BRICS AND ILLICIT FINANCIAL FLOWS

Introduction

There is a growing sense of anguish among the citizens across the world[1] with the increasing number of public disclosures[2] exposing how a small group of global elite (individuals as well as MNCs) have been abusing the loopholes in national and global financial structures for their personal gain at the expense of the State. This small group consists of people from diverse backgrounds – politicians, business people, sports persons and people from the entertainment industry, among others. They (mis)use the technical legal provisions or bypass them to move the funds/money around the globe escaping the eyes of tax officials and government authorities. These kinds of fund movements are globally known as "Illicit Financial Flows (IFFs)" while in India the more common term used is "Black Money". Global Financial Integrity (GFI), a US-based think-tank, defines Illicit Financial Flows or IFFs as[3] –

Movements of money or capital from one country to another that is illegally earned, transferred, or utilised.

Examples of such flows include, but are not limited to, money laundering, proceeds from criminal activities and income from corruption.

Many researchers and commentators also include in IFFs those fund flows which are borderline legal or illegal. These funds, though technically legal, exploit the limitation of legal frameworks using sophisticated accounting and legal tools, i.e. these funds, in the guise of being legal, violate the spirit and the motive of the legal architecture.

Such kinds of flows are generated mainly through aggressive tax planning and tax avoidance by corporates and individuals[4]. In this process, they are aided by Tax Havens/Bank Secrecy Jurisdictions and enablers (individual as well as institutional)[5]. While Tax Havens/Bank Secrecy Jurisdictions provide a legal framework to escape the scrutiny of tax and financial regulations, the enablers of IFFs assist these actors to establish shell companies/trusts/foundations and anonymous financial accounts which are then used to move the funds globally[6]. The secrecy and anonymity associated with these entities make it near impossible for the government authorities to see the nature of the fund or detect its legality[7].

Given that these flows are inherently intended to be kept secret, the un-availability of data is a major hurdle in assessing the magnitude of IFFs. Various researchers have tried to estimate the scale of these flows using different methodologies. The most widely used is the one published by GFI. According to the latest report published in 2015, developing countries lost

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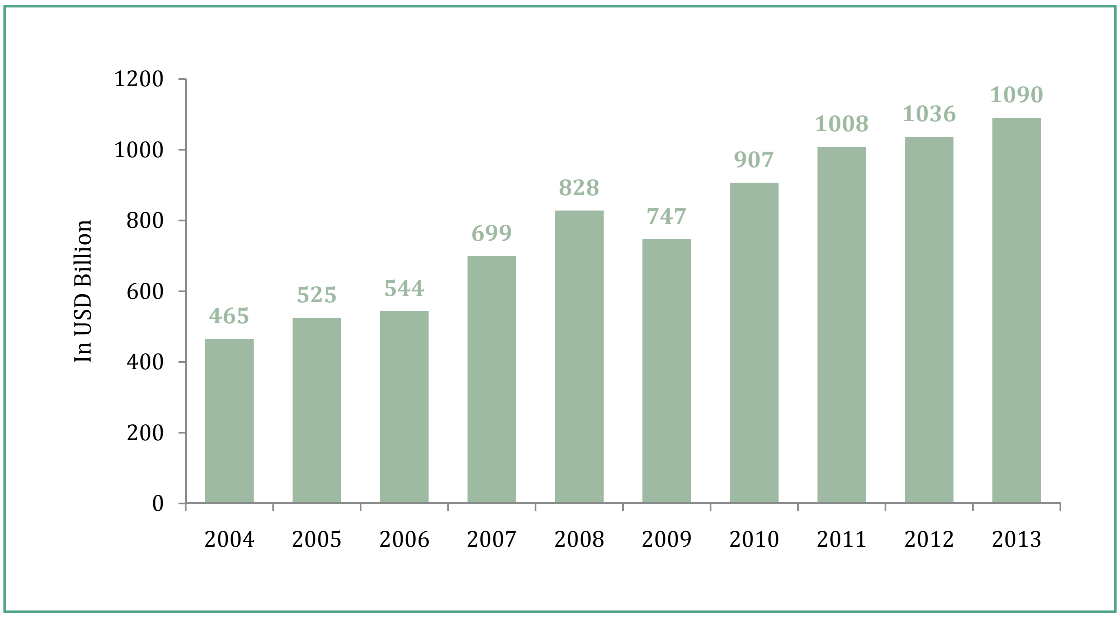
[1] Barford and Holt, 2013; Mowat, 2016.
[2] Harding, 2016; Tran, 2015; Millane, 2014.
[3] http://www.gfintegrity.org/issue/illicit-financial-flows/
[4] Rubin, 2014; Samuel Raja, 2013.
[5] For example – Accountants, Lawyers, Bankers, Accounting Firms, Law Firms, Banks. See - Henning, 2016; CBS 60 Minutes, 2016; Rushe, 2014.
[6] Garside, 2016.
[7] Chittum et al, 2016.

$7.8 trillion in the form of IFFs during the period 2004-13. For the year 2013 alone, the loss was more than $1 trillion[8].

It needs to be highlighted here that due to the unavailability of data, this estimate does not include mis-invoicing of service trade, cash transactions, faking by duplication of invoices, hawala transactions, and legal but unethical tax evasion by MNCs or individuals. This means the exact magnitude of IFFs is much bigger than estimated and there is a need for more detailed and innovative research in this area. Nevertheless, the study does succeed in providing a lower limit to the magnitude of problems faced by developing countries due to IFFs. The following chart shows the trend of IFFs from developing countries over the period 2004 to 2013.

Chart I: Illicit Financial Flows from Developing Countries



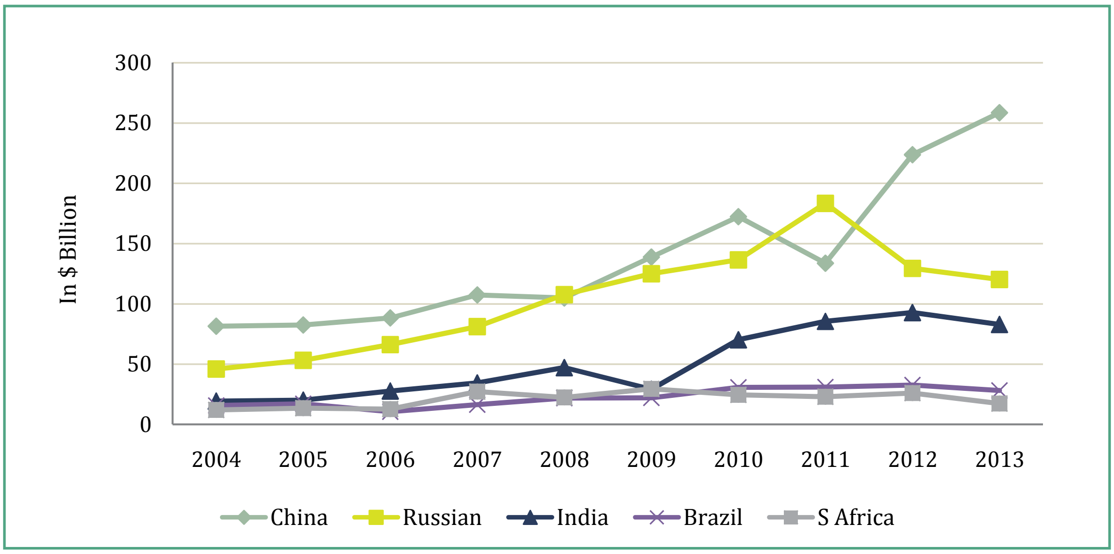
Source: Kar and Spanjers, 2015

In this short 10-year period, IFFs from developing countries have more than doubled in magnitude. Out of this total outflow from developing countries, the BRICS[9] member countries are major contributors to illicit outflows. These five countries alone contributed about 43% of the total outflows from developing countries in the period between 2004 and 2013. The enormity of the problem can be gauged from the fact that in the global ranking of countries for Illicit Outflows, 5 of the top 7 places are occupied by BRICS member countries. During this period, China has been the biggest source of IFFs outflows followed by Russia. India comes at number four while Brazil and South Africa occupy the sixth and seventh place respectively. The following chart shows the trend of IFFs from individual BRICS countries for the period over 2004-13.

[8] Kar and Spanjers, 2015.

[9] BRICS refers to a group of countries consisting of Brazil, Russia, India, China and South Africa.

Chart II: Illicit Financial Flows from the BRICS Member Countries



Source: Kar and Spanjers, 2015

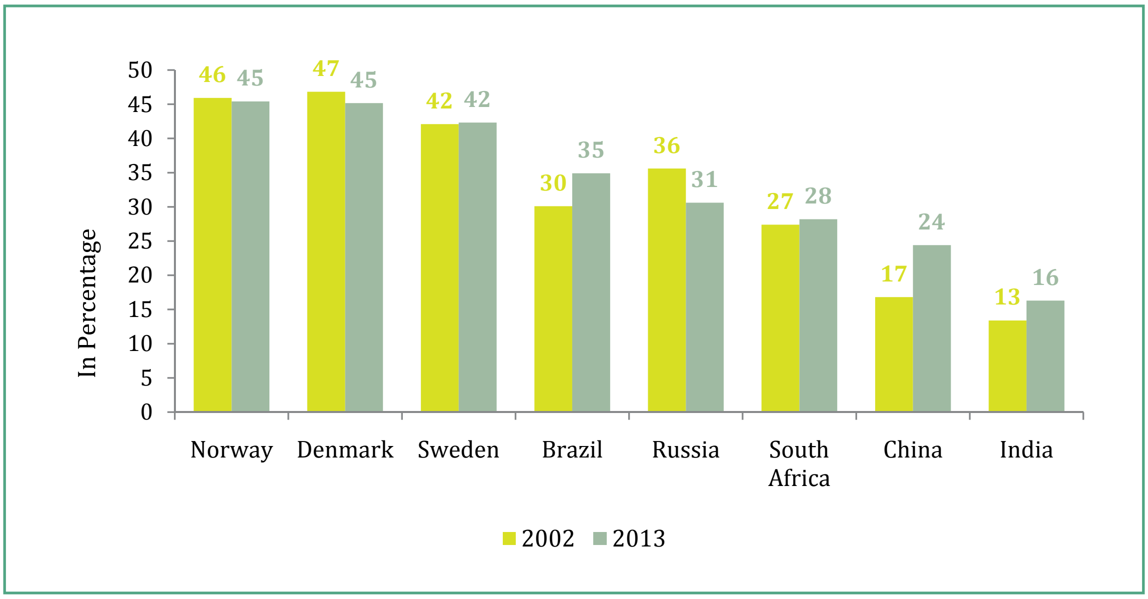
While the above mentioned study looks into the annual outflows from developing countries, some other studies have tried to estimate the wealth stashed in tax havens. One such study by Gabriel Zucman (2015) estimates that there are about $7.6 trillion in tax havens currently that is unaccounted for by government authorities[10]. The sources of these funds are both developing and developed countries. Another study by the James Henry (2012)[11], which considers a broader spectrum of variables[12], estimated that the wealth hidden in tax havens is in the tune of $21 – 32 trillion. These numbers only highlight the magnitude of the problem caused by IFFs.

Here it is important to note that the illicit funds are a bigger problem for developing countries due to the adverse impact they have on their domestic resource mobilisation. Developing countries, including the BRICS member countries, lag behind in terms of tax collection, which ultimately constraints the government's ability to spend on various welfare/development programmes.

The chart given below shows the comparison of the level of tax collection in BRICS member countries vis-à-vis some of the countries which perform well in terms of the Human Development Index[13]. It also depicts the change within the country over the period of 10 years:

[10] Zucman, 2015.
[11] Henry, 2012.
[12] While Zucman (2015) uses the data from Bank of International Settlement to find out unreported capital at country level, Henry (2012) uses source and use model for country by country capital flows, accumulated offshore wealth model, offshore investor portfolio method, and market research report by leading consulting firms on the size of offshore banking.
[13] The Human Development Index (HDI) is a measure of average achievement in key dimensions of human development such as a long and healthy life, being knowledgeable and a decent standard of living. http://hdr.undp.org/en/content/human-development-index-hdi

Chart III: Tax GDP Ratio: BRICS Member Countries vs. Select High HDI Countries



Source: Revenue Statistics: Comparative tables, OECD; Government Finance Statistics Yearbook of various years published by IMF; China Statistical Yearbook, 2003, published by National Bureau of Statistics of China; Revenue Statistics in Latin America, 2014, published by OECD; Indian Public Finance Statistics, 2013-14, published by Ministry of Finance, India.

Notes: (1) Figures for Brazil are calculated from Revenue Statistics in Latin America 2014 published by OECD.

(2) Figures for India are from 2001-02 and 2011-12 respectively and obtained from Indian Public Finance Statistics 2013-14 published by the Ministry of Finance, India.

(3) Figure for China for 2002 was calculated from the China Statistical Yearbook 2003 published by the National Bureau of Statistics of China.

(4) Figures for South Africa and Russia were obtained from Government Finance Statistical Yearbook 2003 published by IMF.

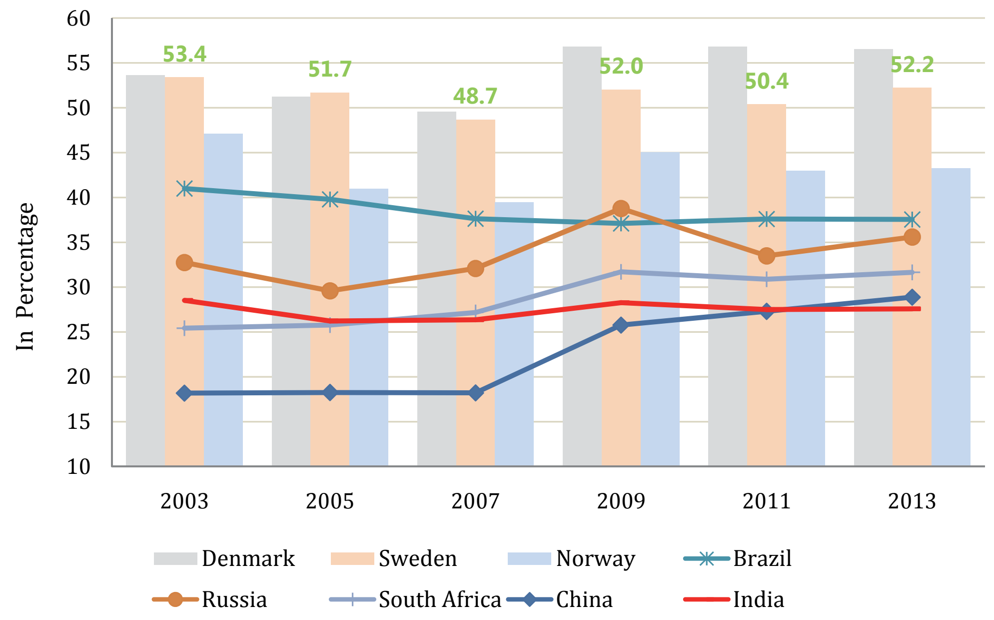
(5) Figures for Russia and South Africa for 2012 and China for 2011 were extracted from the IMF Data warehouse on 12/27/2014, Government Finance Statistics Yearbook.

Gabriel Zucman, an economist who works on issues of IFFs, estimates that globally governments' tax revenue loss due to IFFs is in the tune of around USD 200 Billion per annum[14]. Corporate sector and High Net-worth Individuals (HNIs) have been able to reduce their tax bill and sometimes even avoid taxes with the help of accountants and lawyers, as highlighted by various data leaks from financial institutes, such as Swiss Leaks, HSBC Leaks, Panama Papers.

The shortfall in tax collection severely constraints the government's ability to fund various development and welfare programmes. The following chart shows a comparison of public spending of BRICS member countries with that of Denmark, Norway and Sweden.

[14] Zucman, 2014.

Chart IV: Government Spending as Percentage of GDP:
BRICS Member Countries vs. Select High HDI Countries



Source: International Monetary Fund, 2016
Note: Total expenditure consists of total expense and the net acquisition of nonfinancial assets. Apart from being on an accrual basis, total expenditure differs from the GFSM 1986 definition of total expenditure in the sense that it also takes the disposals of nonfinancial assets into account

As is known, BRICS member countries are in the lower or middle income group and in terms of Human Development index there are needs for substantive improvement. That, in turn, requires much higher levels of government spending, especially on basic facilities like health, education, sanitation, infrastructure, etc. However, it is clear from the chart given above that the spending levels are comparatively lower in the BRICS member countries. Though Brazil has the highest government spending among the BRICS member countries, in the period of between 2003 and 2013, it has infact fallen by 4 percentage points. While South Africa and China have seen some improvement on this front over this period, it has been the opposite in case of Russia and India. The case of India is especially stark as the period from 2004 to 2014 has seen unprecedented economic growth which should have been associated with increased spending and not a decline. The current human development indicators in the country demands that government increases its spending especially on vital areas like – drinking water and sanitation, health, education and infrastructure. This can be done only if the government is able to mobilise more resources. On this front, being able to curb IFFs should prove useful.

The Way Forward

Given the corrosive impacts of IFFs on the development and welfare of society, domestic economy as well as on aggravating wealth inequality, there is an urgent need to curb the illicit outflows.

Since these flows are generated and facilitated due to the secrecy provided by Tax Havens/ Bank Secrecy Jurisdictions as well as due to the constraint of national boundaries for government authorities, the curbing of IFFs requires not only domestic initiatives but also global co-operation among government authorities.

In this regard, the following measures, along with strengthening of domestic tax and judicial system, should be undertaken by various governments:

- **Exchange of Tax/Financial Information (EOI)** – it refers to a process whereby two or more countries engage in sharing relevant information, available within their own jurisdiction but related to the citizens and legal entities of other countries, with the respective government authorities of those individuals and entities.

  The availability of such information will enable authorities to assess which of the funds (movements) need further scrutiny or legal action and in the process will create disincentive for IFFs.

  Countries should build EOI arrangements with all the relevant countries, such as major trade partners, major international financial centres, and major tax havens, among others. They should also create an effective mechanism to exchange and exploit information for taxation purposes.

- **Public Beneficial Ownership (BO)** – As noted above, IFFs are facilitated by anonymous entities and accounts. That veil of secrecy needs to be removed and for this, there must be strict provisions related to the "Know your Customer" (KYC) process, whereby all the financial institutions are required to have details of the individuals who are the ultimate beneficiaries from such anonymous entities/accounts.

  Governments should create a list of the beneficial owners of all legal entities (companies/ trusts/foundations) and make it public, so that this information is accessible to all, at all times. Public availability of this information will not only be helpful to financial institutions to verify the details given to them, but any other misuse of the anonymity in the wider public sphere will be easier to detect.

- **Country-by-Country Reporting (CBCR)** – Currently, MNCs report their revenue, profit/ loss, taxes paid, other expenses, employee details, etc. in a consolidated form of all the subsidiaries in various countries. The consolidated nature of these numbers helps them evade the scrutiny of tax officials in individual countries.

  MNCs should be required by law to publish their data of revenue, profit-loss, tax, number of staffs employed and other reportable details for each of the countries separately. These publications would not only enable the government authorities to evaluate the reports properly, but from an economic standpoint, the transparency will enable the investors to make more informed investment decisions.

  In the Base Erosion and Profit Shifting (BEPS) initiative taken by the OECD, MNCs are required to report using a country by country reporting (CBCR) template but this is applicable only for MNCs with turnover higher than EUR 750 million annually. This will exclude approximately 80-90% of MNE groups[15], especially in developing countries. Hence it is required that for CBCR to succeed in its goal, the threshold limit needs to be lowered to bring in higher number of companies in the fold.

[15] OECD, 2015.

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AUTHOR: SURAJ JAISWAL

EDITORIAL INPUTS: MALINI CHAKRAVARTY

FOR FURTHER INFORMATION, PLEASE WRITE TO: suraj@cbgaindia.org

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CBGA

CENTRE FOR BUDGET AND GOVERNANCE ACCOUNTABILITY (CBGA)

B-7 Extn./110 A (Ground Floor), Harsukh Marg, Safdarjung Enclave, New Delhi – 110029

Ph: +91-11- 49 200 400 / 401 / 402 Email: info@cbgaindia.org Website: www.cbgaindia.org

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