



# CURBING ILLICIT FINANCIAL FLOWS TO UNLOCK A SUSTAINABLE FUTURE

Achieving the sustainable development goals and countering climate change will require considerably more resources than what public finances alone can afford.

By curbing illicit financial flows and recovering stolen assets, governments can unlock precious resources needed to close the financing gap.

The year 2015 marks a critical juncture for determining the future of our planet. In September, the world's political leaders will be asked to agree to a new set of development goals to steer international cooperation to 2030. In December a binding agreement to keep global warming below 2°C is planned for adoption at the 21<sup>st</sup> Conference of the Parties (COP21) in Paris. Achieving ambitious goals — such as eradicating poverty, ensuring proper healthcare and education for all, reaching full employment, having accountable and open institutions, and combating climate change — will likely require both strong political will and solid financing. It will also require tackling corruption and ensuring transparency, accountability and participation.

Every year the developing world loses staggering amounts of its wealth to corruption, tax evasion and money laundering, which could help to fill the shortfall for funding sustainable development. Repeated calls for innovative financing mechanisms underline the need to generate more resources domestically. In spite of a substantial increase in global economic growth and investment flows, the enormous financing gap for sustainable development has not been closed. The estimated costs remain well beyond what developing countries can fund. Putting a stop to this haemorrhaging of public resources would unlock considerable domestic revenues. Transparency International urges all governments to crack down on illicit financial flows and strengthen mechanisms for asset recover to ensure that the world invests in a common sustainable future.

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## THE ISSUE

### THE FINANCING GAP

To achieve the Sustainable Development Goals (SDGs), as well as substantially reduce greenhouse gases, conventional financing methods must be drastically reformed. While aid flows are critical to building the institutional, social, environmental and physical infrastructure of developing countries, they are largely insufficient. Only some 30 countries can expect to receive development aid for the entire 2015-2030 period, mainly from about 30 major donor countries,<sup>1</sup> most of whom have reduced or will reduce their official development assistance (ODA).<sup>2</sup> Adequately financing a post-2015 development framework will require finding complimentary financing that catalyses private investments, uses resources more efficiently and mobilises domestic resources in developing and developed countries alike.

#### Financing development

Development efforts under the previous set of commitments, known as the Millennium Development Goals (MDGs), proved successful in some areas. However, they left considerable “unfinished business” in many others and often failed to mobilise the necessary resources to deliver on all the goals.<sup>3</sup> The government discussions around the Third International Conference on Financing for Development in Addis Ababa have signalled the need to cover the financing gaps that remain for achieving sustainable development and to bring critically-urgent public resources to the table.<sup>4</sup>

Levels of ODA in 2013 equalled roughly US\$ 167 billion, while private aid amounted to US\$ 274 billion (i.e. monies coming from private organizations and donations).<sup>5</sup> As big as these amounts may seem, they far fall short of the financing needed to fulfil the SDGs. Incremental annual investments on the magnitude of US\$ 50-80 billion will be required to reach universal health care by 2030. An additional estimated US\$ 38-42 billion is needed to achieve primary education for all. One can also add to these figures other annual costs to ensure food security (US\$ 46-50 billion), access to water and sanitation (US\$ 15-27 billion), and sustainable and modern energy for all (US\$ 34-45 billion).<sup>6</sup> These costs alone – which go toward meeting a fraction of the proposed SDGs – require up to US\$ 244 billion in funding each year. Moreover, the undersupply of infrastructure in developing economies has been estimated at around US\$ 1 trillion per year through 2020, with an additional US\$ 200-300 billion annually required for low-carbon emitting and climate-resilient infrastructure investments.<sup>7</sup>

#### Financing a low-emissions economic model

When it comes to addressing climate change, the financing gap is wide, and will only expand as the required financing costs rise.

In spite of the increase in “green investments” over the last decade, progress towards low-emission economies remains slow and prolonged.<sup>8</sup> This pushes the planet’s climate dangerously closer to a point of no return, after which it will no longer be possible to contain temperatures within safe limits. This would have devastating consequences on the safety and food security of the world’s population and effectively undo the SDG commitments.

Developed countries have committed funds, in addition to development financing, to support developing countries to mitigate and adapt to climate change. At the same time the concept of common but differentiated responsibilities (CBDR) across all countries means that to varied degrees all countries should commit to ensure that money is available and spent to achieve long term results to combat climate change.

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## TAPPING FUNDING: THE CASE OF KENYA

The alleged theft of government monies in Kenya offers a vivid example of what development programmes the country could have funded if it were not for corruption. The government would have had millions of dollars in additional funding to support desperately needed public services to reduce hunger, maternal mortality, HIV rates and the housing shortage. These are all areas where the country has critical development challenges and is lagging behind on the Millennium Development Goals (MDGs).

The continuing case of the Anglo Leasing scandal shows how much money is at play. This public procurement corruption scandal dates to 1997 and still remains unresolved. At the heart of the affair are 18 allegedly grossly overpriced state security contracts worth a combined US\$ 770 million. The transactions became known as the Anglo Leasing scandal after the name of the company that was awarded the first of the contracts.

If this money had not gone missing, the government would have had enough funding to pay for programmes to provide any one of these critically-needed public services:

- Clean water access for nearly 22,482,000 people;
- Sewage and clean water supply connections for over three million households;
- Annual antiretroviral therapy (ART) for 3,437,500 patients; or
- In-facility and safe births for more than 41,848,000 deliveries.

As a result of corruption, such funding choices are not up for discussion. They remain a lost set of options critical to tackling the country’s remaining development deficits.<sup>26</sup>

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It is estimated that an additional US\$ 700 billion per year is required to meet the challenges posed by climate change, an amount that could be largely mobilised from private capital.<sup>9</sup> As for adaptation costs, calculations by UN Environment Programme (UNEP) show that developing countries will require as much as US\$ 150 billion per year between 2025 and 2030, and then US\$ 250-500 billion per year by 2050. After that point, the annual costs of adaptation are predicted to rise even further.<sup>10</sup> Mitigation costs just for the energy sector have been estimated in the range of US\$ 136-510 billion a year until 2020.<sup>11</sup>

The international community is making significant steps to face this challenge. At the COP17 in 2011, the Green Climate Fund was created to finance adaptation and mitigation actions in developing countries. However, out of the announced US\$ 100 billion per year to be made available by 2020, only one-tenth of this amount has been pledged so far, about half of which has been deposited into the fund.<sup>12</sup> Several other climate funds, both privately and publicly funded, have been set up, but their combined (deposited) funds remain below US\$ 15.7 billion.<sup>13</sup>

## A DRAIN ON DEVELOPMENT

As governments struggle to obtain sufficient financing for the development and climate agendas, immense streams of assets flow out of both developed and developing countries alike. Known as illicit financial flows (IFFs), an estimated US\$ 1 trillion<sup>14</sup> may be leaving developing countries in the form of tax evasion, embezzlement, bribes, trade mis-invoicing, money laundering and smuggling (see side bar). Worryingly, these flows have been increasing at a rate of 9.4 per cent each year during the last decade.<sup>15</sup>

The consequences of IFFs can be devastating. Reduced tax earnings have a direct and negative effect on public and private investments as well as the provision of public services. This means fewer schools, clinics, jobs, infrastructure, and social protections. IFFs indirectly impose an unfair regressive tax burden on poorer citizens and honest businesses. The toll is especially high for low income countries, which in 2011 lost at least 6.7 per cent of their GDP to IFFs.<sup>16</sup> Developing countries, in fact, are often unable to generate enough domestic investment to ensure sustainable economic growth, and they lack resources to fund infrastructure and social policies. The loss of assets through IFFs entrenches and aggravates these shortcomings, slowing economic growth, diverting resources from development, increasing external indebtedness and deepening reliance on foreign donors. Some estimate that Africa's capital stock would have expanded by more than 60 per cent if funds illicitly leaving Africa had remained there, while GDP per capita would be up to 15 per cent higher.<sup>17</sup>

The challenge is how to stop this drain on development. IFFs represent, first and foremost, a governance problem – of financial institutions and countries. IFFs thrive where institutions are weak, regulations are poor and decision making is not transparent. Several actors may be at the root of the problem: corrupt public officials may stash abroad bribes received and embezzled public funds; large companies may evade taxes by engaging in abusive transfer mis-pricing or trade mis-invoicing; and criminals may launder away proceeds of crime. IFFs are often facilitated by financial institutions and a range of intermediaries in the North and South that (wittingly or unwittingly) fail to perform appropriate due diligence checks on the assets they handle. The lack of information on the true owners of companies and existence of financial secrecy jurisdictions deepen the problem.

## A FUNDING SOLUTION TO STEM THE FLOW

Tackling illicit financial flows and mobilising resources to finance the development and climate agendas are strongly interrelated challenges. Successfully curbing IFFs would help to reduce one key constraint to a country's

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## DEFINING ILLICIT FINANCIAL FLOWS

There is no single definition of illicit financial flows (IFFs). Transparency International describes them as “the movement of money that is illegally acquired, transferred or spent across borders.” Along these lines, Global Financial Integrity defines them as cross-country movements of money or capital illicitly earned, transferred, and/or utilised. Meanwhile, the OECD talks about “a set of methods and practices aimed at transferring financial capital out of a country in contravention of national or international laws.”<sup>27</sup>

Once the flows are moved across a border, they may be re-invested in illegal activities or diverted to investments and purchases in legal economic sectors. This conversion into ostensibly legitimate funds is known as money laundering.

IFFs may derive from legal sources that have been illegally transferred (as in the case of tax avoidance and transfer mis-pricing). They may also come from inherently illegal sources such as the proceeds of corruption (e.g. bribery and theft by government officials) or other criminal activities (e.g. drug trading, human trafficking and illegal arms sales).

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development by taking on corruption and illicit activities, with positive impacts on governance and business.<sup>18</sup> At the same time, it would enable higher levels of domestic resources and provide governments with the funds needed to invest in development and climate financing projects. A commitment to free up these existing but misappropriated finances stashed abroad might also help give confidence to climate change negotiators in agreeing on ambitious emission-reduction targets in Paris. To achieve such outcomes, actions will be needed to minimise the outflow of funds domestically, to improve the transparency and accountability of international development and climate financing, and to seize assets illicitly transferred abroad.

A large bulk of IFFs is generated through tax evasion that can occur as a result of illegal activities like trade mis-invoicing and transfer mis-pricing. Like other actors, the EU and OECD are trying to respond to these problems. In the case of the EU, they are promoting standards for transparent, financial reporting on a country-by-country basis. The OECD is calling for collecting and sharing cross-border transaction data although critics cite it is not going far enough or fast enough.<sup>19</sup>

Illicit financial flows usually transit through secrecy jurisdictions and tax havens, which use complex legal arrangements and privileged fiscal regimes that can allow corrupt individuals to hide their assets from taxation and discovery. Money launderers employ these same techniques to disguise the true source of their money. Transparency about who owns and controls companies, trusts and other legal entities is critical for detecting illicit funds and identifying who is behind them. As underscored by the G20, all countries should collect information on the identity of the ultimate beneficiary or controller of corporate vehicles (i.e. beneficial owner). This information should be updated regularly, and publicly made available. Governments should also put political pressure on jurisdictions that enable financial opacity and banking secrecy. The UK has had a difficult time vis-à-vis its Overseas Territories and Crown Dependencies to follow its lead and endorse registries to track the beneficial owners of companies.<sup>20</sup>

Global standards, such as those established by the Financial Action Task Force (FATF), require financial institutions and related professional intermediaries to run checks on their clients, in order to make sure they do not participate in laundering schemes by accepting illicit funds. Transactions by politically exposed persons (PEPs) and opaque corporate structures (such as trusts) are considered high-risk and subject to greater scrutiny. Governments must strengthen current requirements on vetting such clients and facilitate the identification of PEPs.

Identifying, blocking, freezing and returning illicit assets has the double advantage of providing developing countries with resources they would have otherwise lost as well as deterring further illicit financial flows. Unfortunately, existing asset recovery initiatives are hindered by delays, legal complexities and capacity constraints. It is estimated that only a minuscule share of the total laundered assets are seized (less than 1 per cent),<sup>21</sup> and even less are returned.<sup>22</sup> One of the main obstacles is the requirement that proceedings can only be started if the suspect has a prior criminal conviction, which is often very hard to establish. Not surprisingly, countries that have been the most successful in tracing, freezing and returning stolen assets are the same ones that have legal frameworks which allow asset forfeiture based on civil procedures, without requiring criminal conviction of the offender.<sup>23</sup> Funds invested in asset recovery can leverage considerable resources in developing countries: government experience suggests that for each dollar spent on investigating the proceeds of corruption, up to US\$ 20 is tracked and frozen, with a significant proportion of that sum being then repatriated to the source country.<sup>24</sup>

Once assets have been identified, it must be ascertained to whom they should be returned. One key consideration is to make sure they will not return to corrupt individuals but rather serve development purposes. A first option could be to

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## OPENING THE DATA

Financing dedicated to development and to offset the effects of climate change flows through new, often uncoordinated channels, where traceability is low and the risk of corruption is high. Proactively disclosing and sharing understandable, timely, accessible and comparable information on related financial flows would allow for the tracking of how the money is being spent and whether funding is being diverted. The International Aid Transparency Initiative (IATI) is one framework that meets these criteria.

Without a complete picture of how resources are invested and managed, it will be impossible to assess their effectiveness and improve the efficiency of how monies are spent. For this reason, countries should work together to achieve greater mutual accountability, improved data collection and strengthened monitoring when it comes to development and climate finance.<sup>28</sup>

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store frozen assets during the seizing procedures in escrow accounts held by regional development banks, rather than keeping them in the banks that are complicit in receiving these assets.<sup>25</sup> Countries should also equip themselves with legal instruments that allow seized funds to be allocated to development and capacity-building projects in the country of origin (for the funds), when mutual legal assistance is impossible or where there is a serious risk that repatriated funds would illicitly flow out of the country again. Switzerland adopted such an approach in the so-called “Duvalier law” that was passed in 2010 (see side bar).

## WAY FORWARD

Tackling illicit flows and channelling them to close the financing gap to meet development and climate commitments is critical. The following are some potential actions to put countries on such a path:

- **More and better information is needed on IFFs.** All parties should elaborate an official definition of IFFs, in cooperation with relevant international and regional organisations. As a second step, they should publish official estimates of their volume and breakdown, in line with the proposed outcome document for the Addis Ababa conference (2015).
- **International and domestic regulatory bodies should promote standards with greater transparency and reporting by firms.** This should be done on a country-by-country basis, for example by implementing agreements such as the Extractive Industries Transparency Initiative (EITI) and ensure beneficial ownership transparency, such as by adopting a global Legal Entity Identifier system. Governments should also increase the exchange of tax information by enacting the automatic exchange of tax information for a limited time period as well as support technical capacity building by developing countries.
- **All countries should collect beneficial ownership information for companies, trusts and other arrangements.** Information should be updated regularly and, in the case of companies, publicly available. Public procurements should require bidders to declare their beneficial owners.
- **Actions to stop IFFs must be taken by decision-makers in both developing and developed countries.** To do so, they must increase pressure on financial secrecy jurisdictions and tax havens to increase corporate ownership transparency and to avoid harmful taxation practices. They must also encourage greater cooperation between tax authorities, investigator, banks and prosecutors to locate and return the money.
- **Governments should reinforce rules and implementation of due diligence procedures by banks** and support financial institutions in this task by publishing lists of PEPs, as well as any asset declarations filed by PEPs. When failures arise, governments should prosecute wrongdoings.
- **Legal and institutional instruments to recover stolen asset must be reinforced** by introducing civil forfeiture and illicit enrichment offences.
- **The repatriation of assets should be tied to developmental and green projects,** in close cooperation with development agencies and with national authorities of the source country. A criteria would need to be mutually agreed between countries on the types of qualifying projects.
- **Transparency, accountability and participation in climate and sustainable development finance should be guaranteed.** The International Aid Transparency Initiative (IATI) offers a good open data standard for reporting on aid, and could help track other development flows.

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## CASE STUDY: THE SWISS “DUVALIER LAW”

In 2010 the Swiss Parliament adopted its ‘Act on the Restitution of Illicit Assets’, commonly called *Lex Duvalier*. Under that law, Switzerland can confiscate stolen assets and allocate them to development projects for the benefit of the population concerned. This is only for cases where a request for mutual legal assistance cannot proceed owing to the failure of state structures in the requesting state.

The reversal of the burden of proof applies in such a case, meaning that it would be up to the claimant to prove the frozen assets have a legitimate, rather than an illicit, origin.

Under the law, seized assets shall be returned in the form of funding for programmes of public interest, to be agreed with the country of origin. In case of failure to conclude such an agreement, forfeited assets may be restituted using international or Swiss development institutions.

The law is currently under revision in Parliament and could lead to assets not being returned if the crimes that they are associated with are circumscribed by statutes of limitation.<sup>29</sup>

## NOTES

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- <sup>2</sup> World Bank, "Financing for Development. Post-2015," Oct. 2015.
- <sup>3</sup> J. D. Sachs, G. Schmidt-Traub, "Financing Sustainable Development: Implementing the SDGs through Effective Investment Strategies and Partnerships," SDSN, 2014; L. Atakpu, "A Post-2015 Drive for Universal Access to Water and Sanitation", in *Rethinking Partnerships in a Post-2015 World: Towards Equitable, Inclusive and Sustainable Development*, Reality of Aid, 2014.
- <sup>4</sup> <http://www.un.org/esa/ffd/wp-content/uploads/2015/03/1ds-zero-draft-outcome.pdf>.
- <sup>5</sup> OECD, Query Wizard for International Development Statistics.
- <sup>6</sup> Data retrieved from: G. Schmidt-Traub, and A. Shah, "Investment Needs to Achieve the Sustainable Development Goals," Sustainable Development Solutions Network, 2015 (forthcoming); and UNTT Working Group on Sustainable Development Financing, "Financing for sustainable development: Review of global investment requirement estimates," 2013.
- <sup>7</sup> A. Bhattacharya, M. Romani and N. Stern, "Infrastructure for development: meeting the challenge," Centre for Climate Change Economics and Policy, Grantham Research Institute on Climate Change and the Environment, 2012.
- <sup>8</sup> See: <http://www.bloomberg.com/news/articles/2015-04-14/fossil-fuels-just-lost-the-race-against-renewables>.
- <sup>9</sup> World Economic Forum, *The Green Investment Report*, Geneva 2013.
- <sup>10</sup> UNEP, *Adaptation Gap Report 2014*.
- <sup>11</sup> M. Fischesdick, et al., "Mitigation Potential and Costs." In *IPCC Special Report on Renewable Energy Sources and Climate Change Mitigation*, 2011.
- <sup>12</sup> See: [http://news.qcfund.org/wp-content/uploads/2015/04/GCF\\_contributions\\_2015\\_june\\_12.pdf](http://news.qcfund.org/wp-content/uploads/2015/04/GCF_contributions_2015_june_12.pdf).
- <sup>13</sup> Data from <http://www.climatefundsupdate.org/>.
- <sup>14</sup> D. Kar and J. Spanjers, "Illicit Financial Flows from Developing Countries: 2003-2012," *Global Financial Integrity*, 2014.
- <sup>15</sup> *Ibid*.
- <sup>16</sup> J. Griffiths, "The State of Finance for Developing Countries, 2014," Eurodad, 2014.
- <sup>17</sup> J. K. Boyce and L. Ndikumana, "Capital Flight from Sub-Saharan African Countries: Updated Estimates, 1970–2010." *PERI Research Report*. University of Massachusetts, Amherst, 2012.
- <sup>18</sup> "Illicit Financial Flows," *Report of the AU/UNECA High Level Panel on Illicit Financial Flows from Africa*.
- <sup>19</sup> See EU legislation on country-by-country reporting for the financial sector, OECD BEPS process and the OECD standard for automatic information exchange: [http://ec.europa.eu/finance/bank/regcapital/index\\_en.htm](http://ec.europa.eu/finance/bank/regcapital/index_en.htm), [www.oecd.org/ctp/beps.htm](http://www.oecd.org/ctp/beps.htm) and [www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm](http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm). For criticism, see: [www.eurodad.org/Entries/view/1546260/2014/09/22/OECD-BEPS-process-Minor-victories-in-the-battle-against-tax-dodging-but-we-risk-losing-the-war](http://www.eurodad.org/Entries/view/1546260/2014/09/22/OECD-BEPS-process-Minor-victories-in-the-battle-against-tax-dodging-but-we-risk-losing-the-war).
- <sup>20</sup> There are 14 overseas territories (e.g Gibraltar, Bermuda and BVI) and two Crown Dependencies (the Channel Islands and Isle of Man).
- <sup>21</sup> UNODC, "Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes," 2011.
- <sup>22</sup> L. Gray et al., "Few and Far: The Hard Facts on Asset Recovery," StAR, 2014.
- <sup>23</sup> Among others: L. Gray et al., "Few and Far: The Hard Facts on Asset Recovery," StAR, 2014; "Illicit Financial Flows," Report of the AU/UNECA High Level Panel on Illicit Financial Flows from Africa.
- <sup>24</sup> OECD, "Measuring OECD responses to illicit financial flows," Issue Paper, DAC SENIOR LEVEL MEETING, Paris 2013.
- <sup>25</sup> "Illicit Financial Flows," Report of the AU/UNECA High Level Panel on Illicit Financial Flows from Africa.
- <sup>26</sup> For info on Anglo-Leasing, see: [www.ft.com/cms/s/0/bf75a7ee-c7f9-11e4-8210-00144feab7de.html#axzz3BoBskJYJ](http://www.ft.com/cms/s/0/bf75a7ee-c7f9-11e4-8210-00144feab7de.html#axzz3BoBskJYJ) and <http://star.worldbank.org/corruption-cases/node/18608>. For costs, see: <https://thewaterproject.org/give-water> (water); [www.wds.worldbank.org/external/default/WDSContentServer/WDS/IB/2013/05/23/000356161\\_2013052311732/Rendered/PDF/779210ISDS0App00230201300Box377316B.pdf](http://www.wds.worldbank.org/external/default/WDSContentServer/WDS/IB/2013/05/23/000356161_2013052311732/Rendered/PDF/779210ISDS0App00230201300Box377316B.pdf) (sewage); [www.hivresearch.org/news.php?NewsID=266](http://www.hivresearch.org/news.php?NewsID=266) (HIV/AIDS); and <http://heapol.oxfordjournals.org/content/24/4/289.full.pdf> (maternal mortality).
- <sup>27</sup> For TI, see: [www.transparency.org/glossary/term/illicit\\_financial\\_flows](http://www.transparency.org/glossary/term/illicit_financial_flows); for GFI, see: [www.gfintegrity.org/issue/illicit-financial-flows](http://www.gfintegrity.org/issue/illicit-financial-flows); For OECD, see: [www.oecd.org/dac/SLM2013\\_issue%20paper%20illicit%20flows.pdf](http://www.oecd.org/dac/SLM2013_issue%20paper%20illicit%20flows.pdf).
- <sup>28</sup> UN General Assembly, "Report of the Intergovernmental Committee of Experts on Sustainable Development Financing," 2014.
- <sup>29</sup> See: <https://www.admin.ch/opc/en/classified-compilation/20100418/201102010000/196.1.pdf>.

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