## “A SNAPSHOT OF ILLICIT FINANCIAL FLOWS FROM EIGHT DEVELOPING COUNTRIES: RESULTS AND ISSUES FOR INVESTIGATION”

***Capital Flight and Illicit Financial Flows: What are we talking about?***

Capital flight is complex and difficult to define. Some definitions stress risk and portfolio factors as the main drivers of flight capital. Under this view, capital flight is regarded as large legal or illegal outflows of financial resources due to high political or economic instability in the originating country or higher returns on investment in the destination country. This is also sometimes referred to as “hot money” (Cuddington 1986, 1987). Another definition refers to capital flight as the unrecorded movement of funds between a country and the rest of the world (World Bank 1985). It involves resources which have entered or ought to have entered the country as a result of trade and financial transactions between residents and foreign counterparts which cannot be traced in the use of resources in the country’s official statistics.

Most of these definitions miss an important component of the capital flight problem; financial outflows which result from the illegal appropriation of resources through theft, plundering of public resources, corruption and trade mispricing. This money is intended to disappear from any record in the country of origin, and earnings on the stock of flight capital outside of a country do not normally return to the country of origin. The term commonly used to describe this form of capital flight is ‘illicit financial flows’.

The illicit outflow of capital is facilitated by a shadow international financial system, especially offshore financial centres, tax secrecy jurisdictions or ‘tax havens’. This system enables individuals and corporations to hold their wealth—often accumulated as a result of criminal activities—abroad by capitalizing on banking secrecy and loose financial regulation.

Over the last decade, most low-income and Least Developed Countries (LDCs) have recorded steady improvements in economic performance. During the “lost decades” of the 1980s and 1990s, GDP growth for low-income countries as a whole averaged 2.7 percent annually; between 2000 and 2011, the figure almost doubled to 5.3 percent annually (World Bank, 2012). Despite this progress, the poorest countries still face considerable development challenges, including with many off-track on one or more of the Millennium Development Goals (MDGs).

To help developing countries address these development challenges, national and international policy debates have tended to focus on how to mobilize more domestic and foreign financial resources in support of development. This has translated, in part, into increased aid levels as well as initiatives to increase the effectiveness of this assistance. Net Official Development Assistance (ODA) from OECD-DAC members to Sub-Saharan Africa doubled in absolute terms between 2000 and 2010 from USD 14.5 billion to USD 29.5 billion (2010 constant prices, OECD-DAC, 2012) (although it has, since then, declined).

At the same time, less attention has been paid to capital flight – and especially illicit financial flows – which drain scarce resources and severely undermine our collective efforts to achieve sustainable development in the poorest countries.

This Issue Brief summarizes recent research on illicit financial flows from eight low-income and Least Developed Countries (LDCs) over the last four decades (1970-2010). These countries are: Bangladesh, Bolivia, Côte d’Ivoire, Guinea, Nepal, Sierra Leone, Tanzania and Zambia.

The Issue Brief provides a snapshot of the magnitude and main drivers behind illicit financial flows from these eight countries. More detailed country level work is also underway which aims to provide a more exhaustive picture of the patterns, trends and major causes of illicit capital outflows in different country contexts.

Our research reveals that capital flight and illicit financial flows are a pervasive phenomenon in all eight countries under review, to different degrees. There has been a recent increase in most countries, but the phenomenon itself is not new. This suggests that there are underlying structural factors that perpetuate the illicit outflow of capital from these countries. These include inter alia: openness to trade in the context of weak regulation and poor governance, natural resource dependence, poor governance and the institutional environment, inadequate regulation of the financial system and capital account, and others.

The aim of UNDP’s research into capital flight and illicit financial flows are threefold: (1) to raise awareness of the problem in the poorest countries; (2) build research and analytical capacities on capital flight and illicit financial flows at the national level; (3) explore strategic options and contribute to the policy debate within developing countries on initiatives that could stem illicit financial flows and prevent further leakages of scarce resources from these countries.



## Capital Flight and Illicit Financial Flows: Why Do We Care?

Capital flight and illicit financial flows affect human development progress through several channels.

* **First,** capital flight undermines domestic resource mobilization by eroding the tax base. This occurs through the illicit transfer of private capital abroad, tax evasion and tax avoidance by individuals and corporations, and embezzlement of government revenue.
* **Second**, capital flight can cause greater dependency on official development assistance as a result of its negative effects on domestic resource mobilization.
* **Third,** it can reduce domestic investment and lead to slower economic growth which in turn may slow poverty reduction efforts.
* **Fourth**, capital flight is a symptom and partly an outcome of a breakdown in governance both in the originating country as well as in the international financial system. It is a result of corruption, dysfunctional regulation and weak enforcement of rules at the national and international levels.
* **Fifth,** capital flight can also worsen inequality as wealthy residents incur a relatively smaller tax burden than poorer citizens who do not have the opportunity to hide their wealth abroad. While technically legal, tax avoidance has similar adverse distributional effects. As a result, the middle class and the poor end up subsidizing the consumption of public services by the rich.
* **Sixth**, capital flight also has distributional effects through exchange rate depreciation, which can be caused or exacerbated by capital flight. While capital flight holders are shielded against depreciation of the national currency, those who hold all their wealth domestically bear its full costs.
* **Finally**, capital flight has important political economy implications notably through its impact on the distribution of power. By accumulating illicit wealth through capital flight, political elites are able to consolidate power which may end up in more difficulties for the state to impose taxes on its citizens and businesses.

## Capital Flight and Illicit Financial Flows from Eight Developing Countries: What the Data Shows

The research shows substantial variation across countries with regard to trends in capital flight and illicit financial flows as well as the pattern of accumulation of illicit external assets.

Over the period 1970 – 2010, total real capital flight (constant 2010 dollars) from the eight country case studies was USD 157 billion. The measure used to arrive at this estimate was the standard measure where capital flight is estimated as net unrecorded flows of capital between the country and the rest of the world. Figures 1 and 2 show the annual average capital flight in these eight countries for 1970-2010 period and capital flight as percentage of their 2010 GDP.

***Figure 1: Annual average Capital Flight (USD) Figure 2: Capital Flight as % of GDP in 2010***

Notes: Standard method; constant 2010 USD million. The standard measure of capital flight provides the lower-bound estimate of illicit financial flows. The standard method inherits one problem: poorly collected trade statistics in developing countries which can influence Balance of Payments data.

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| *Table 1: Capital flight per capita in 2010* | |
|  | *US Dollars* |
| Cote d'Ivoire | 2,838 |
| Guinea | 156 |
| Sierra Leone | 1,704 |
| Tanzania | 327 |
| Zambia | 1,336 |
| Bangladesh | 205 |
| Bolivia | 1,678 |
| Nepal | 347 |

Capital flight and illicit financial flows phenomena have been observed in these countries from the 1970s to the most recent years, with the exception of Nepal where net inflows are negative in most years until the mid-1990s. Moreover, for Bolivia and Nepal, capital flight has increased considerably in the past two decades.

Capital flight is large relative to the size of the economy in all eight countries under review (Table 1). At the low end, total real capital flight from Bangladesh over the past four decades represents 30.4 percent of its 2010 GDP. At the high end, the ratio is 523.6 percent of GDP for Sierra Leone.

The results also show a substantial burden of capital flight on the population. The average Ivorian shoulders a cost of capital flight of USD 2,838. This compares with per capita income of USD 1,161 in 2010. So, capital flight over the period is nearly three times the average income of an Ivorian in 2010. The ratio is higher for Sierra Leone (6 to nearly 10 times) given the small size of the economy: capital flight per capita in 2010 was USD 1,704.

With the exception of Guinea, all the countries under consideration are ‘net creditors’ to the rest of the world, in the sense that their assets represented by the stock of capital flight (with compound interest) exceed their liabilities vis-à-vis the rest of the world as measured by the stock of external debt in 2010. Repatriation of even a fraction of this wealth could enable these countries to expunge their external debts.



***Main components and drivers of capital flight***

The challenge in global and national efforts to stem capital flight is to explain its drivers and dynamics. In other words, how is capital ‘leaking out’ of the economy and what are the main causes of these leakages? How may observed upward or downward trends in capital flight be explained? And what makes some countries more prone to capital flight than others? The research shines new light on these issues.

The main conduits of capital flight are: (1) Balance of Payments leakages; (2) export misinvoicing; (3) import misinvoicing; (4) unreported remittances. The relative importance of these elements is illustrated in Figure 3.

Trade misinvoicing appears as a major conduit of capital flight contributing 85.7 percent of total capital flight in the case of Nepal, 58.2 percent for Bangladesh and 20.5 in the case of Côte d’Ivoire. Leakages through the Balance of Payments represent more than half of capital flight for Côte d’Ivoire (76.4%) and Tanzania (50.9%).

UNDP (2011) estimated that by 2008, LDCs were losing between US$ 20 billion and US$ 28 billion annually due to illicit financial flows. This sum is roughly equivalent to the amount of Official Development Assistance which flows annually into these economies.

*Figure 3: Components of capital flight (% of total)*

Notes: Standard method; constant 2010 USD million and % of total

The key drivers of capital flight may be grouped into the following categories:

* Structural features of the country’s economy;
* Factors related to the macroeconomic environment and macroeconomic policy;
* Factors affecting the risk and returns to private investment;
* Political and governance factors.

First, some countries may be prone to capital flight due to the specific characteristics of their economy. This includes natural resource abundance (and a dependence on natural resources) combined with trade openness in the context of weak governance and regulation. Indeed evidence from Sub-Saharan African countries shows that countries that are rich in oil and minerals figure prominently at the top of the list in terms of capital flight (Ndikumana and Boyce 2011a, 2011b, 2012; Boyce and Ndikumana 2012; UNDP 2011). Endowment in natural resources presents opportunities for embezzlement, theft, and trade misinvoicing given the large volumes of transactions involved in exploration, exploitation and export of these resources. It is important to note, however, that it is not the endowment in natural resources per se that makes a country prone to capital flight, but rather poor regulation, bad governance and the lack of capacity to manage these resources.

In turn, secrecy jurisdictions around the world provide a safe haven for the proceeds of embezzlement of natural resources.

Second, the macroeconomic environment and the macroeconomic policy choices of the government affect the investment climate and therefore the choices by individual investors between domestic and foreign assets. Strong economic performance reflects positive returns to domestic investment, and may serve as a deterrent to capital flight. High and variable inflation in contrast raises investment risk, which may encourage capital flight. High fiscal deficits and high tax rates also discourage domestic investment and could stimulate capital flight.

Third, In the case of legally acquired funds, factors that normally affect the returns to private investment would also influence the decision to invest domestically vs. abroad and hence capital flight. These factors include inter alia: the real interest rate differential between a country and the rest of the world; the real exchange rate; the quality of infrastructure, human capital, and other features of the domestic economy that affect trade and production costs; as well as the business environment in general.

Finally, the political and governance environment of a country influences capital flight. An unstable political environment raises the risk of losses of private wealth through expropriation or destruction of assets by violence. Poor governance in turn facilitates theft, embezzlement of national resources, trade misinvoicing, and smuggling of goods and capital across borders, all of which can induce illicit financial flows.

The relative importance of each of these different factors may however vary across countries and across time periods. Some factors may be related to licit capital outflows, i.e., the part that is purely motivated by honest portfolio diversification, while others may be associated with illicit outflows motivated by the need to evade regulation and inquiry into the sources of the funds. This indicates the need for detailed empirical research at the country level.

***Table 4: Key determinants of capital flight***

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| Factor | | Expected effect | | | | | Explanation |
| 1. Structural factors | | | | | | | |
| Natural resources | | Positive correlation | Opportunities for embezzlement, bribery, etc. | | | | |
| Natural disasters | | Positive correlation | Increases uncertainty and investment risk | | | | |
| International trade | | Positive correlation | Opportunities for trade misinvoicing; facilitated by weak regulation; import-dependency among low-income countries | | | | |
| 1. Macroeconomic environment, macroeconomic policy and the regulatory framework | | | | | | | |
| Growth | | Negative correlation | High growth indicates high returns to domestic investment | | | | |
| Inflation | | Positive correlation | High inflation and high inflation volatility raise investment risk | | | | |
| Fiscal deficits | | Positive correlation | High budget deficits signal high future taxes and lack of control over macroeconomic policy | | | | |
| Taxation | | Positive correlation | High taxes reduce net profitability of domestic investment; increases rewards for tax evasion | | | | |
| Capital account openness | | Ambiguous | An open capital account may either induce (easy to transfer money abroad) or reduce (less risk of capital being ‘locked’ in the country, ease to make payments for international transactions) capital flight. | | | | |
| 1. Risk and returns to investment | | | | | | | |
| Interest rate differential (foreign rate minus domestic rate) | Positive correlation | | | Opportunity for arbitrage in favor of foreign assets | | | |
| Real exchange rate | Overvaluation positively correlated with capital flight | | | Cheaper to buy foreign currency; exchange rate instability also induces capital flight | | | |
| Black market premium | | Positive correlation | |
| Financial depth | | Positive correlation; possibly ambiguous | | On the one hand, financial depth offers more domestic investment opportunities; on the other, financial depth and loose regulation may facilitate outflows of capital | | | |
| Public infrastructure | | Negative correlation | | | Good infrastructure reduces the cost of production and raises returns to domestic investment | | |
| 1. Governance and political factors | | | | | | | |
| Corruption | | Positive correlation | | | | Raises investment risk, including risk of expropriation | |
| Political instability; civil unrest, conflicts | | Positive correlation | | | |
| Democracy, political freedom | | Negative correlation | | | | Reduces investment risk | |
| Government effectiveness | | Negative correlation | | | | Reduces the cost of doing business in the country | |

## Conclusions and next steps

The preliminary results of our investigations suggest that capital flight is a pervasive phenomenon in a diverse range of developing countries. While there has been a recent upswing in outflows of illicit capital, the phenomenon itself is not new. This suggests that there may be a number of structural factors that perpetuate the illicit outflow of capital from these countries. This implies targeted policy interventions are required to stem capital flight.

The results point to a number of issues that need to be investigated in more detail at the country level. These include:

1. **Explaining the trend and pattern of capital flight over time:** Statistical and econometric analysis is needed to explain the observed level, trend, and patterns of capital flight in relation to movements in some of the key drivers of capital flight. In particular, in-country analysis would shed light on co-movements (contemporaneous, leading or lagging) between capital flight and its determinants. For example, country-level analysis could help answer the following question: do the observed trends of capital flight correlate with trends in the country’s overall economic performance and business cycles, international trade and globalization, economic reforms, financial sector reforms, regulatory reforms, sectoral reforms, political cycles or conflicts, etc.? This analysis will help determine the most relevant policy responses.
2. **Investigating and quantifying the channels and conduits of capital flight:** Further analysis at country level could help identify and quantify the mechanisms of leakages in the balance of payments, import and export misinvoicing, and other forms of smuggling resulting in illicit financial flows.
3. **Investigating the destination of capital flight:** Country-level analysis could also shed light on the destination of capital-flight-including trade and financial transactions; the role of safe havens in facilitating capital flight; the extent of trade misinvoicing in key sectors (oil, minerals, services especially finance and telecommunication sectors); the role of external players, especially multinational corporations engaged in the primary sector, banks and other financial institutions, etc. Country studies may shed light on the licit or illicit nature of capital flight.
4. **Investigating the development impact of capital flight:** Country-level analysis could generate new evidence on the impact of capital flight on economic and social development. For example, country studies could quantify the implications of capital flight for poverty reduction through its effects on capital accumulation and growth. Assuming that the capital that fled the country had been invested productively at home, growth would be higher, and so would be government revenue, public service delivery, and household incomes. These positive effects would result in faster poverty reduction. Such an analysis would provide useful input into policy debates on poverty reduction and development financing strategies.
5. **Investigating the role of governance:** Country-level analysis could examine the role of governance, national leadership, and civil society organizations in facilitating or preventing capital flight. It would assess explicit policy measures and commitment by national leadership to combatting capital flight, the extent to which these measures have been implemented, and reasons for successes or failures.

Finally, the role and opportunities presented by regional policy and advocacy initiatives such as Africa’s High Level Panel on Illicit Financial Flows should also be explored at the country level. This initiative – established in 2012 by the United Nations Economic Commission for Africa and chaired by Thabo Mbeki, former President of South Africa – aims to place illicit financial flows at the forefront of policy discourse on the continent. There may be invaluable opportunities for Sub-Saharan countries to share data on capital flight and illicit financial flows, and to discuss policy responses at national and regional levels. Sub-Saharan African countries could also leverage this initiative to develop joint advocacy on this issue at the international level.

The current debates on the future post 2015 agenda also offers important opportunities to foster political consensus around the need to curtail capital flight and illicit financial, flows as well as help secure political commitments to take this agenda forward.



***Major findings:***

1. The phenomena of capital flight and illicit financial flows are widespread although it is more prevalent in some countries than others.

2. Although it is a pervasive phenomenon in these eight countries, various trends can be observed. For example, in Nepal and Bangladesh, capital flight is a relatively recent phenomenon while in Tanzania, capital flight exhibits a steady pattern over the long-term and in Cote d’Ivoire, there are large fluctuations over time.

3. In the eight case studies, the following three areas constitute the most important conduits of capital flight: Export misinvoicing; import misinvoicing, and leakages in the balance of payments. However, the percentage contribution of each of these components varies. For example, the over-invoicing of exports is a major factor in Sierra Leone, while over-invoicing of imports is a problem in Nepal. In Guinea and Zambia, leakages in the balance of payments constitute the most important conduit of capital flight.

4. There is a need to study the underlying factors, mechanisms and specific drivers of illicit financial flows in each country in order to design appropriate policy interventions to prevent such flows. Thus, the primary objective of this short paper is to provide background information and guidance to the country case studies.

*The leakage of financial resources out of LDCs carries severe developmental impacts. While evidence is only beginning to emerge, it is clear that the effects of illicit financial flows are damaging and deserve serious attention.*

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**Contact Information:**

Gail Hurley, Policy Specialist, [gail.hurley@undp.org](mailto:gail.hurley@undp.org);

Anga Timilsina, Programme Manager, [anga.timilsina@undp.org](mailto:anga.timilsina@undp.org)