Illicit Financial Flows, Trade Misinvoicing, and Multinational Tax Avoidance: The Same or Different?

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Abstract

Illicit financial flows (IFFs) connected with corruption, crime, and tax evasion are an issue of increasing concern. A target to reduce IFFs is included in the Sustainable Development Goals (SDGs). However, there is not yet a clear consensus on how to define illicit financial flows, and even less on how to measure them. In particular, while tax fraud and evasion clearly fall within the definition "illicit," several arguments have been put forward for widening the term to also include legal behaviour which reduces tax payments. Rationales for this include the dictionary definition of the word "illicit" and the existence of enforcement uncertainty. One of the most practically compelling arguments has been a belief that there is a large "grey zone" reflecting an absence of clear defining lines between legal tax planning and tax evasion. This is often linked to the idea that *transfer pricing* and *trade misinvoicing* are areas of overlapping practice where major multinational companies engage in illicit financial flows. This paper explores the definitional questions and the estimates of trade misinvoicing to shed light on whether these behaviours and issues are the same or different. This paper argues that conflating legal and illegal behaviour under a single definition involves a loss of clarity and a risk of confusion.

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1. Introduction

Illicit financial flows (IFFs) have become an issue of increasing concern over the past 20 years, reflecting the damage wrought by kleptocracy, corruption, state capture, and organised crime. Focusing on cross-border financial flows in particular highlights the role of international banks, real estate, and corporate legal structures as vehicles for enabling ill-gotten gains to be kept out of the reach of law enforcement.

The need for international cooperation to assist countries in tracking, tracing, and retrieving assets across borders and to prevent impunity is increasingly well recognised. In 2000 the UN General Assembly adopted the Convention Against Transnational Organised Crime, including a commitment to criminalise the transfer, concealment, or disguise of assets of illicit origin. In 2001 the Economic and Social Council agreed a resolution (2001/13) to strengthen international cooperation in preventing and combating the transfer of funds of illicit origin derived from acts of corruption, and in 2005 the UN Convention Against Corruption (UNCAC) was adopted, including commitments on returning stolen assets. Since the 9/11 attack in 2001 there has also been increasing in focus on financial networks that support terrorism, as part of anti-money laundering controls.

Cross-border flows of money (or other assets) associated with crime, corruption, and tax evasion are diverse, and by their nature hard to measure. However, large estimates of the scale of illicit financial flows have played a key role in attracting attention and encouraged political momentum. In 2004, Transparency International estimated that ten of the most notoriously corrupt heads of state such as Ferdinand Marcos of the Philippines, Sani Abacha of Nigeria, and Suharto of Indonesia had together embezzled as much as US$60 billion from their countries over the previous 20 years (Transparency International 2004). In the same year Peter Reuter and Edwin Truman's book "Chasing Dirty Money: The Fight Against Money Laundering" reviewed emerging global estimates of the proceeds of crime and corruption hidden through money laundering, and concluded they were likely to amount to several hundreds of billions of dollars annually. In 2005 Raymond Baker published his seminal book *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System* in which he set out a global estimate of illicit financial flows in the hundreds of billions. He went on to found the NGO Global Financial Integrity "with the aim of quantifying and studying the flow of illegal money while promoting public policy solutions to curtail it," which has popularised figures in the order of one trillion dollars in annual illicit financial flows from developing countries.[1]

In 2007 the government of Norway called on the World Bank to undertake a study of IFFs. However, finding the concept too poorly understood to support quantification, the Bank instead began by convening the first major international conference on the topic, commissioning analytic contributions from diverse experts. This culminated in the publication of *Draining Development* (World Bank, 2012). The book highlighted confusion and contestation at every level of the issue; What does "IFFs" include? What do we know about

[1] www.gfintegrity.org/about

them? How can they be measured? What damage do they do? How should they best be addressed? Reuter, as editor, concluded that illicit financial flows are diverse and that we know too little to take the reductionist approach of assuming that each dollar (whether related to grand corruption, criminal enterprise, tax fraud and evasion, or evasion of capital controls) does equal damage, or that they can all be dealt with through a single set of actions. He argued that focusing on "black box" aggregate figures obscures the causes and consequences of different streams and that "it is not clear how much effort should go toward halting illicit flows, as opposed to dealing with the underlying phenomena."

In 2015 IFFs was included in the Sustainable Development Goals (SDGs) under target 16.4 to "significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organised crime." It was agreed that this would be measured using the indicator "total value of inward and outward illicit financial flows."

The setting of this target and concrete indicator might perhaps suggest that in the ten years since the first conference on illicit financial flows there must have been significant progress in resolving the definitional questions, as well as breakthroughs in understanding and measurement. In fact the state of knowledge and consensus has hardly advanced, and debates are often confused.[2]

1.1 Are tax avoidance and illicit financial flows the same or different?

One question which needs to be answered in clarifying, defining, measuring, and effectively tackling illicit financial flows is whether the concept should primarily concern financial flows that relate to illegal actions, or whether a broader conception should be used that takes in tax avoidance by multinational enterprises (so-called **base erosion and profit shifting or BEPS**).

While these may seem like quite distinct areas of concern it is often that legal transactions and practices that result low tax bills should also be included under the umbrella of illicit financial flows.

One argument is that not only *should* corporate tax avoidance be included as part of IFFs, but that it *already is*. In particular this view has been put forward by the NGOs the Tax Justice Network (TJN) and the Global Alliance for Tax Justice (GATJ) and the Independent Commission for Reform of International Corporate Taxation (ICRICT) in letters to the UN Secretary General. They argue that this is a settled matter and "no amount of reinterpretation or redefinition can raise any legitimate question over this point" (see Box 1).

[2] See the review of the state of knowledge and understanding of illicit financial flows at the end of 2017 by Frederik Erikkson for the U4 Anti Corruption Resource Centre: https://medium.com/u4-anti-corruption-resource-centre/iff-definitions-3f3d0ba106c3

Box 1: Letters to the Secretary General

Global Alliance for Tax Justice: "The global agreement reached in the Sustainable Development Goals to seek to reduce illicit financial flows is an agreement that clearly covers tax avoidance by multinational companies. No amount of reinterpretation or redefinition can raise any legitimate question over this point. But the effort now to exclude tax avoidance retrospectively is well underway."

Independent Commission for Reform of International Corporate Taxation: We understand that some actors within the UN system are lobbying for a redefinition of the term 'illicit financial flows' in order retrospectively to exclude tax avoidance by multinational companies from the definition. Such a course of action represents a clear threat to the SDG contribution of domestic resource mobilization, and will also undermine confidence in the UN's ability to deliver honestly on what member states have previously agreed upon.

https://www.taxjustice.net/2017/06/23/un-must-defend-target-curtail-multinational-companies-tax-abuse/

Sometimes this argument is made "by the numbers"; it is often stated that tax related illicit flows through trade misinvoicing attributed to multinational companies make up the largest proportion of illicit financial flows and therefore must be core to the IFFs agenda.

This paper argues that combining legal and illegal activity into a vaguely defined composite category is not something to do lightly, if the overall goal is to strengthen the rule of law, democratic accountability, and the effectiveness of states. It sets out the arguments for and against including BEPS within the definition of illicit financial flows and examines the assumptions behind the methodologies used to calculate popular and influential measures of trade misinvoicing which give rise to the "by the numbers" argument.

2. Illicit financial flows: definition debates

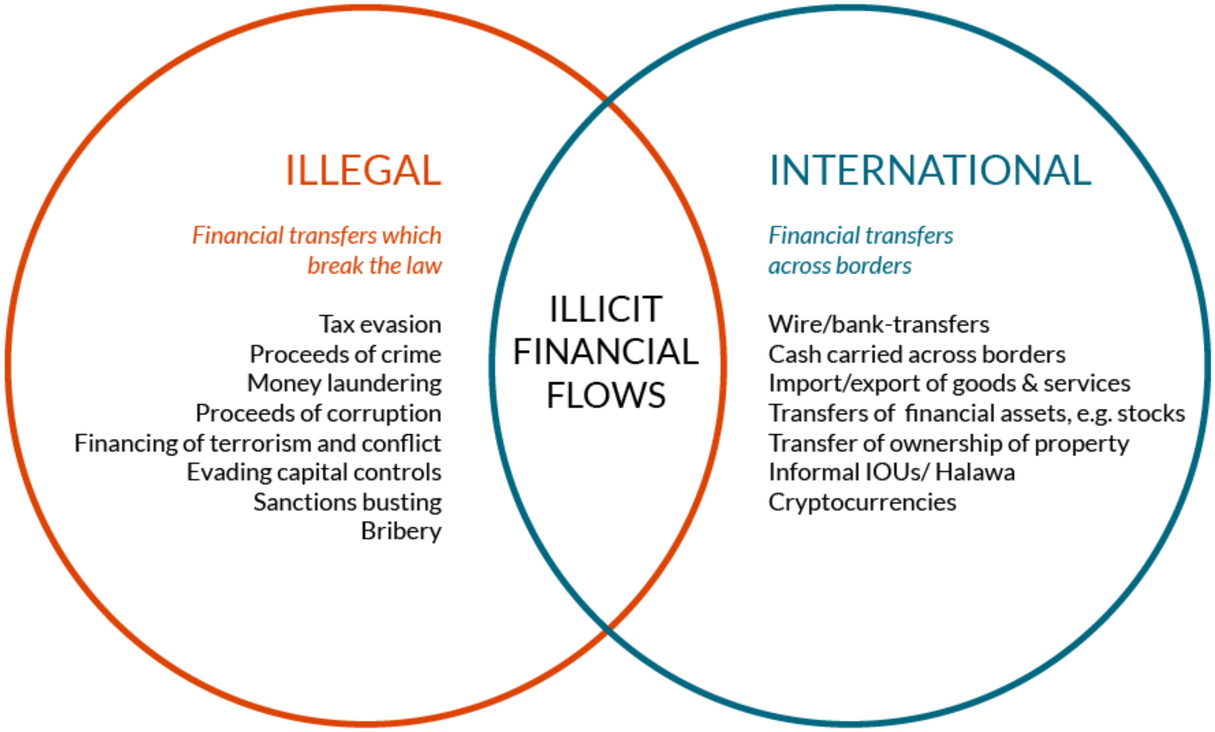
The most common working definitions of illicit financial flows converge around the core concept of *financial transfers across borders* that are in some way *related to illegal activity* (see Table 1).

Table 1. Converging definitions of illicit financial flows

Source	Working definition
African Tax Administrators Forum (2105) Illicit Financial Flows and Trade Misinvoicing	"Illicit Financial Flows (IFF) is defined as any money that is illegally earned, transferred or utilised"
Global Financial Integrity (2015) "Illicit Financial Flows from Developing Countries: 2004-2013"	"Funds crossing borders [that] are illegally earned, transferred, and/or utilized."
High Level Panel on Illicit Financial Flows from Africa (2015)	"Money illegally earned, transferred or used"
Inter-Agency Task Force on Financing for Development (2017)	"There are… some parameters that members of the Task Force agreed on, namely: i) illicit financial flows constitute money that is illegally earned, transferred or used and ii) that crosses borders."
OECD (2014) Illicit Financial Flows from Developing Countries	"There are various definitions of illicit financial flows, but essentially they are generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws.
United Nations (2016) Coherent Policies for Combatting Illicit Financial Flows	IFFs are defined broadly as all cross-border financial transfers, which contravene national or international laws.
United Nations (2016) World Economic Situation and Prospects 2016	"There is no agreed definition of the concept of illicit financial flows (IFFs), but it is generally used to convey three different sources of IFFs: the proceeds of commercial tax evasion, revenues from criminal activities, and public corruption."
World Bank (2016) The World Bank Group's response to illicit financial flows: a stocktaking	"Generally refers to cross-border movement of capital associated with illegal activity or more explicitly, money that is illegally earned, transferred or used that crosses borders."

This "narrow" definition of illicit financial flows covers a range of activities including hiding the proceeds of crime, drug trafficking, and embezzlement; channelling funds towards criminal destinations, such as bribery or terrorism; misreporting transactions in order to evade tariffs or taxes; and capital flight in disobedience with currency controls.

Figure 1. Conceptual map for core definition of illicit financial flows



Source: Forstater, M (2016) Illicit Flows and Trade Misinvoicing: Are we looking under the wrong lamppost?

While there is a fair degree of convergence between these definitions, there remains some fuzziness. For example, the definition suggested in the OECD publication seems to focus only on the illegality of the transfer, rather than the source or use of funds (although this may be assuming predicate offenses which underpin the crime of money laundering). The GFI definition refers to *funds* (i.e., money), while the OECD describes movement of *financial capital* which could cover loans, equity, financial instruments, or possibly even physical assets if used in the pursuit of future revenue. (In practice, however, GFI's definition also includes transfer of goods in the case of trade based money laundering.)[3]

Beyond these detailed definitional questions, some actors propose a much wider "normative" definition, which is not limited to financial or capital flows with a connection to illegality, but includes activities which are deemed to be undesirable, immoral, or "unacceptable to the public," in particular focused on tax avoidance. This of course begs the question who holds these morals or ethics, and whether they are universal and well defined.

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[3] Erikkson, Frederik. 2017. Illicit financial flows definitions—crucial questions. U4 Anti Corruption Research Centre https://medium.com/u4-anti-corruption-resource-centre/iff-definitions-3f3d0ba106c3

Table 2. Broader use of "illicit financial flows"

Source	Description
High Level Panel on Illicit Financial Flows from Africa (2015)	Also includes activities "that, while not strictly illegal in all cases, go against established rules and norms, including avoiding legal obligations to pay tax." They include in their list of activities aggressively avoiding tax and "base erosion and profit shifting."
European Parliament (2015) Report on tax avoidance and tax evasion as challenges for governance, social protection and development in developing countries	Includes in description of illicit financial flows: "typically originate from tax evasion and avoidance activities, such as abusive transfer pricing, against the principle that taxes should be paid where profits have been generated."
Cobham, A. (2015) Illicit Financial Flows Assessment Paper.	"IFF is by its nature hidden, whether it is illegal or simply unacceptable to the public -- This makes clear that the source of funds may be perfectly legal, while the avoidance of tax, for example, may be technically legal but illicit according to societal norms."
UN Human Right Council (2016) Final study on illicit financial flows, human rights and the 2030 Agenda for Sustainable Development of the Independent Experts	In their broader sense, illicit financial flows refer also to funds that, through legal loopholes and other artificial arrangements, circumvent the spirit of the law, including, for example, tax avoidance schemes used by transnational corporations.
UNCTAD (2014) Trade and Development Report	"In a broader sense, IFFs also encompass all kinds of artificial arrangements that have been put in place for the essential purpose of circumventing the law or its spirit. Thus, illicit might not necessarily mean contravening the letter of the law but going against its spirit. In this case, illicit can be understood as something hidden or disguised…In this report, the key criterion used is whether such tax-motivated IFFs are justified from an economic point of view. If a given international financial flow is part of a "tax-optimization" scheme without any concrete related economic activity, it could be considered "illicit."
Picciotto, Sol (2018) Illicit financial flows and the tax haven and offshore secrecy system. Tax Justice Network	"Offshore is a murky world which facilitates a range of criminal, illegal, illegitimate and undesirable practices, all covered by the broad term illicit… They range from facilitating serious crime to behaviour which is unethical or undesirable, such as concealing assets from family members or business associates. It is sometimes said that many of these activities are 'perfectly legal', and hence legitimate."

Several justifications have put forward for the wider approach:

1. **By etymology:** One argument is that the dictionary definition of the word "illicit" is inherently wider than the word illegal; relating to action that is morally wrong or against societal norms and therefore, by definition, "illicit financial flows" must address areas beyond illegality (Cobham, 2015).

2. **By enforcement uncertainty:** Financial flows related to illegal activities may go unchallenged, such as when the revenue agency lacks capacity or there is no political will to address the theft of state funds. Chowla and Falcao (2016) therefore rehearse the argument that legal non-compliance cannot be a clear dividing line, because uncovering financial flows which would be prevented if they were detected and challenged depends on the investigative and legal resources to do so.

3. **By legal grey area:** A further argument is that there is a large grey zone in the area of tax avoidance reflecting an absence of clear legal defining lines between tax compliance and non-compliance, and therefore that the distinction between the two areas is arbitrary (Chowla and Falcao, 2016). The UN Human Right Council (2016) report refers to "legal loopholes" and other artificial arrangements, circumventing the "spirit of the law."

4. **By consensus:** A final argument, as put forward by the Tax Justice Network and Global Alliance for Tax Justice is that there is *already* global political agreement that a broad normative definition of illicit financial flows underpins the SDGs, and that focusing on the narrower law related definition would therefore be a clear subversion the existing global consensus about the meaning of IFFs.

Table 3. Summary of arguments for broad definition

By etymology	By enforcement certainty	By legal grey area	By consensus
The meaning of Illicit inherently includes a sense of "against custom"/ frowned upon.	Taxpayers can sometimes get away with tax evasion, but it is still illicit.	There are large areas of practice where it is not clear what is legal and what is not.	Governments are already in clear agreement that tax avoidance is included under illicit flows.

2.1 Is there already consensus?

The meaning of novel policy terms, is of course, politically defined. It is entirely up to parties to any international agreement to establish what they mean. Therefore the fourth argument could trump all others. If the governments involved in developing the SDGs had reached consensus on the meaning of "illicit financial flows" (or indeed "red flag financial flows" or "harmful financial flows" or any other form of words they might have chosen to use) then that would be the established definition. Alex Cobham (2017) argues that when SDG 16.4 was agreed, "there was no question that avoidance was included" and that there is "no question that those signing up to the SDG agreement to include target 16.4, did so in the belief that avoidance was included."

However there is no record of the architects of the SDGs in practice adopting such a definition. Those that have reviewed the field such as The Interagency Taskforce on Financing for Development state that there is "as yet no firm agreement on conceptual and definitional issues related to the term IFFs" (Chowla & Falcao, 2016). The Report of the High-Level Panel of Eminent Persons on the Post 2015 Agenda, which informed the development of the SDGs, highlights both illicit financial flows and tax avoidance, however, it does not elide the two; it describes illicit flows as money illegally taken out of developing countries through money-laundering of bribes and stolen funds and to evade taxes, while also covering tax avoidance in a separate paragraph.

Civil society organisations argued in the run up to the UNCTAD summit in 2016 that the UN should adopt a normative definition of illicit financial flows (Declaration of Civil Society, 2016), suggesting that this was not already the common accepted definition. The Financial Transparency Coalition says that "different country and regional interpretations of the term have made achieving political consensus at the global level challenging."[4]

If there is already a clear global consensus around the wider definition, it is a well-kept secret.

2.2 Can the dictionary solve it?

Another argument is that the dictionary definition of the word "illicit" requires that a broad approach which goes beyond illegality. For example the Oxford English Dictionary gives a definition of "not authorized or allowed; improper, irregular; esp. not sanctioned by law, rule, or custom; unlawful, forbidden." Certainly in everyday speech a married person can have an illicit affair. A person on a diet might eat an illicit candy bar. A Muslim can have an illicit drink.

However this argument is trivial. The sense of the word "illicit" is that something is against the rules in its relevant domain (and is therefore carried out clandestinely). In the domain of determining whether the assets a person holds rightly belong to them, to someone else or to the government the relevant domain is the law.

The fact that the term "illicit financial flows" in the SDGs is sandwiched between illicit arms trade, theft of public assets and organised crime (indeed the phrase used is "reduce illicit financial and arms flows") suggests that the definition of "illicit" should be the same as in these closely related domains. *Illicit manufacturing and trafficking of firearms* in the UN Convention Against Organised Crime is defined in relation to being unauthorized by the relevant states. *Illicit enrichment* (UNCAC Article 20) is where the assets of a public official increase beyond what can be explained by their lawful income. *Illicit origin of property* (in UNCAC Article 23) is referred to under "laundering proceeds of crime." The *illicit cigarette trade* is defined by the FATF as "the production, import, export, purchase, sale, or

[4] https://financialtransparency.org/conferences/tipping-point/

possession of tobacco goods which fail to comply with legislation." All of these meanings suggest that illicit in this context should be defined in relation to illegality.

A further clue in this direction come from the specific origin of the term. Raymond Baker, founder of Global Financial Integrity, an organisation that has played a key role in coining the term IFFs and promoting it onto the international agenda, describes its origins in "A Brief Biography of Illicit Financial Flows" (GFI, 2015) as being more sophisticated than "dirty money" but less legally demanding than "illegal":

> "One of our early conversations surrounded the phrase dirty money." We both felt that this was counterproductive. It made people cringe and shrink from the subject.…So what should we call these enormous sums of money shifting out of emerging market and developing countries? After considerable discussion we homed in on the wording "illicit financial flows." This had a number of advantages. "Illicit" is a slightly less demanding word than illegal and would be a bit more palatable to lawyers. "Financial" makes it clear that we are talking about money more than about drugs or arms or contraband. And "flows" is perhaps the most important word, making it clear that what is being addressed has an origin and a path and a destination. The combination of the three words is obviously more sophisticated than "dirty money," not nearly so off-putting, much more robust, appealing to economists, lawyers, and policymakers. So "illicit financial flows" it was and still is."

2.3 Grey areas?

Chowla and Falcao (2016) rehearse the second argument, that sticking with the narrow definition could mean that IFFs could only be counted if they had been discovered and ruled against by a court or competent authority. This seems an overly narrow interpretation. The fact that some individuals and businesses get away with hiding, misreporting, or obscuring transactions in order to successfully evade a legal liability does not invalidate the conceptual definition of illicit flows being linked to illegality. Indeed this same issue could be raised for money laundering, drug trafficking, theft of public assets, and other core areas of illicit flows.

Thus we are left with argument three, that there are large areas where there is uncertainty about the interpretation of the law or where there are "loopholes" which allow taxpayers to get away with following the letter but not the spirit of the law, and that these should be considered illicit. This is what is commonly termed "avoidance" (or aggressive avoidance, or abuse).

However, there are important distinctions. Avoidance is often formally defined as practices designed to gain a tax advantage by contravening the intention of the legislation. For example the UK government says abusive tax avoidance is when "the course of action taken by the taxpayer aims to achieve a favourable tax result that Parliament did not anticipate when it introduced the tax rules in question and, critically, where that course of action cannot reasonably be regarded as reasonable." The US Internal Revenue Service (IRS) characterises abusive tax avoidance transactions as those that "take a tax position that is not supported by tax law or manipulate the law in a way that is not consistent with the law's intent." (Hoddes, 2016). In these and many other jurisdictions courts already seek to close this down, giving effect to the "spirit of the law" through purposive interpretation and anti-abuse rules, and revenue authorities can challenge unreasonable transfer prices and other transactions through audit. Such avoidance can therefore be found to be unlawful (i.e., turned into "failed tax avoidance"), and as such might be included under a definition of illicit on this basis, although it is not clandestine.

Other common conceptions of "avoidance" go beyond this. For example the European Commission say avoidance is "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."[5] Devereux, Freedman and Vella (2012) argue that it is inconsistent with the rule of law to try to invoke a further "spirit of the law" which is different from the interpretation of legislation by the courts, or mechanisms such as General Anti-Abuse Rules (GAARs). Where a defect (or "loophole") in the legislation is found, or where there is a problem of misalignments between the tax rules of different countries allowing taxpayers to arbitrage between them, they argue the most efficient course of action is to revise the specific legislation or treaty to close the loophole.

Many BEPS planning strategies such as strategic transfer pricing and use of debt, treaty shopping and "hybrid mismatches" (such as the famous "Double Irish-Dutch Sandwich") fall into this category (although are called "tax avoidance" in everyday speech). They can remain legal tax planning, unless rules and treaties are updated to prevent them. Changes to laws and tax treaties can prevent certain actions which were previously allowed, but this does not make them by definition "illicit."

3. "Trade misinvoicing": the meeting point between IFFs and avoidance?

Beyond these conceptual distinctions, a practical argument is often made that there is a major category of action which has been identified as both "illicit financial flows" and also as "legal avoidance," and therefore that the two areas cannot be separated. This category of action is "trade misinvoicing."

Trade misinvoicing is a form of customs and/or tax fraud involving exporters and importers deliberately misreporting the value, quantity, or nature of goods or services in a commercial transaction. Estimates of trade misinvoicing are closely linked the term "IFFs," as both were popularised by Global Financial Integrity (GFI).

GFI famously estimates that trade misinvoicing is the largest portion of illicit financial flows. It uses a methodology based on adding up gaps and mismatches in trade data to estimate

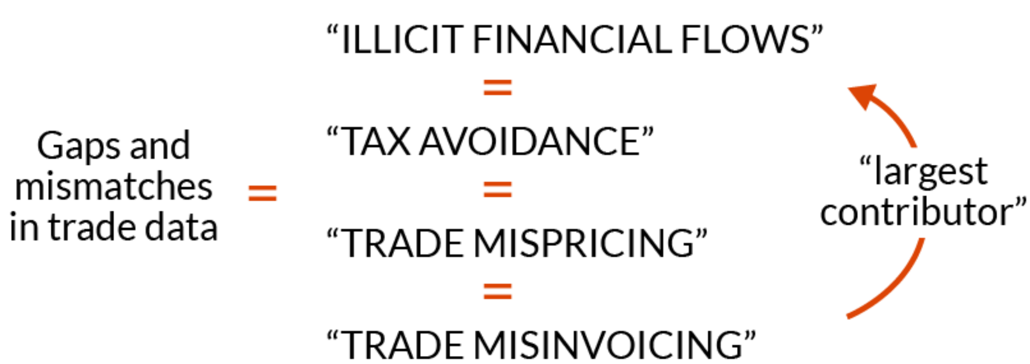
[5] European Commission Recommendation on aggressive tax planning, 6 December 2012: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32012H0772&from=EN

that misinvoicing drains $800 billion from developing countries annually (GFI, 2015). Their work also inspired the UN Economic Commission for Africa (UNECA) and the African Union to set up a High Level Panel on Illicit Financial Flows from Africa which estimated that this practice, concentrated on a few commodities, is responsible for $50 billion of illicit flows from Africa (HLP, 2015). These numbers played a key role in the arguments for IFFs to be included the SDGs.

The same numbers are often used to represent both fraudulent *trade misinvoicing* (for the purposes of smuggling, tax and tariff evasion, paying bribes and kick-backs, and to evade capital controls) and *strategic transfer pricing* used for profit shifting by multinational corporations. For example early NGO reports on corporate tax avoidance, such as Christian Aid's "Death and Taxes" (2008) and "False Profits" (2009), used measures based on these misinvoicing estimates to assess the scale of corporate tax avoidance through "transfer mispricing." The High Level Panel on Illicit Financial Flows also explicitly conflates trade misinvoicing and corporate tax avoidance, while others such as The Africa Progress Panel in 2013 simply confused them—suggesting that the gross amount of trade misinvoicing estimated by GFI was a tax loss due to transfer pricing (Forstater, 2013).

This conflation can lead to circular arguments: for example the Financial Transparency Coalition (2016), whose leading member is Global Financial Integrity, argues that "excluding **tax avoidance** [from the definition of IFFs] would have detrimental consequences on revenue mobilization," citing the Human Rights Council on Illicit Financial Flows and Human Rights (2016) which says that "tax-related illicit financial flows has the potential to make the largest fiscal impact." However the evidence that the Human Rights Council draws on for this is GFI's estimate of **trade misinvoicing**.

Figure 2. Terms that are often perceived to be equivalent



In recent years it is becoming increasingly clear that the trade misinvoicing estimates are problematic *both* in terms of understanding the scale and nature of customs fraud *and* as indicators of the kinds of structures and practices that major corporation use for tax planning.

3.1 Problem I: Gaps and mismatches in trade data don't reliably reflect misinvoicing

Trade misinvoicing certainly is a real phenomenon. For example business people in China have used overpayments for imports as a means to get around the country's currency controls, and build up an nest egg of savings outside China. Companies in South Africa smuggle in shipments of clothing from China evading import duties.[6] Dealers in Tanzanite has been found to be smuggling the gemstone out of Tanzania including in private cars and carried by Maasai herdsmen.[7] In Venezuela scammers used inflated import invoices to buy cheap dollars from the official currency control agency. In Nigeria oil is sold from the national oil company at advantageous prices to politically well-connected middlemen known as "briefcase companies" who sell it on at a significant margin without serving any commercial function, essentially privatising what should be public revenue. In 2015 Côte d'Ivoire Customs issued 2,420 fraud reports. The offences most commonly recorded by frontline services are false values, false goods, and false weight declarations (Victorien Gnogoue, 2017).

However, while it is clear that customs fraud is real, it is not clear that the influential and widely quoted figures based on adding up gaps and mismatches in trade data can be directly interpreted as trade misinvoicing.

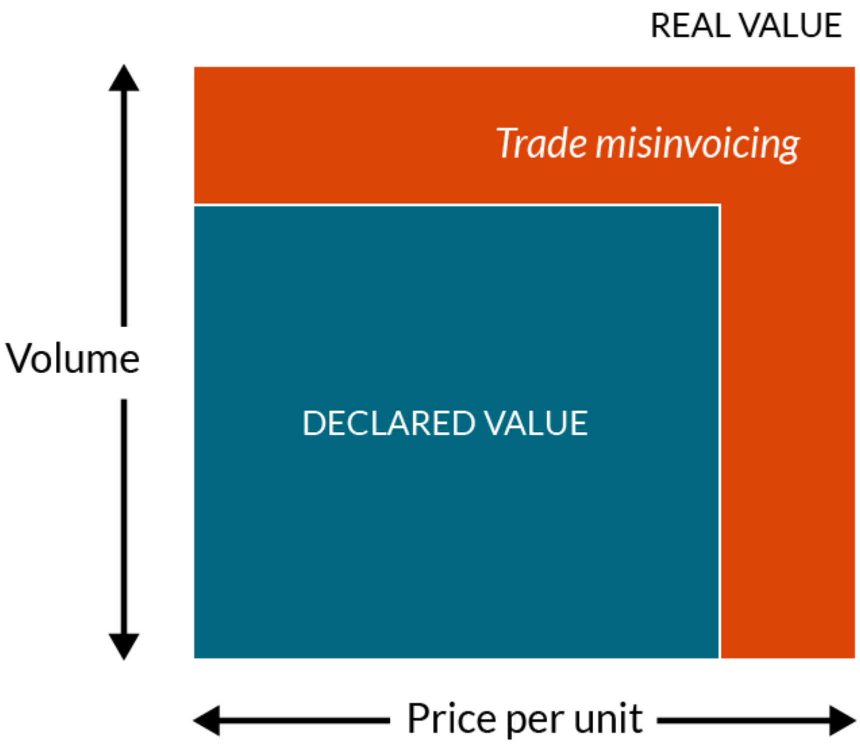
The theory of assessing trade misinvoicing is simple. When a shipment of goods crosses a border the importer or exporter declares what is in the container: 12 dozen cuddly toys valued at $1 each say, or twenty tonnes of copper valued at $4,000 per tonne. If the unit value and the amount declared match with what is actually in the container then there is no illicit flow. The correct tariff and VAT are levied, any export credits are correctly awarded, and eventually the companies involved will pay the right amount of corporate income tax, given the profit or loss they made on the deal.

However the exporter or importer may seek to evade tariffs or taxes or hide a payment to an associate by declaring a value that does not reflect the real value of the goods (in either direction—higher or lower). Thus if there is a difference between what is declared and the actual nature, quantity, or value of the goods then this may be customs fraud and diversion of funds.

[6] www.dailymaverick.co.za/article/2017-03-09-sars-unravels-sa-clothing-industry-tax-leakages-job-losses-blamed-on-illegal-imports

[7] http://allafrica.com/stories/201608170084.html

Figure 3. Trade misinvoicing: Volume, price, and value

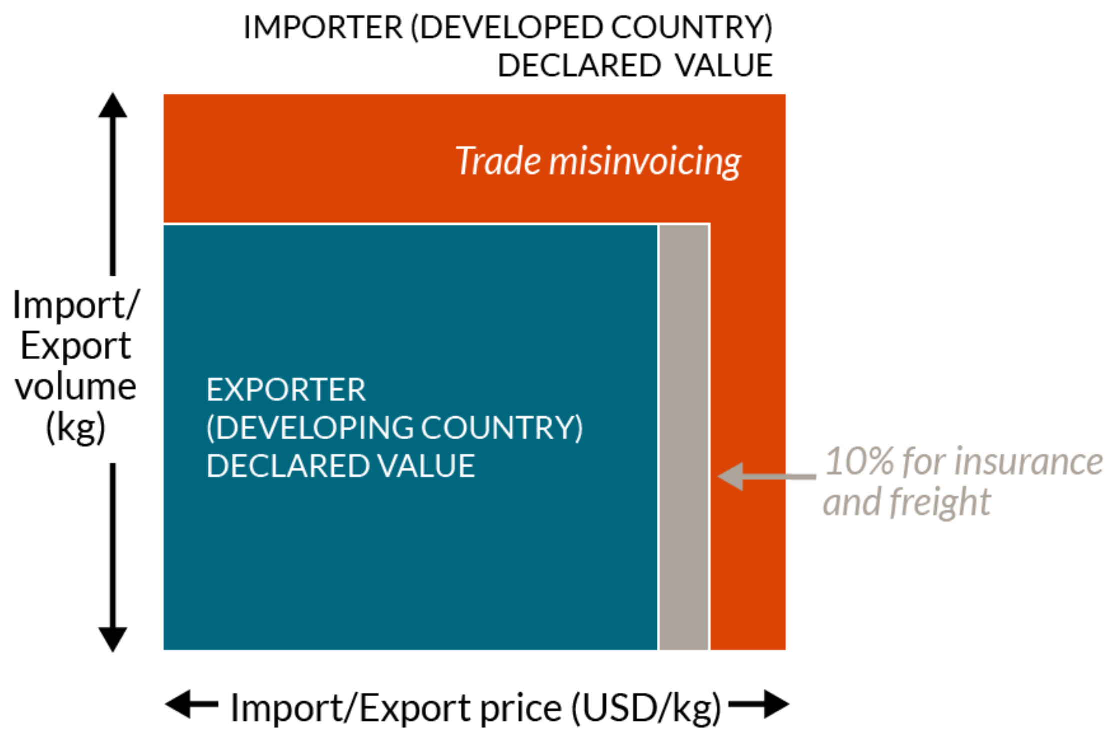


If for example the container really contained 22 tonnes of copper, or the cuddly toys were worth $10 each, the value of the additional two tonnes of copper or the additional nine dollars per toy would be an illicit flow and could indicate a side payment being made through collusion between the buyer and seller and not declared for tax purposes (this mechanism can also be used as a channel for paying bribes or making kickbacks, as well as for evading currency controls).

Customs inspectors may be able verify the actual volume and nature of individual cargo shipments and assess whether the price and overall value declared are correct. Large scale estimates of trade misinvoicing, however, rely on comparing trade statistics: looking at the declared value of transactions at one end of the trade (when the cargo is exported) with the value declared at the other (when it is imported). This "mirror data" approach of comparing what country A reports as an export to B and what country B reports as an import from A (or vice versa) is the basis for the widely cited trade misinvoicing studies, such as those carried out regularly by Global Financial Integrity as well as others such as UNECA/ High Level Panel (2015), and Boyce and Ndikumana (2012). In each case the calculation assumes that, where there is a developed country on one side of the trade, and the developing country on the other, the price and volume declared to its authorities and compiled into trade statistics on the developed country side will be correct (due to greater capacity for customs enforcement), and that, allowing for insurance and freight costs, any further difference between the trades reported by bilateral pairs of countries indicates trade misinvoicing.

Most commonly studies use a rule of thumb of allowing a 10 percent margin for insurance and freight, but some seek to take a more sophisticated approach applying different margins for different types of good.

Figure 4. Estimating trade misinvoicing using mirror data



The estimation problem is that not all trade misinvoicing shows up as mismatches in the trade data, and not all mismatches in the trade data are evidence of misinvoicing.

This was illustrated clearly in 2016 when The UN Conference on Trade and Development (UNCTAD) published a study on trade misinvoicing of commodities under the headline "some countries are losing 67% of the value of their exports." It highlighted specific instances which it saw as evidence of this level of misinvoicing (Ndikumana, 2016).

The report by Professor Léonce Ndikumana analysed mismatches in international trade data in the UN COMTRADE database for seven country-commodity pairs: gold, silver/platinum, and iron ore from South Africa; copper from Chile and Zambia; cocoa from Côte d'Ivoire; and oil from Nigeria. In all seven cases it came to a single conclusion: there were substantial levels of misinvoicing. However in most of the cases a simpler explanation could be readily found.

- **South African gold:** The UNCTAD report calculated that "virtually all gold exported by South Africa leaves the country unreported," accusing mining companies of smuggling billions of dollars' worth of gold. This was promptly disputed by the South African Chamber of Mines and the South African Revenue

Authority. The Chamber of Mines commissioned an independent report from economics consultancy Eunomix (2016) which found that the mining companies and public agencies do report gold exports, just not in the right format for COMTRADE. They found that three quarters of the observed discrepancy could be explained just by looking up the official statistics.

- **Zambian copper:** Copper is one of Zambia main exports. Trade statistics show that more copper is exported from Zambia to Switzerland and the UK than arrives in these destinations, but more Zambian copper arrives in countries such as China, Korea, Italy, and Saudi Arabia than Zambia reports as exports to those them. This has often been interpreted as indicating massive tax evasion and capital flight associated with copper exports from Zambia.[8] The UNCTAD report the trade statistics as showing underinvoicing and overinvoicing in the two directions. However it is more readily explainable by merchanting trade involving trading companies in Switzerland and the UK, and by the London Metals Exchange system of bonded warehouses. For example if copper is reported as an export from Zambia to Switzerland, but in practice sits in a bonded warehouse before being delivered to Germany, this would show up as "overinvoiced exports" to Switzerland and "underinvoiced exports" to Germany, even if at each stage of consignment the declaration matched exactly with the contents of the container.

- **South African silver and platinum:** The analysis suggested overall high levels of misinvoicing, made up of a combination of years when the discrepancy in the trade data is relatively small, and a few years when there are substantial discrepancies. In other words, it describes a scenario where the industry swung from legal compliance, to massive undetected smuggling, and then back again on an annual basis (and that no one noticed). This seems unlikely. It is notable that the COMTRADE database contains no record of South Africa's platinum exports in 2000 and 2002, but SARS statistics show normal levels of platinum exports. The UNCTAD study attributes several billions of dollars' worth of underinvoicing by exporters to the gap in the COMTRADE data for these two years.

- **Chilean copper:** The study found significant overinvoicing of copper from Chile (i.e., copper imports from Chile are reported to be worth less than copper exports, given a 10 percent allowance for insurance and freight). This is likely to reflect shipping costs being lower than 10 percent. Copper cathode sells at about $5,000 / tonne, while freight shipping rates are measured in tens of dollars. Relatively valuable but non-perishable goods such as this are likely to appear to be overinvoiced by exporters because of their relatively low actual freight costs.

- **South African iron ore:** The study observed a "drastic" shift from apparent underinvoicing to overinvoicing—suggesting illicit outflows, followed by illicit inflows. However this may also be explainable through relative transport costs. Iron

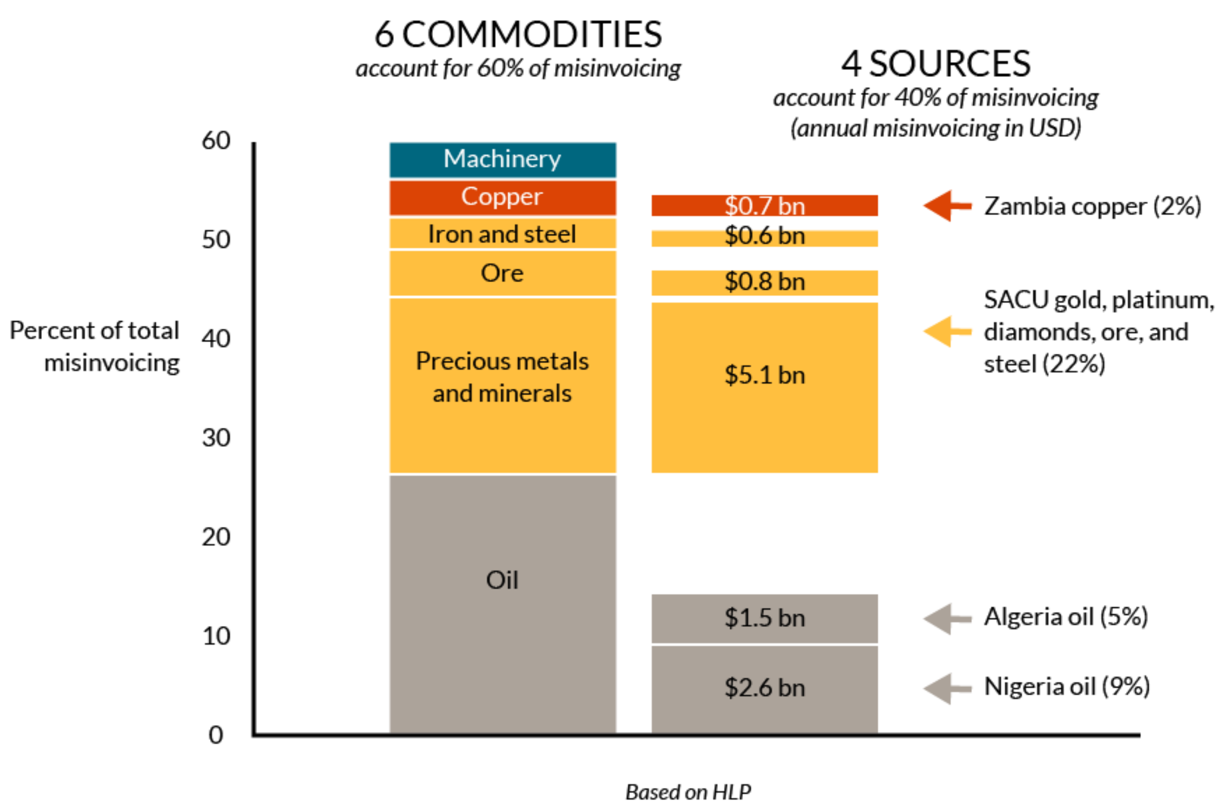
[8] https://www.cgdev.org/blog/stop-spreading-myth-zambia-not-losing-3-billion-tax-avoidance

ore prices were rising till 2009 then fell gradually, while shipping costs fell precipitously, thus the margin of difference would have changed without indicating alleged secret side deals inexplicably being renegotiated.

By looking at individual commodities it is possible to see that price volatility, **transit and merchanting trade**, and the use of bonded warehouses **can result in large trade data discrepancies arising from legitimate trade.** In particular ordinary, legitimate trade can generate systematic discrepancies in trade data involving three countries. For example a single shipment of copper could lead to apparent underinvoicing from Zambia-Switzerland and equal apparent overinvoicing from Zambia-Germany.

Global Financial Integrity's "Gross Excluding Reversals" method is based on the same general principle as the UNCTAD study (but uses aggregate "Direction of Trade" statistics), while the UNECA High Level Panel report on Illicit Financial Flows ("Africa is losing $50 billion to misinvoicing") uses a similar methodology. The same country-commodity pairs as those that feature in the UNCTAD study are strong contributors to the UNECA total, with 60 percent of apparent misinvoicing relating to oil, precious metals, ore, machinery, copper and iron, and steel. In fact, gold, silver, and platinum are the second largest source of alleged misinvoicing in the UNECA study, and almost all of this relates to Southern Africa, where it now seems likely that the explanation is far more pedestrian.

Figure 5. The High Level Panel's findings indicate concentrated misinvoicing in a few countries and sectors



Further clues that ordinary merchanting and transit trade may be responsible for a large part of what is picked up in trade misinvoicing estimates can be seen from the overall pattern of trade reported globally. Carriere and Grigoriou (2014) note that discrepancies ("missing exports and phantom imports") are very common when looking at country-commodity pairs at a detailed level, but that they cancel out when looking at wider commodity categories and world trade. CEPII, the French research institute which manages the BACI trade database, analysed 5000 products over ten years in the UN COMTRADE database and find that the declared quantities of commodities traded between country pairs were only similar in 11 percent of cases (Gaulier et al, 2008). For example reported exports of cocoa from the Netherlands are consistently greater than reported imports of cocoa from the Netherlands by partners (mainly developed countries, particularly Germany). The widespread nature of quantity divergences in trade statistics even between developed countries with strong customs and statistical capacity means that the assumption that the trade statistics at the developed country side are a sound benchmark against which any divergence can be interpreted as "misinvoicing" should not be taken for granted.

It is striking that globally, imports and exports track each other closely, falling within the 10 percent margin conventionally allowed for the cost of transport and insurance overall.

Figure 6. Global reported imports and exports (USD trillion)

Adapted from Levinson and Kellenberg 2016, drawing on COMTRADE data

Adapted from Kellenberg, D and Levinson, A (2016). Misreporting Trade: Tariff Evasion, Corruption, And Auditing Standards. NBER Working Paper Working Paper 22593

This pattern of widespread statistical discrepancies between country-commodity pairs cancelling out at a global level could either reflect massive real illicit financial flows in all directions (independent, but oddly coordinated and involving diverse and unrelated parties), or could be caused by the value of shipments being correctly recorded under mismatched country and/or commodity categories.

These observations provide concrete illustrations of the general problem with these estimates. Volker Nitsch in his paper "Trillion Dollar Estimate: Illicit Financial Flows from Developing Countries" reviews GFI's "gross excluding reversals" methodology. He concludes that the quantitative results have no substantive meaning and that therefore the estimate of $800 million of trade misinvoicing globally "lacks evidence and is uncorroborated." The IMF and the UN, whose data these studies draw on, warn that the statistics cannot be reliably used in this way. The IMF says, "we caution against attempting to measure [illicit flows] by using discrepancies in macroeconomic datasets… official estimates of trade misinvoicing cannot be derived by transforming trade data from the IMF Trade Statistics and/or UN COMTRADE, either by individual country or in aggregate." The World Customs Organisation says that mirror trade analysis can be used as a risk assessment tool to highlight potential cases of misinvoicing, but that before the findings of any mirror analysis lead to assumptions of fraud they must then be verified by investigations in the field or in-depth document reviews (Gnogoue, 2017).

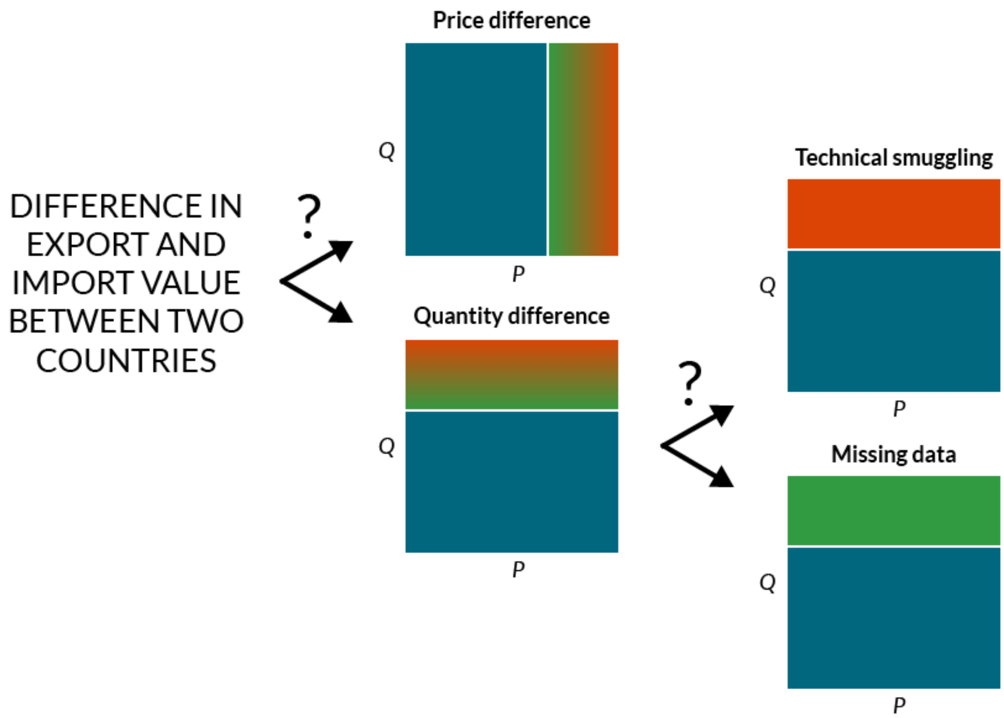
3.2 Problem II: "Misinvoicing" is not mispricing

When Raymond Baker first wrote about the practice of misinvoicing in his book *Capitalism's Achilles Heel* (2005) he called it trade mispricing, and he drew from 550 with officials from trading companies which largely focused on pricing. He said, "mispricing in order to generate kickbacks into foreign bank accounts was treated as a well-understood and normal part of transactions."

However GFI's core methodology which uses aggregate IMF "Direction of Trade" statistics cannot differentiate mispricing from misdeclaration of quantities. Thus the language that GFI uses was later changed from "mispricing" to "misinvoicing."

Direction of Trade statistics only provide details of the aggregate value of trades—they don't give details of prices and quantities. Thus a mismatch in value might mean that the price was misdeclared ($1 teddy bears instead of $10 ones) or that the quantity was misdeclared (22 tonnes of copper instead of 20) or it could reflect "orphan imports" or "missing exports" where there is no record of the shipment at all on one side of the transaction. In each case there might be innocent (green) or illicit (red) explanations as shown below.

Figure 7. Different possible interpretations of mismatched values of exports & imports



Because Direction of Trade statistics aggregate across all commodities and over time they cannot be used to tell the difference between a concentrated area of customs fraud hiding amongst other compliant shipments and widespread marginal discrepancies of declared price or quantity.

Figure 8. Concentrated fraud or widespread marginal differences?

The differences matter in practice because different types of misdeclaration represent different types of behaviour by taxpayers, and could be closer or further away from the "grey area" between legal and illegal action, and relatively harder or easier for customs officials to detect in practice.

For example (aside from genuine administrative errors such as recording the wrong commodity code or unit of measure by accident), misdeclaring the quantity or nature of a shipment could be outright customs fraud (for example shipping cars and declaring them as scrap metal, or shipping 20 kgs of gold but only declaring 5kg). Massively under- or over-reporting prices could also be customs fraud (such as exporting buckets for $973 each), or outright smuggling. However such cases are either technically easy to detect through visible inspection or (somewhat harder, but still straightforwardly) through systems for monitoring commodity exports, such as in the mining sector. If blatant huge misdeclarations of quantities and prices (including outright smuggling) are taking place this suggests massive *tax evasion*, with customs inspectors are looking the other way (whether through lack of capacity, or complicity). This though is not what is usually understood as "mispricing."

Table 4. Implications of different misinvoicing scenarios

Misinvoicing scenario		Behaviour by tax payer	Ease of detection by customs
Pricing difference	**Large/ concentrated**	**Tax evasion/ Customs fraud**	**Relatively easy** (requires some price knowledge but easy to spot, particularly for commodities)
	Marginal/ widespread	**BEPs/ transfer price abuse?** **Could reflect ordinary costs/ variance?**	**Hard** (requires detailed price knowledge)
Quantity/ commodity difference	**Large/ concentrated**	**Tax evasion/ Customs fraud**	**Very easy** (gross physical inspection)
	Marginal/ widespread	**Tax evasion/ Customs fraud?**	**Medium** (precise physical inspection, minerals monitoring)
Destination difference	**Large / concentrated**	**Smuggling?** **Ordinary transit/ merchanting trade?**	**Relatively straightforward** to investigate large scale smuggling by major corporations—through tax audit, minerals monitoring
	Small/ widespread	**Smuggling?** **Ordinary transit/ merchanting trade?**	**Hard** to detect small scale cross-border smuggling

The only type of taxpayer behaviour which equates to BEPS type tax avoidance and which might show up as discrepancies in trade data is transfer price manipulation being used to shift profits to a third country. However these marginal price differences could also reflect legitimate use of a marketing hub.

For example many mining companies use a subsidiary in marketing hub to sell commodities to end consumers. It could charge a margin of 2-4 percent of the value of the commodity, or even 6 percent if the hub takes physical and legal possession of the commodity or undertakes innovative marketing or risk exposure (Readhead, 2016). Tax authorities might challenge the level of the marketing charge on audit—as Australia has done recently with BHP Billiton, and it could result in more tax being payable in a particular jurisdiction (and perhaps less in another) but such disputes are not uncovering about clandestine transfers but challenging the valuation of the service provided by the hub.

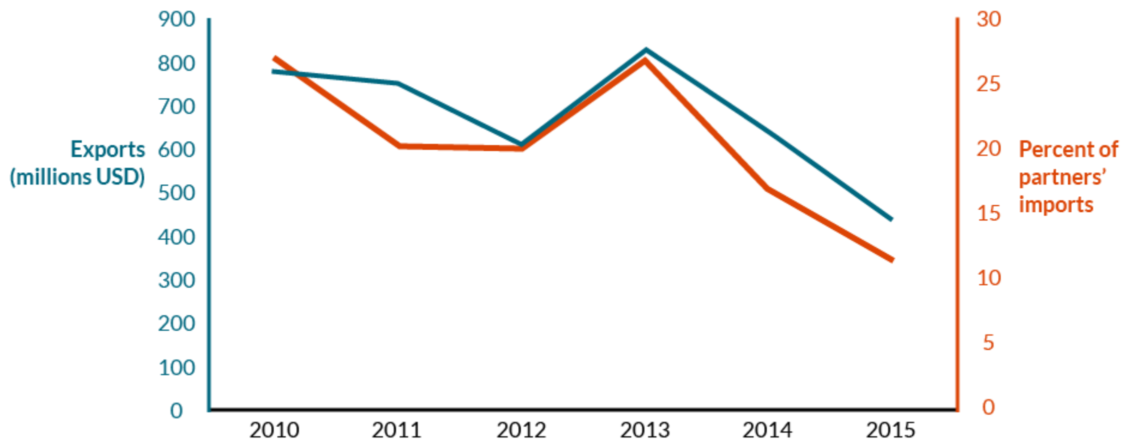
Often the term *trade misinvoicing* and *trade mispricing* are conflated suggesting that the behaviour being described by the data is largely about price manipulation by companies operating at the borders of legality by declaring barely acceptable transfer prices. However in practice it appears that what the misinvoicing studies pick up often is destination mismatches (which may well have ordinary explanations in transit and merchanting trade) and quantity differences (which could have either criminal or ordinary explanations).

Box 2: Exploring prices, quantities and destinations: The case of cocoa

Côte d'Ivoire has often been highlighted as a country which suffers large illicit flows from the cocoa trade—which makes up over 40 percent of its exports (Côte d'Ivoire cocoa features in both the UNCTAD report and High Level Panel report). The High Level Panel report states that cocoa is a significant source of IFFs, and that Côte d'Ivoire accounts for 38 percent of this.

A simple calculation comparing cocoa exports and imports on a bilateral basis confirms that there are significant mismatches.[9]

Figure 9. Calculating underinvoiced exports of cocoa from Côte d'Ivoire using the Gross Excluding Reversals methodology

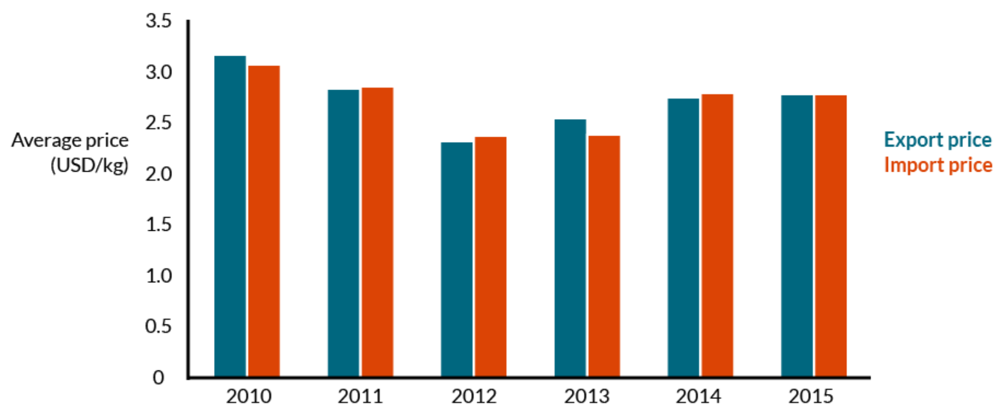


Author's calculations based on COMTRADE data

This reflects large bilateral mismatches—for example cocoa is reported as an export to Estonia, Belgium, and the Netherlands, but does not arrive there. Meanwhile more cocoa arrives in Germany, Russia, and France than is reported as exported to those destinations. Trade misinvoicing studies tend to interpret these mismatches as separate and unrelated smuggling reflecting illicit financial flows into and out of Côte d'Ivoire. However this seems less likely than the alternative scenario which is that cocoa bean wholesalers in countries such as Estonia, Belgium, and the Netherlands are buying cocoa beans which are then delivered (including via bonded warehouses) to chocolate manufacturers in countries such as Germany, Russia, and France. When we look at the price per kg of cocoa beans on export and import, there is in fact no sign of *mispricing*.

[9] NB: the calculation done here is slightly simpler than GFI's "Gross Excluding Reversals" methodology as it treats all partner countries—both developed and developing equally, whereas GFI applies a slightly different method when partner countries are also developing economies.

Figure 10. Export price and import price of cocoa from Côte d'Ivoire (USD/kg)



Author's calculations based on COMTRADE data, with 10% allowance for freight and insurance

If we look only at the quantity effect (how many kilogrammes of Ivorian cocoa beans are imported by the world compared to how many are exported from Côte d'Ivoire) there remains some discrepancy, which in most years is less than 10 percent (usually under, but sometimes over). This could reflect a degree of smuggling, cocoa beans going into or out of store, or cocoa beans from other countries being mislabelled. Similar analyses might be undertaken on other commodities to break down misinvoicing estimates into destination, price, and quantity effects.

3.3 Problem III: Findings from trade misinvoicing studies do not reflect corporate practice by major multinational companies

Raymond Baker began to work on IFFs following his own experience as a business owner and manager in a number of African countries. The practices that Baker describes from his experience and interviews with other tightly-held companies suggest illicit behaviour. They include misinvoicing in order to pay a bribe, generate a kickback, or to evade taxes or currency controls, in each case to divert funds into hidden accounts. While multinational corporations have too often been involved in corruption, this is not the kind of thing that is generally being defended when companies face tax controversies and respond that "we pay tax according to the rules."

Shareholder owned companies in particular have procedures and controls in place to try to prevent bribery, kickbacks, and embezzlement, as it would mean shareholders being defrauded (Truman, 2010). Similarly where misinvoicing methodologies indicate large scale smuggling or misdeclaration of quantities, again this is not the kind of practice that would be defended as ordinary business. This is recognised by the African Tax Administration Forum (ATAF, 2014) which notes that misinvoicing is not significantly related to multinational corporations, and that while multinational corporations may undertake sophisticated tax avoidance involving complex but well documented transfer pricing design, they do not tend to undertake fraudulent activity. They distinguish this from the risks emanating from owners and managers of closely held companies, noting that "there is evidence that business receipts due to individuals or smaller businesses may be diverted to privately owned companies in tax havens, with little or no justification or documentation."

Nevertheless misinvoicing estimates have been used to stand in for multinational corporate tax avoidance. The adoption of trade misinvoicing measures as indicators of the problem of corporate tax avoidance has leads to a misperception of the nature of transfer pricing issues—in particular assuming large hidden margins in commodity supply chains such as for bananas and copper. Examples such as the "$973 bucket" and "the 50 pence fridge" which derive from outliers in trade data have been widely used as popular explanations of transfer pricing issues but bear no relationship to actual transfer pricing practices by major corporations (Forstater, 2015).

Box 3: The $973 bucket

The $973 bucket (reportedly exported from the Czech Republic to the US) is a popular illustration that has been used as a demonstration of transfer pricing abuse, alongside others such as fenceposts from Canada at $1,853, a kilo of toilet paper from China for $4,122, and a pair of tweezers from Japan at $4,896. As Prem Sikka (2003) argued these "actual prices charged by some of the world's biggest multinational corporations, all authorised by some of the best accountants, and by political friends in high places. Their game is to shift the tax burden onto somebody else. It is played through 'transfer pricing'." Similarly Eurodad (Ruiz and Romero, 2011) highlights the $973 bucket as a case of one US corporation using manipulated pricing schemes to avoid paying taxes. Forum Syd (Fröberg and Waris, 2013) also highlights the for $973 bucket as a case involving a profit shifting from a developing country to a tax haven. "A more realistic price paid on the open market would have been around one dollar. The rest of the price paid is just a way to shift profit to the subsidiary in the tax haven where less tax is paid."

If the famous $973 was a true reflection of corporate transfer pricing practice then it would it makes sense to view avoidance, misinvoicing, and illicit financial flows as so closely related that they cannot be differentiated. As Prem Sikka says "They are suggestive of a widespread, systematic setting of transfer prices in whatever direction helps to avoid taxes and boost profits"

However evidence for the $973 bucket does not come from a particular business that was caught at mispricing, but from analysis of US published trade data by Pak and Zdanowitz (2002). A more parsimonious explanation of the $973 bucket and the other similar examples is that they reflect mistakes in recording the quantity of items (for example the price of a shipment of items rather than a single item) or mistakes in the commodity code recorded. Certainly no one would try to defend these as "arms length prices" and the US Internal Revenue Service would challenge them if they tried (Lunnan, 1996 and Weisman, 2002)

3.4 Are there large hidden margins in commodity trading?

Cross border-criminals, money launderers, bribe payers, bribe takers, and tax evaders *do* hide transactions amongst legitimate trade flow. Products such as diamonds, other gemstones, and gold and jewellery are easy to smuggle, while other products such as oil may be stolen or misreported. The problem is real. However the idea that such illicit financial flows can be reliably identified through simple calculations using publicly available data appears overoptimistic.

These calculations systematically transform records of ordinary trade flows into large misinvoicing estimates which in turn have been interpreted as reflecting systematic and egregious mispricing by multinational companies. They create perceptions that major companies doing international business in developing countries must be getting away with hiding vast illicit flows, while customs, revenue, and statistics agencies in developing countries must all be utterly incompetent or complicit.

These calculations have supported a widely held perception of large hidden margins in commodity supply chains. One common reading of the illicit flows estimates is that they must reflect exploitation of primary producers through trading relationships which extract a high margin on commodities. However, as the cocoa bean example above highlights destination (i.e., volume) mismatches can have a much bigger effect on the numbers than price effects, without indicating any illicit flow or hidden price margin.

Another reason to be sceptical of the idea that simple calculations on publicly available trade data reveal large hidden margins in the commodity trade is that commodity trading is a competitive business that is based on low margins and high volumes. If there was a better deal to be done, or if traders found out that their competitors were making large margins, this would be commercially valuable information, and would an opportunity for arbitrage. Large scale misinvoicing estimates are often reported as a development issue, but have been largely ignored by the financial and trade media, although if they had information about hidden margins this would be highly material for traders. The experience of Fairtrade also suggests that there is not a big margin in the supply chain of commodities such as cocoa, tea, and coffee which can simply be reallocated to producers.

Box 4: Acacia Mining: A case of massive illicit flows?

Developing countries face real challenges in securing revenues from natural resources. However, inflated expectations of massive hidden margins can contribute to policy instability and undermine government accountability. One current example of this is the dispute between Acacia Mining and the Government of Tanzania (see Forstater and Readhead, 2017). There have long been concerns about whether Acacia Mining is paying enough tax in Tanzania. Between 2010 and 2015, Acacia paid $444 million in dividends to shareholders, despite not yet paying any income tax in Tanzania. There is a widespread belief expressed in the media and by politicians that underlying Acacia's tax affairs are mechanisms which enable it to illicitly export much of the value of its products. However analysis of mining revenues by Open Oil (2016) highlight that the main reason for the lack of corporate tax is that there were generous fiscal terms in the original mining agreement, specifically an additional capital allowance, that meant Acacia could deduct 100 percent of its $4 billion investment, plus a 15 percent margin, before paying any income tax.

In March 2017 an export ban was introduced on unprocessed minerals and ores. Exports of concentrate (an intermediary product between ore and metal) were halted due to the ban. In May 2017, President Magufuli appointed two special committees to investigate the contents of 277 of the containers stuck at the port. The first committee reported that the concentrate contained around twice as much copper and silver, and around eight times as much gold than was declared by the company. They also detected a range of other metals. If the committees' findings are accurate, the extent of the undervaluation would be enormous, amounting to almost $4 billion annually (one tenth of Tanzania's GDP). The second committee scaled these figures up to cover 61,320 containers exported between 1998 and 2017, suggesting the true value of concentrate exports was $83 billion and that the government had lost $31 billion of revenue trade due to misinvoicing and transfer price manipulation. The company maintains they have always declared all materials produced and paid all royalties and taxes that are due, while The Tanzania Mineral Audit Agency (TMAA) undertakes careful work to monitor minerals exports.

The committee's belief that they have uncovered a case of massive misinvoicing (i.e., misrepresentation of the value or quantity of exports) does not seem plausible for economic and geological reasons (Forstater and Readhead, 2017). The committee's reports suggest that the mine was producing massive amounts of unreported gold, iridium, and ytterbium, but that this has been covered up. This would mean an extraordinary conspiracy, including defrauding shareholders.

4. "Tax-havens": The meeting point between IFFs and tax avoidance?

Another argument is made that illicit financial flows and corporate profit shifting are fundamentally the same phenomena because they both involve "tax havens" and/or "secrecy jurisdictions." The three topics of IFFs, havens, and multinational profit shifting are often considered together (for example see Fjeldstad et al, 2017), particularly by civil society networks and the media. The linkage between tax havens, illicit financial flows, and multinational corporate taxation goes back to the early days of Norway's advocacy engagement (Tilley, 2016) and can be seen in the original *Draining Development* book (World Bank, 2012).

Sol Picciotto (2018) makes a strong form of the argument stating that any financial transaction or structure that takes place "offshore" (a term that he does not define) is by definition illicit:

> "Offshore is a murky world which facilitates a range of criminal, illegal, illegitimate and undesirable practices, all covered by the broad term illicit. …. It is sometimes said that many of these activities are 'perfectly legal', and hence legitimate. However, if they are legal, there is no need to carry them out offshore. Offshore devices or structures all involve using the laws or facilities of another country to obtain an advantage not possible under the law that should apply. Private persons' bank accounts, financial information and other aspects of their personal affairs are generally protected in all countries by laws on confidentiality and privacy, which can only be overridden in specified circumstances, when there is a public interest. There is a network of tax treaties aimed at preventing double taxation, and in any case countries wishing to attract investments generally provide inducements, not excess taxation. Resorting to an offshore arrangement always involves trying to get around an inconvenient law – dodging the law."

This categorical equation between "offshore/ tax havens" and "illicit" seems overly sweeping. Everywhere is "offshore" to everywhere else. While it is certainly true that people and enterprises can access legal frameworks that more convenient and advantageous than if they were confined to their home jurisdiction, this does not necessarily mean that they are evading or breaking rules at home or that they are doing something illegitimate.

Piciotto's formulation seems to rely on the idea that there is a single set of laws which "should" apply to every person or enterprise. However a wealthy international family which owns properties in several countries, a multinational enterprise managing risk, assets, and inventories across borders, or a joint-venture involving investors from several different countries all face choice of jurisdictions to use for legal structures and financial assets in the ordinary course of their affairs—and whichever they choose will be "offshore" to some parties.

Nor should it be assumed that people everywhere enjoy the confidence that information held by banks or public authorities is securely held and protected from political or criminal interference. Zucman (2017) finds that countries whose residents have the largest stock of offshore assets compared to GDP include autocracies (such as Saudi Arabia or Russia) and countries with a recent history of autocratic rule (such as Argentina or Greece), suggesting that lack of confidence in legal protections at home could be a key motivation for offshore holdings. Similarly not every country has institutions that enable businesses to raise capital on foreign stock markets, access reliable courts, or use flexible and sophisticated financial products. Jason Sharman (2012) finds for example that it is these factors, rather than criminal money or tax arbitrage, that explain the popularity of the British Virgin Islands as a conduit for investment into China (including round-tripping by Chinese investors). Development finance institutions investing public money in private enterprises regularly route their investments through tax havens as a means to overcome shortcomings in the legal systems in the poor and capital-scarce countries in which they invest (Carter, 2017).

Multinational corporations tend not to seek out jurisdictions with weak legal or financial governance or those with extreme secrecy. For example Oxfam (2017) found that the top 5 "tax havens" where European banks earn profits are Hong Kong, Luxembourg, Belgium, Ireland, and Singapore (only two of which score below 60 on the Tax Justice Network's Financial Secrecy Index). Simply deeming that everything involving international finance that goes on in these places is murky and "illicit" requires stretching the definition far beyond boundaries which relate to the law.

The use of international financial system to enable tax evasion, and hiding of stolen assets, is clearly a problem. Preventing financial institutions, and the financial centres that host them, from being used in this way by crime syndicates, kleptocrats, and opportunistic tax evaders is core to the illicit financial flows agenda. However the role that international financial centres play in mediating investment, enabling people to diversify their assets, and supporting global commerce are also critical benefits to society. Too little is known about the how much of what takes place offshore is beneficial, defensible, or objectionable, and bundling these categories together under the "illicit" umbrella will not support greater clarity and understanding.

5. Conclusion

The distinction between doing something that is currently against the law (or that abets those seeking to get away with illegal acts) and doing something that is within the bounds of civil liberties is critical to protecting civil rights and freedoms. It is fundamental to the democratic political process and the rule of law that laws are set by the legislature and interpreted by the judiciary.

Legislative changes can shift behaviours from one category to the other (as has been the case with the BEPS), and administrative improvements and information sharing can make it easier to determine which side of the line activities are on—but the distinction remains important. Using a conceptual definition of illicit financial flows which combines what is illegal with what uncertain, or what is judged to be undesirable by some unelected group, undermines and confuses accountability and understanding.

A careful analysis of the trade misinvoicing estimates and cases, and of the role of international financial centres does do not support the view that illicit financial flows, legal tax avoidance and the use of "tax havens" are categorically the same. Nor, as it is sometimes stated, is it true that corruption is only a minor part of the IFFs agenda, dwarfed by massive outflows related to multinational investment.

Figure 11. These terms are not equivalent

Ultimately the question of how the term "IFF" is defined will only settled by those that define and use it, whether as international organisations, governments, researchers and academics, or activists. While different players have different perspectives, they have a common interest in strengthening administration of tax law so that it is neither weakly enforced, nor capricious and predatory. This is positive for citizens, businesses, and government, and ultimately critical for sustainable development.

Concentrating on battling definitions may be seen as a distraction from this underlying common objective, but incompatible language can become a barrier to understanding and dialogue. Being clearer about the distinction between acts of tax fraud and evasion (alongside bribery, corruption, money laundering, and theft of public assets) on one hand and tax avoidance and tax uncertainty on the other does not entail an absolute "parting of the ways" of tax and anti-corruption, but a clearer understanding of issues and potential solutions.[10] Transparency and accountability of fiscal regimes (including in areas such as the extractive sector), ending abuse of anonymous companies, tackling customs fraud, and rationalising and regularising tax incentives are areas of common ground which necessitate collaboration.

Certainly, globally integrated value chains combined with complex (and sometimes incomplete) tax rules mean that the tax affairs of major multinational companies will always be challenged or adjusted. There are wider questions about how the international tax system should be developed to address the digital economy and to better serve developing countries. However, bracketing questions of how to allocate international taxing rights along complex international value chains into the same category as prosecuting theft of public assets, or money laundering of criminal proceeds, implies guilt-by-association which is not be helpful for public-private dialogue, development of effective fiscal regimes and accountability, or cooperative compliance.

[10] See also Transparency International's deliberations about whether "tax abuse" and corruption should be equated. Barrington, R. 2016. When Is Tax Abuse Corruption? The New Official View of Transparency International http://www.transparency.org.uk/when-is-tax-abuse-corruption/#.Wp00KhPFLeQ

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