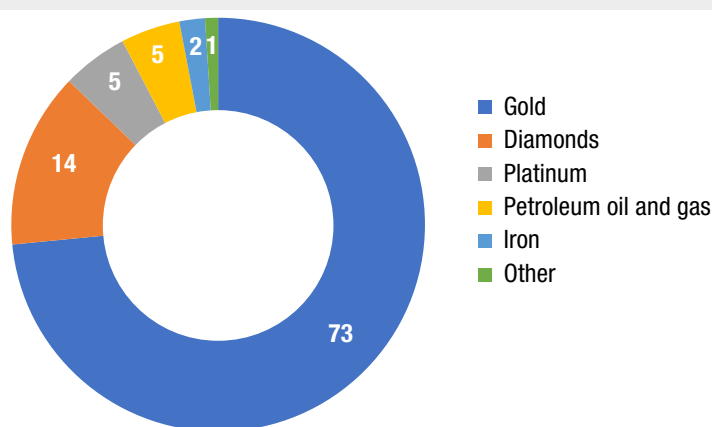
Figure 1
Sum of partner-country trade gaps by commodity group
(Millions of dollars)



Source: UNCTAD calculations, based on data from the United Nations Comtrade database.

The results are largely due to high-value, low-weight commodities with, in 2010–2018, gold exports from Africa representing 73 per cent of the total partner-country trade gap, followed by diamonds (14 per cent) and platinum (5 per cent). The remaining commodities covered, such as petroleum and base metals, together represented only 8 per cent of the total (figure 2).

Figure 2
Sum of partner-country trade gaps by commodity group: Share of total gap, 2010–2018
(Percentage)



Source: UNCTAD calculations, based on data from the United Nations Comtrade database.

Socioeconomic impact of illicit financial flows

Illicit financial flows are a global phenomenon but are particularly costly with regard to socioeconomic development in Africa. Countries with high levels of illicit financial flows spend on average 25 per cent less on health and 58 per cent less on education compared with countries with low levels, indicating the significant redistributive effects of such flows.⁶ Illicit trade in extractive resources can have an unquantifiable multiplier effect because it undermines peace and security, which can confine an economy in a “conflict trap” and stall development for decades.⁷ Given these interlinkages, the target on illicit financial flows is under Sustainable Development Goal 16 on peace, justice and strong institutions. The attractiveness of the international trade system with regard to illicit financial flows is due to the possibility of co-mingling illicit funds with legitimate funds; the limited verification procedures in exchanging customs data between countries; and the limited resources of customs agencies, to detect illegal transactions.⁸

⁶ Ibid.

⁷ P Collier, 2007, *The Bottom Billion: Why the Poorest Countries are Failing and What Can Be Done About It* (Oxford University Press, Oxford).

⁸ Financial Action Task Force, 2006, Trade-based money laundering, available at <https://www.fatf-gafi.org/publications/methodsandtrends/documents/trade-basedmoneylaundering.html> (accessed 22 June 2021).

The trade channel of illicit financial flows is more important for countries that are rich in natural resources and less integrated into international financial markets; this applies in many countries in sub-Saharan Africa.

Future opportunities and new methodologies for detecting illicit financial flows

The continent of Africa is rich in natural resources, holding 30 per cent of global mineral reserves, 8 per cent of global oil reserves and 7 per cent of global natural gas reserves.⁹ In addition, with regard to reserves of key metals needed for the low-carbon transition, which requires significant amounts of metal-intensive lithium-battery storage technologies, demand will increase by as much as 1,000 per cent by 2050.¹⁰ Trade in metals such as chromium, manganese, molybdenum and other rare-earth metals involves the greatest relative risk of illicit financial flows in comparison with the smaller export volumes of such metals, implying that if volumes or prices increase due to increases in global demand, the risk of losses due to export underinvoicing will also increase.¹¹ Methodologies for better customs fraud detection, such as a price filter analysis of customs invoices to detect abnormal pricing, can help improve revenue collection linked to the export of extractive resources. The price filter analysis uses transaction-level customs data based on the price range of a specific commodity over time, to distinguish between normally and abnormally priced transactions and detect abnormal prices, that is, prices lying outside the price filter, which can be defined either statistically (interquartile-range price filter) or using free market prices (arm's length price filter).¹² For example, in Ghana, a recent study finds evidence of a significant undervaluation of commodity exports, using free market prices (for gold and cocoa beans) and the interquartile-range price filter (for cocoa paste); in 2011–2017, \$3.5 billion in exports of gold (bullion and unwrought gold) were undervalued, or 10 per cent of the total export value of gold (\$35.6 billion).¹³

Recommendations

To help combat illicit financial flows, policymakers at the national, regional and international levels may consider the following recommended actions:

National: Governments are encouraged to improve resource governance through increased transparency with regard to resource contracts, for example by joining the Extractive Industries Transparency Initiative. In addition, better customs fraud detection with price filter methods can help improve the ability to identify, trace and recover illicit financial flows related to the export of extractive resources. Finally, the inclusion of relevant stakeholders, with statistical authorities leading the process of measuring illicit financial flows, can help ensure the use of proper data, to support effective policies.

Regional: Cooperation with regard to tax-related and commercial illicit financial flows may be improved through automated exchanges of information and by reviving the Africa Mining Vision, which focuses on resource governance and the role of resources in the long-term development agenda. The Africa Mining Vision can play a critical role in creating a unified African position that would help Africa to leverage its market power in international commodity markets.

International: The international community needs to scale up efforts to test and share standards and methods for measuring illicit financial flows in an internationally comparable manner, based on the outputs of the UNCTAD and United Nations Office on Drugs and Crime task force; strengthen transparency; ensure reporting on illicit financial flows; and engage in multilateral dialogues on harmful tax-related

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