BACKGROUND PAPER I: MACROECONOMIC IMPACT OF ILLICIT FINANCIAL FLOWS (IFF)

Executive Summary

IFF have received increased attention globally due to their significant adverse effects on the macroeconomies of countries where they originate, transit, and/or are integrated. This background paper takes stock of the efforts to estimate and address cross-border IFF and discusses potential solutions that the Fund could advance to mitigate IFF, highlighting how technology can be leveraged to analyze big data on cross-border payments and prioritize efforts. The paper discusses the economic impact of IFF and how the Fund—although it does not yet have a dedicated policy on IFF—could help address related macroeconomic risks building on its anti-money laundering and combating the financing of terrorism (AML/CFT) strategy and the Framework for Enhanced Engagement on Governance.

A. Addressing IFF[1]

1. **In recent years, IFF started attracting increased attention of policymakers, civil society, and international organizations**. Relevant work by the United Nations (UN), the World Bank, the Organisation for Economic Co-operation and Development (OECD), national AML/CFT authorities' risk assessments; and typologies of relevant crimes contributed to the growing awareness about IFF adverse effects on tax and broader public financial expenditures and revenues, external and financial sectors' stability, and governance and rule of law. In addition, IFF are often discussed as a barrier to sustainable and inclusive economic growth, benefiting narrow elites and widening inequality, promoting informality, and undermining social cohesion and trust in governments.

2. **International organizations and civil society organizations (CSO) have contributed to a multi-pronged global agenda on IFF.** The discourse around IFF gained increased prominence in 2015 with the adoption of the Sustainable Development Goals (SDGs), which include tackling of IFF as a target[2] in its recognition as a key disabler of sustainable development. In recent years, IFF have been recognized among significant global economic challenges, as reflected, for instance, by the Group of Twenty (G20) and Group of Seven (G7).[3] International organizations including the World Bank and the OECD have also been active in global efforts against IFF, for instance, through development of methodologies and toolkits on measurement of IFF as well as through analytical and capacity development (CD) support on topics including AML/CFT, anti-corruption, beneficial ownership transparency, stolen assets recovery, among others to strengthen countries' capacity to tackle IFF.

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[1] Prepared by Maksym Markevych, Alexander Malden, Adrian Wardzynski, and Indulekha Thomas (all LEG).

[2] SDG 16 on Peace, Justice and Strong Institutions includes addressing IFF as a target in SDG 16.4.

[3] For instance, countries expressed their strong commitment to address IFF in the 2021 and 2019 G20 Declarations. The importance of tackling IFF was also noted in the G7 Leaders' Communiqué in 2022 and 2023.

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National and bilateral efforts have also begun to emerge in the fight against IFF. In 2021, the United Kingdom and the United Arab Emirates signed a partnership which focuses on addressing IFF used for terrorist financing (TF) and those resulting from money laundering (ML) in high-risk sectors such as dealers of precious metals and stones, real estate, and virtual assets (VAs).[4] CSOs are also prominently involved in combating IFF through the development of global measures, as well as analytical work and campaigns against proceeds generating crimes (including tax crimes and corruption).[5]

3. Following the 2009 financial crisis, the issue of tax abuse, a key component of IFF, found its way to the top of the global policy agenda. The public interest in this area was further fueled by tax scandals and numerous data leaks. The Financial Action Task Force (FATF) Recommendations recognized serious tax crimes as one of the predicate offenses for ML in 2012. Another major breakthrough was the international tax transparency standards developed throughout the 2010s and their peer review by the OECD Global Forum.[6] It is estimated that progress on transparency and exchange of information helped to identify about €114 billion in additional revenue (tax, interest, penalties).[7] O'Reilly, Ramirez, and Stemmer (2019) further demonstrated that increased international tax transparency led to a decline of about 24 percent (or US$410 billion) between 2008 and 2019 in offshore bank deposits by foreign residents in offshore financial centers (OFCs).[8] Today, international tax abuse, one of the key components of IFF, continues to be the focus of policymakers, supported by the challenging post-pandemic economic outlook with high sovereign debt levels and persistently high inflation.

B. Economic Impact of IFF

Definition

4. There is no internationally accepted definition of IFF, but certain common features or hallmarks can be distinguished among its various definitions. This paper refers to IFF as cross border-financial flows associated with illegal activities in their origin (e.g., results of illegal acts such as corruption), transfer (e.g., conduit tax arrangements), or destination (e.g., funds used for illegal purposes such as TF). This definition excludes legal tax avoidance flows, consistent with approaches

[4] United Kingdom Ministry of Justice, "New landmark partnership with UAE to tackle illicit finance" (London, 2021). https://www.gov.uk/government/news/new-landmark-partnership-with-uae-to-tackle-illicit-finance

[5] Report of the High-Level Panel on IFF from Africa

[6] For a discussion on the relevance of the international tax transparency standards to tackling IFF, see OECD, "Facilitating the Use of Tax-Treaty-Exchanged Information for Non-Tax Purposes: A contribution to a whole-of government approach to tackling illicit financial flows" (Paris, 2023).

[7] Organisation for Economic Cooperation and Development, "OECD Global Forum Annual Report 2022" (Paris, 2022). https://www.oecd.org/tax/transparency/documents/global-forum-annual-report-2022.pdf

[8] Additional analytical work from the Fund—Sebastian Beer et al., "Hidden Treasure: The Impact of Automatic Exchange of Information on Cross-Border Tax Evasion," International Monetary Fund (IMF) Working Paper No. 2019/286 (Washington, 2019). https://www.imf.org/en/Publications/WP/Issues/2019/12/20/Hidden-Treasure-The-Impact-of-Automatic-Exchange-of-Information-on-Cross-Border-Tax-Evasion-48781.

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adopted by the OECD[9] and the World Bank.[10] Notably the UN's statistical definition of IFF has a broader scope, including flows that are not strictly illegal (such as tax avoidance flows) as well as exchange of value beyond financial transfers (e.g., illicit cross-border bartering).[11] For the purpose of staff's work on IFF, the narrower definition used by the OECD and the World Bank seems to be more fitting.

5. **IFF may have a negative macro-critical effect through a variety of economic channels.** The fundamental impact of IFF is undermining the productivity and growth of the economy, as IFF and underlying criminality distort market prices and balance of payments, inhibit genuine investment and effective allocation of resources, eroding the incentive structure of voluntary exchange, embezzle public resources, create volatility not linked to economic fundamentals, as well as weaken cooperation and fair market competition. As an example, tax crimes—one of the main IFF components by value—undermine efficient revenue collection and lead to revenue leakage, while fraud, corruption, and embezzlement lead to misallocation of public expenditure and lower productivity. Furthermore, organized crime, drug trafficking, environmental crimes, and their proceeds could deepen the informality of the economy, distort markets, weaken trust in the government and institutions and rule of law, and affect climate change.

6. **Economic and other indirect benefits from IFF can be enjoyed—at least in the short and medium term—by international financial centers (IFCs) focusing on global provision of banking and professional services, which however entail risk of facilitating IFF.** Financial centers attract inflows for many legal reasons, including a well-developed financial sector, infrastructure, an educated population, strict adherence to the rule of law, and lack of corruption. At the same time, mixed in with legal flows, IFF can distort normal economic activity. For example, IFF can create "hot money" in the banking sector and/or asset bubbles and push out regular real estate buyers and make the government overly dependent on fees connected to IFF (e.g., fees charged under the citizenship or residency by investment programs), and certain taxes (e.g., higher employment tax and value-added tax yields).

7. **IFCs are drawn to gaining a short-term competitive edge through attractive tax, and secrecy and data protection regimes.** The more immediate economic benefits, as noted above, often outweigh the less apparent longer-term-risks relating to the balance of payments instability or broader financial integrity of the financial system and the inclusive and sustainable growth in the economy. Such IFCs design tax regimes geared toward non-residents, including citizenship by investment schemes, and offer favorable, or zero tax rates coupled with increased financial secrecy and excessive data protection, and limited international cooperation. All this provides an attractive environment to hide illicit funds and wealth. The international tax transparency standards helped to provide for increased cross-border transparency to tackle tax evasion. The ongoing reforms of the

[9] OECD, "Assessing Tax Compliance and IFF in South Africa 2022" (Paris, 2022).

[10] World Bank, "Board Update on Domestic Resource Mobilization and IFF" (Washington, 2017).

[11] United Nations Conference on Trade and Development (UNCTAD)—United Nations Office on Drugs and Crime (UNODC) Statistical Task Force, "Conceptual Framework for the Statistical Measurement of IFF" (2022).

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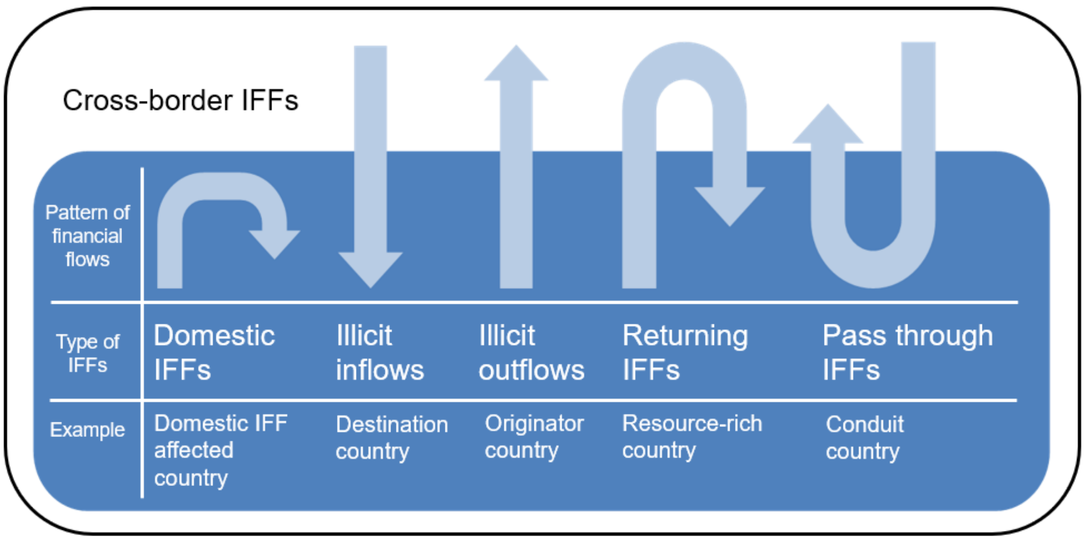
international tax architecture, such as the Global Minimum Tax envisaged under the OECD Project, could help rein in a "race to the bottom" on tax rates.[12]

Figure I.1. Modalities of IFF



Originator Countries

8. IFF outflows negatively impact the macroeconomy of the originator country through impeding domestic revenue mobilization and public and private investment. The majority of global IFF originate from low-income countries (LIC) and fragile and conflict-affected states (FCS),[13] hindering domestic revenue mobilization, which in turn affects these jurisdictions' ability to address their development challenges and to reduce their dependency on aid. Putting in place measures to mitigate risks of domestic laundering of proceeds of crimes and reduce IFF outflows can increase a country's domestic revenue mobilization from taxes, especially those generated from goods and services. Significant illicit outflows can also distort originator countries fiscal position, asset prices, and reduce foreign reserves, resulting in significant development challenges. The impacts of IFF outflows are particularly acute in resource-rich and low-income FCS, which often face severe governance vulnerabilities and corruption, and IFF challenges that can stifle economic growth and development. Furthermore, illicit outflows have been found to have a strong negative effect on public and private investment rates[14] in a country, depriving it of domestic resources required to foster robust long-term sustainable and inclusive economic growth needed to help reduce poverty.[15] The African

[12] See https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

[13] Kasper Brandt, "Illicit financial flows and developing countries: A review of methods and evidence," *Journal of economic surveys* (2022). https://doi.org/10.1111/joes.12518

[14] J.D. Nkurunziza, "Illicit Financial Flows: A Constraint on Poverty Reduction in Africa," *Association Of Concerned Africa Scholars Bulletin,* 87 (2012).

[15] Marc Herkenrath,"Illicit Financial Flows and their Developmental Impacts" (2014).

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Development Bank (AfDB) noted that in Nigeria and Angola, for example, preventing IFF could have resulted in additional investment of US$10.7 billion and US$3.6 billion per year, respectively, in the period 2000 to 2008.[16] According to this study, had illicit outflows from Africa been invested efficiently, their economic impact could have reduced the poverty ratio for the continent by an additional 4 to 6 percentage points.[17]

9. Resource-rich FCS are often most heavily impacted by illicit outflows. These countries face significant governance, corruption, and IFF challenges that can stifle economic growth and development. In sub-Saharan Africa and the Middle East, countries with a high share of oil and petroleum products in their total exports have been found to have higher levels of IFF.[18] The high-value, complex value chains and transnational ownership structures, high-level of discretionary political control, and difficultly of monitoring outputs within the extractives industries make the sector high-risk for significant IFF, through corruption, trade mis-invoicing (i.e., trade based money laundering (TBML)), and tax evasion. The heightened IFF from resource-rich countries impede the ability to use the resource revenues resulting from the extractive industries to support the development priorities of the country. In order to address IFF more effectively in the extractives sector, efforts have been made to produce official data on the size of IFF, including a pilot project aiming to identify the IFF through gold exports in Burkina Faso.[19]

Transit Countries

10. IFF can result in short-term economic benefits for transit countries but present also longer-term negative consequences risks. As outlined above, IFCs or smaller offshore centers may benefit from attracting IFF inflows through offering favorable tax regimes and quality professional services (neither of which are illicit), and financial secrecy and overly restrictive data protection rules (which are not in line with international standards). (See Box I.1 which discusses the role of OFCs and IFCs in facilitating IFFs). However, these transit countries can face longer-term economic impacts as they face pressures from countries and multilateral institutions to minimize global negative externalities of facilitating transit of IFF, notably if it is established that their system is not in compliance with international norms. Countries that pose risks to the international financial system, including those that are placed on the FATF grey list or the European Commission's list of high-risk third countries, can face correspondent banking pressures, and increasing cost of payments critically on remittances. Being listed as a ML/TF high-risk country can impact a country's cross-border trade

[16] AfDB, OECD, United Nations Development Programme, and United Nations Economic Commission for Africa, "African Economic Outlook 2012" (Paris: OECD, 2012).

[17] Landry Signé, Mariama Sow, and Payce Madden, "Illicit Financial Flows in Africa: Drivers, destinations, and policy options," *AFRICA GROWTH INITIATIVE 2020* (2020). https://www.brookings.edu/articles/illicit-financial-flows-in-africa-drivers-destinations-and-policy-options/

[18] Natural Resources Governance Institute, "Resource Governance Index 2021" (New York, 2021). https://resourcegovernanceindex.org/publications-data

[19] UNCTAD, "First-ever official data on illicit financial flows now available" (Geneva, 2023). https://unctad.org/news/first-ever-official-data-illicit-financial-flows-now-available

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and have a significant reduction in capital inflows. Grey-listed countries can also face reductions in access to development assistance.

Destination Countries

11. The country where the IFF are integrated into the legitimate economy can also be negatively impacted, although the impact on these countries is less well understood and more difficult to measure. IFF destination countries can face distortion of the sectors targeted for integration of the criminal proceeds, notably banking and real estate, but often face bubbles and busts and reputational risks when scandals erupt. For example, Canada's 2018 Article IV (AIV) consultation covered ML through the real estate sector and the country's latest ML risk assessment acknowledges that illicit foreign funds have been used to purchase Canadian real estate.[20] The United States Strategy on Countering Corruption recognized that illicit actors take advantage of the vulnerabilities in the United States and in the international financial system more broadly to conceal their illicit proceeds, noting, for instance, that the U.S. real estate market had become a significant destination for the integration of proceeds of illicit activity.[21] The strategy highlighted the need to address gaps in the domestic AML frameworks to curb illicit finance. Similarly, in the United Kingdom, a report by Transparency International indicated that £4.2 billion worth of property owned in London has been bought by individuals and companies representing a high ML risk.[22] The U.K.'s Foreign Affairs Committee assessed the impacts of illicit finance on the United Kingdom following the additional attention brought to the issue by the initiation of the war in Ukraine. The Committee noted that the United Kingdom's role as a global financial center is damaged by its reputation as a destination for illicit finance and that the inflow of illicit flows can have consequences for the country's national security and integrity of its institutions.[23] Strong institutions and proper regulations coupled with effective AML/CFT frameworks can help minimize the macroeconomic impact on the integrity of the financial sector and the broader economy, and assist those countries to detect and disrupt those activities and recover the ill-gotten proceeds to the country of origin. Efforts to prosecute the perpetrators of financial crimes, confiscate and recover the ill-gotten proceeds are becoming more effective in countries of destination but they are still not commensurate with the size of laundered

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[20] A survey of real estate advisors in Canada showed that plurality of real estate advisors reported purchase by foreigners of 25 percent or more of luxury properties (Royal LePage, "One in Four Real Estate Advisors Believe that 25 Per Cent or More of Luxury Properties Are Purchased by Foreign Buyers" (2016). https://www.royallepage.ca/en/realestate/news/one-in-four-real-estate-advisors-believe-that-25-per-cent-or-more-of-luxury-properties-are-purchased-by-foreign-buyers/). Risk assessment available at: Department of Finance Canada, "Updated Assessment of Inherent Risks of Money Laundering and Terrorist Financing in Canada" (2023). Updated Assessment of Inherent Risks of Money Laundering and Terrorist Financing in Canada

[21] White house, "United States Strategy on Countering Corruption" (2020), https://www.whitehouse.gov/wp-content/uploads/2021/12/United-States-Strategy-on-Countering-Corruption.pdf.

[22] Transparency International United Kingdom and Thompson Reuters, "London property: A top destination for money launderers" (London, 2023). https://www.thomsonreuters.com/en/press-releases/2016/december/foreign-ownership-of-london-property-shrouded-in-secrecy.html

[23] The Foreign Affairs Committee, "The cost of complacency: illicit finance and the war in Ukraine," Second Report of Session 2022–23 (2023). https://publications.parliament.uk/pa/cm5803/cmselect/cmfaff/688/report.html

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proceeds.[24] This is partly due to the fact that the proceeds are already layered and far from the country of origin where the underlying crimes were committed which make the detection more difficult and the negative impact on the macroeconomy more diffuse, but also because destination countries are often focused on proceeds of crimes produced domestically and less so on cross-border financial flows from other countries. Finally, professional enablers (e.g., lawyers, accountants, real estate agents) continue to play an important role in facilitating IFF, notably when effective AML/CFT regulations and implementation are significantly lacking (Box I.1).

Box I.1. OFCs and IFCs and the Role of Professional Enablers

The role of OFCs and IFCs are critical puzzle pieces in any discourse on IFF. In its simplest form, an OFC is a jurisdiction where the bulk of financial sector activity is offshore.[1] The broad scope entails significant diversity in the types of jurisdictions that could be categorized as OFCs, including advanced and emerging economies. The Fund has not maintained a classification of OFCs since 2008, when its OFC program was integrated with the Financial Sector Assessment Program. However, financial centers that exhibit the characteristics of OFCs have unique vulnerabilities to the flow of illicit funds and the creation of companies/trusts that are at risk of misuse for criminal purposes, which merit consideration in discussion of mitigation measures. IFCs, on the other hand, are large international full-service centers with advanced settlement and payments systems, supporting large domestic economies, which have diverse sources and uses of funds. The ill-gotten proceeds are often far from the underlying crimes when they transit or are integrated in other economies. They would have followed many routes of layering which would make the detection and re-establishing the connection to the original crimes more difficult for AML agencies.

OFC and IFCs present significant vulnerabilities to the transit and integration of IFF. Large financial sectors serving non-residents make OFCs and IFCs vulnerable to the passthrough of IFF or their final integration. Characteristics of some OFCs including financial secrecy, relaxed regulatory and tax regimes, and weak financial sector supervision can provide 'efficient routes' for the transit of IFF. IFCs are attractive destinations for IFF due to the size of the financial sector and the stability and strength of their domestic economies. IFCs with weak AML/CFT frameworks can be 'magnets' for IFF, attracting global illicit flows.

In addition to direct IFF routes, OFCs and IFCs may also have well-developed sectors providing 'enabling' services to non-residents, indirectly facilitating the transit and integration of IFF. Many OFCs and IFCs have large sectors providing specialist services to non-residents, including company formation, tax planning, accountancy, and legal services. Some of these sectors (especially lawyers, trust and company service providers, accountants) are identified as 'enablers' or 'gatekeepers' in that they provide services that can allow criminals to legitimize their illicit proceeds and thus gain access to the financial system and legitimate economy. Thus, even where there is no significant direct movement of IFF through these jurisdictions, the presence of large and underregulated gatekeeping sectors can indirectly facilitate IFF through the use of these services to legitimize illicit funds.

[1] This includes centers where counterparties of the majority of financial institutions' liabilities and assets are non-residents, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents.

[24] Greater emphasis on implementation of a risk-based approach in the fifth round of FATF's AML/CFT assessments could enhance attention on measures to mitigate risks of integration of IFFs in the destination countries.

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Box I.1. OFCs and IFCs and the Role of Professional Enablers (Concluded)

Weak AML/CFT frameworks in OFCs and IFC have negative spillovers for global financial stability. Weak AML/CFT preventive controls and deficiencies in risk-based supervision in the financial sector in OFCs and IFCs can provide established pathways and preferred habitats for IFF. Weak AML/CFT frameworks for enablers can allow their abuse by illicit actors to legitimize illicit funds, indirectly helping the movement of illicit flows. These weaknesses thus have negative externalities for the rest of the world: they undermine other countries' AML/CFT mitigation efforts by facilitating the flow and integration of illicit proceeds.

Global coordination actions would be key in addressing the role of OFCs and IFCs in enabling IFF. The provision of services to non-residents through oversized sectors (financial or specialist services) may be significant contributors to domestic GDP. Strengthening AML/CFT frameworks—for instance, through more intensive supervision of banks and related (incoming) cross-border flows and gatekeepers or increased transparency on beneficial owners of legal entities—may undermine the competitiveness of sectors seeking to attract non-resident activity, affecting the size of the financial sector and its liquidity, fiscal revenue, and growth. The medium-term impacts (including undue emphasis on the financial sector and adjacent services and the sidelining of other productive sectors) as well as their negative externalities for global integrity and stability remain understudied and under-accounted. To address those issues, the next round of FATF assessments could focus further on materiality and spillovers across jurisdictions resulting from those vulnerabilities. Furthermore, the Fund could highlight those vulnerabilities in FSAPs and both bilateral and multilateral surveillance of OFCs and IFCs, as necessary.

Other IFF Trends and Emerging Issues

12. The AML framework is currently underutilized in the fight against tax crimes and to improve tax compliance, and vice versa. While AML measures have already been deployed to improve tax compliance, including during the European debt crisis, the benefits that such measures could bring to the integrity of the tax system are yet to be fully realized, as set out in a recent working paper.[25] Notably, tax enforcement laws are equally useful in the fight against ML, including to support efforts to strengthen asset recovery frameworks.

13. TBML is another central way IFF are transferred, beyond all other regular channels for moving value. TBML refers to the process of disguising the proceeds of crime and moving value using trade transactions in an attempt to legitimize their illegal origins or finance their activities.[26] TBML occurs through the misrepresentation of the price, quantity, or quality of goods and services resulting on the movement of overvalued cross-border transactions. This can be conducted through over or under invoicing or shipment of goods and services, multiple invoicing of the same goods and services, or through falsely describing the nature or value of goods and services. The financial impact of TBML has been estimated as close to US$9 trillion in losses between 2008 and 2017 in developing

[25] IMF Working Paper advocates leveraging AML measures to enhance tax compliance, tackle tax crimes, and, in turn, help mobilize domestic revenues. See Emmanuel Mathias and Adrian Wardzynski, "Leveraging Anti-money Laundering Measures to Improve Tax Compliance and Help Mobilize Domestic Revenues," IMF Working Paper No. 2023/083 (Washington, 2023).

[26] Financial Action Task Force, "Best Practices on Trade-Based Money Laundering" (Paris, 2008). https://www.fatf-gafi.org/en/publications/Fatfrecommendations/Bestpracticesontradebasedmoneylaundering.html

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countries.[27] TBML can also provide unfair access to foreign currency in times of economic crisis. Importers could over-invoice the value of imported essential goods and services, so they get privileged access to scarce foreign currency held by the central bank, banks, and foreign exchange offices. When those trends become the norm for importers, such mis-invoicing could lead to foreign exchange (FX) shortages and manipulation of the FX and large spreads on the black market. The United States Financial Crimes Enforcement Network (FinCEN) also identified TBML as a vehicle for laundering significant illicit proceeds, including those resulting from drug trafficking and transnational organized crime.[28]

14. Although the key risks of IFF remain through the banking and broader financial sector, an additional emerging risk is the vulnerability of VAs to be exploited for IFF. While efforts have been made to introduce greater supervision and regulation of VAs, their high inherent ML/TF vulnerability, the uneven implementation AML/CFT measures by virtual asset service providers (VASPs), as well as regulatory arbitrage possibilities create opportunities for abuse of VAs.[29] Criminals may choose to use VAs to transfer illicit funds due to availability of anonymous transactions with limited traceability and an opportunity to transfer value outside the formal banking system, potentially lowering the risk of being detected by financial institutions through the reporting of suspicious activities or by law enforcement authorities through their investigations.

Measurement

15. Several methodologies have been developed to measure IFF at the global and national levels. Measurement efforts were spurred, in part, by the adoption of the 2030 SDG, which includes a target on the reduction of IFF,[30] and calls for the measurement of global values on IFF.[31] Since then, UN agencies such as the UNCTAD and UNODC have developed a conceptual understanding and guidelines for the measurement of IFF, which have now been piloted in nine countries. This pilot program aims at identifying IFF on a sectorial basis. In certain pilot countries, this sectorial approach is focused on sectors of economic significance, including, for example, a program dedicated to estimating IFF in the precious metals and stones and electrical machinery and equipment sectors in South Africa. The hidden nature of IFF necessitates indirect approaches to measurement. Common methodologies include TBML mis-invoicing typologies (i.e., assessing the discrepancies between reported and true values of traded goods and services), capital account models (i.e., calculating capital accounts anomalies from IFF), offshore wealth models (i.e., deriving IFF from calculation of stock of

[27] World Economic Forum, "How trade-based money laundering works and its impact on world finances" (Geneva, 2021).https://www.weforum.org/agenda/2021/06/trade-based-money-laundering/

[28] FinCEN, "Update on U.S. Currency Restrictions in Mexico: Funnel Accounts and TBML" (Washington, 2014). https://www.fincen.gov/resources/advisories/fincen-advisory-fin-2014-a005

[29] Vitalii Rysin and Maria Rysin, "Vulnerability of Virtual Assets to Illicit Financial Flows", *Economics, Entrepreneurship, Management. 2021,* Volume 8, Number 1, pp. 35–42 (Lviv, Ukraine, 2021). Vulnerability of Virtual Assets to Illicit Financial Flows | Academic Journals and Conferences (lpnu.ua)

[30] Target 16.4 calls for the significant reduction of illicit financial and arms flows, strengthening of the recovery and return of stolen assets, and combating of all forms of organized crime.

[31] Indicator 16.4.1 is set as the total value of inward and outward IFF in U.S. dollars.

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undeclared wealth in low-tax jurisdictions), tax gap models (i.e., based on the assessment of difference between potential and actual tax collection), and integrated IFF measures[32] (i.e., combining several models to increase accuracy).[33] A survey of existing measurement techniques by the UNCTAD/UNODC IFF Task Force broadly categorizes existing efforts into top-down and bottom-up approaches.[34] The former comprises models based on inconsistencies in aggregated macroeconomic datasets, while the latter estimates IFF from relevant illicit activities (by IFF source) and aggregates these values to arrive at overall estimates. Top-down approaches have thus far been more prevalent, with common measurement techniques including estimates derived from discrepancies in imports and export statistics (mirror trade statistics) and net errors and omissions in balance of payment statistics (hot money method).[35]

16. However, by nature, IFF present serious challenges to measurement, as highlighted by the wide range in existing estimates of IFF. Challenges stem from the temporality of IFF (illegality arising in different stages of the life cycle of the flows) and difficulty establishing linkages between the IFF and the underlying criminal activity. In particular, top-down approaches are hindered by the limited comparability for macroeconomic indicators due to variations in legal and statistical frameworks across jurisdictions and the challenges in distinguishing IFF from measurement inconsistencies. These limitations in measurement manifest in a significantly wide range in estimates of IFF and potentially inflated and misleading estimations of IFF.

17. The challenges in measurement signal the need for a shift towards bottom-up methods for measurement of IFF supported by national strategies. Micro-data for the measurement of IFF are held at the national level, albeit by a range of agencies, including customs, tax, law enforcement, and central banks, among others. National approaches to the measurement of IFF allow the tailoring of measurement to the data specifically available at national/sectoral levels. Recent efforts at developing measurements of IFF have put forth bottom-up measures, particularly to leverage micro-data held by national authorities: For instance, a recent pilot by South Africa with the OECD measured taxpayer data to estimate the stock of non-tax compliant assets held in IFCs and link them to preceding IFF.[36]

[32] UNCTAD, "Methodological Guidelines to Measure Tax and Commercial Illicit Financial Flows" *(published draft for pilot testing)* (Geneva, 2021).

[33] In a 2019 Evaluation of existing models for estimation of IFF, Nicolaou-Manias categorizes prevalent models as trade mispricing estimates; shadow economy—tax gap models; capital and wealth models; international tax avoidance models; risk-based models; integrated IFF models; and artificial intelligence (AI) and machine learning models. See Kathy Nicolaou-Manias, "Supplementary Report: Review of Existing Indicators for Illicit Financial Flows and Possible Alternative Indicators for African Countries" (2018).

[34] UNCTAD-UNODC Statistical Task Force, "Conceptual Framework for the Statistical Measurement of Illicit Financial Flows".

[35] A widely cited top-down measurement of IFF is one used by Global Financial Integrity which aggregates the results from two different methods, i.e., using global trade statistics and balance of payment statistics respectively to derive a total estimate of total IFF.

[36] OECD, "Assessing Tax Compliance and Illicit Financial Flows in South Africa."

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C. Addressing IFF and the Role of the Fund

18. The AML/CFT international standards provide important tools to tackle IFF. Effective implementation of the FATF Standards has been fundamental to strengthening countries' domestic measures against ML/TF, with particular focus on the risk-based approach as required by the standard. As the FATF focuses on the effectiveness of AML/CFT frameworks to tackle ML/TF, it would be important for staff to continue to focus on the impact of ML/TF and IFF on the broader macroeconomic outcomes, such as fiscal performance, financial and external sector stability, economic growth, and its sustainability and inclusivity.

19. Some issues related to countering of IFF are currently covered under the Fund's policies on AML/CFT and on Governance. IFF can have macro-critical impacts in origin, transit, and destination countries across various dimensions of the Fund's work as described above. In addition, as IFF cross borders to lower the probability of detection, asset tracing, and confiscation (e.g., regulatory arbitrage to utilize jurisdictions with the least effective AML/CFT regimes), they have a global dimension and are inextricably linked to global financial integrity and stability. Of high relevance to the Fund's mandate,[37] IFF can lead to unstable exchange rates delinked from the economic fundamentals, imbalanced growth of international trade due to the distorting impact of TBML, as quantity and direction of goods traded is dictated by ML/TF typologies rather than business rationale. In addition, ML/TF concerns undermine trust in the global system of payments, leading to pressures on correspondent banking relationships (CBRs).

20. Staff developed a machine learning algorithm to monitor global cross-border payments to detect unusual and potentially suspicious patterns of financial flows. ML is a covert activity, and ML risks are difficult to identify and assess at the national level, especially when cross-border risks need to be considered. Historically, the Fund's engagement has been mostly externally driven, based on countries' mutual AML/CFT evaluations and other relevant assessments (e.g., OECD Global Forum, UNCAC), listing by the FATF and others, law enforcement actions and public information, which is mostly qualitative. The Fund's access to cross-border payments data provides an important financial integrity tool for staff's work. It allows for the analysis of financial flows patterns, identification of financial flows that are not explained by economic fundamentals (e.g., foreign trade in goods and services, portfolio, and direct investments) and exploring links with higher ML risk jurisdictions. An outlier detection machine learning algorithm relying on "big data" is being employed for financial integrity screening of cross-border financial flows and identification of lower and higher ML risk jurisdictions. The financial flows analysis toolkit is being used to prioritize AML/CFT-related surveillance engagement for a more data-driven and risk-based identification of jurisdictions where financial integrity concerns could be macro-critical. Staff's analysis of financial flows from a financial

[37] The purposes of the Fund include: (i) to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems; and (ii) to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. The full list of purposes of the Fund are set out in Article 1 of the Fund's Articles of Agreement.

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integrity standpoint is intended to provide countries with early warnings regarding elevated risks of systemic ML, possible macro-critical financial sector frauds, corruption events, pressures on CBRs. or evolving tax crimes corridors. The objective of the early warnings is to make the Fund's financial integrity engagement with its members more proactive, providing a detailed understanding of possible macro-critical risks that countries are facing, potentially allowing them to address emerging financial integrity issues much earlier, to limit economic damages.

Box I.2. Use of Financial Flows Analysis for AML in the Fund's Workstreams

The results of staff's toolkit for financial integrity screening of cross-border payments are being increasingly incorporated in all the Fund's workstreams, and have informed the analysis and policy recommendations in:

Financial Sector Assessment Programs (FSAPs): FSAPs (AML/CFT Technical Notes) for the United Kingdom (2022) and Ireland (2022).

Surveillance: AIV for Curacao (2021), Singapore (2022), Malta (2023), Cyprus (2023), Lithuania (2022).

Use of Fund resources: Extended Fund Facilities for Moldova, Lebanon, and Armenia.

CD: Nordic-Baltic Constituency AML Project (self-funded); LEG Thematic IFF CD project.

Selected key recommendations and policy advice:

Deepen understanding of ML/TF higher-risk countries and payment patterns based on country specific risk factors and focus on the countries with the most material cross-border financial flows—Nordic-Baltic AML CD Report (2023)

Further improve breadth and depth of risk-based AML/CFT supervision through enhanced data collection, leveraging technology analytical tools (e.g., big data and machine learning)—United Kingdom FSAP (2022)

AML/CFT national policy and institutions should prioritize tackling ML/TF risks related to cross border and non-resident activity—Ireland FSAP (2022)

Develop a national mechanism for monitoring macro-trends in cross-border financial flows—Lithuania Selected Issues Paper (2022)

21. The Fund's well-developed CD thematic work programs are directly relevant to combatting IFF. A multi-country thematic project on addressing IFF, leveraging staff's machine learning toolkit was launched with the support of the Fund's AML/CFT Thematic Fund in 2023, The CD project is intended to help members monitor cross-border wire transfers and strengthen AML effectiveness in mitigating cross-border ML risks. In addition, Fund's CD engagement has also covered topics directly relevant to the measurement and combatting of IFF, including projects on assessment of cross border ML risks, supervisory strategies to mitigate ML risks, asset recovery, improving tax compliance, enforcement frameworks, and international cooperation and exchange of tax information,[38] among others. On measurement and estimation of IFF, the Fund has elaborated on accounting for illegal activity and IFF in its guidance on fiscal and external sector statistics. For instance, the Fund's proposed framework for measuring the informal economy *inter alia* notes that some forms of illicit activity undertaken in the informal sector should be accounted for in the

[38] More work, including CD assistance, is needed to reap the benefits from exchange of information especially for developing countries. IMF Fiscal Monitor (April 2022) shows that many developing countries (also members of the Global Forum) are not receiving information.

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estimation of the informal economy.[39] Statistics compiled by the Fund, for instance, are also widely used as the dataset in top-down estimations of IFF.[40] Fund's work to strengthen members' governance and enhance anti-corruption measures can be impactful in addressing a variety of economic crimes, preventing IFF at the source.

22. Empowering AML regimes with a greater understanding of risks arising from IFF could also improve tax compliance and help mobilize domestic revenues. Well-designed AML measures could be leveraged for the purposes of tax administration. The AML measures that could be helpful in relation to ensuring tax compliance are the following: (i) greater utilization of customer due diligence (CDD) and transaction monitoring data that can help identify taxpayers, their taxable income, wealth, and assets; (ii) closer inter-agency cooperation and sharing of information between AML and tax authorities, including information available through the various statutory filings made by entities subject to the AML control regime that can support the detection of tax crimes, help assess risks of tax non-compliance, better target tax audits, and contribute to taxpayer risk profiling; (iii) recourse to enforcement tools available under the AML regime that could complement those already available to the authorities responsible for the pursuance of tax crimes, including through parallel ML and tax crime investigations and extending of the accountability framework to accomplices and complicit service providers; and (iv) increase in the overall deterrence effect resulting from the greater transparency, cooperation, and coordination, as well as the threat of potentially higher sanctions arising under the AML laws.

23. Strong beneficial ownership transparency frameworks can also help address the abuse of legal entities for IFF. Notwithstanding the obligation of financial institutions and designated non-financial business professions (DNFBPs) under the FATF standard to identify beneficial owners of their clients, the use of companies and trusts as a vehicle to move illicit funds is likely a significant driver of IFF, with an estimated almost 40 percent of all foreign direct investment passing through empty corporate shells associated with no actual economic activity.[41] Several countries, including the United Kingdom and Canada have looked at strengthening beneficial ownership transparency to prevent the use of shell companies to purchase real estate using illicit funds. The FATF Standards for transparency of beneficial ownership of legal persons and arrangements (Recommendations 24 and 25) were recently revised, requiring member countries to ensure accurate, adequate and up-to-date beneficial ownership information is available to all relevant competent authorities. Supporting the development of these frameworks can ensure that member countries are able to better detect and counter the use of legal structures to move IFF or integrating them into the legitimate economy. The

[39] Gabriel Quiros-Romero et al., "Measuring the Informal Economy," IMF Policy Paper No. 2021/002 (Washington, 2021). Measurement of the informal economy under discussion as part of the update of the System of National Accounts 2008 and the sixth edition of the Balance of Payments and International Investment Position Manual. This includes, in particular, the establishment of the joint informal economy task team to aid the development of statistical standards to conceptually and operationally define concepts to measure work and economic activity, including cross-border transactions, in the informal economy. See [Joint Task Team on Informal Economy: Terms of Reference](#).

[40] IMF's Direction of Trade Statistics, Balance of Payment Statistics, Coordinated Direct Investment Survey, Coordinated Portfolio Investment Survey, International Financial Statistics, and International Investment Position Statistics are among those serving as datasets used in common IFF estimation methodologies.

[41] Jannick Damgaard et al., "Piercing the Veil," IMF Finance & Development. Vol 55, Issue 002 (Washington, 2018).

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Fund has also called for the implementation of beneficial ownership registers as a measure to enhance tax compliance.[42]

D. Way Forward

24. The Fund is well positioned to focus on the macroeconomic impact of spillovers arising from disparities and weaknesses in AML/CFT regimes across jurisdictions. Inefficient AML/CFT measures in one jurisdiction can attract illicit flows and create safe havens for the perpetrators of crimes. Considering the importance of cross-border activity for ML/TF, a risk-based approach to AML/CFT focused on IFF and macroeconomic impact calls for stronger focus on jurisdictions that play an important role in facilitating the channeling and integration of IFF in the international financial system.

25. The Fund could work closely with the UN, World Bank and other international bodies engaged in this area while focusing on its comparative advantage related to macroeconomic impact of IFF. While this paper focuses on the AML toolkit in tackling IFF, staff's broader expertise on fiscal (e.g., tax policy), monetary, financial, and structural reforms could allow an interdepartmental integrated and multidisciplinary approach in developing better measurement and mitigating measures to limit the impact of IFF on both domestic and international levels (e.g., spillovers).

26. The Fund's near universal membership puts it in a unique position to engage with member countries on issues related to IFF. The Fund undertakes regular economic surveillance of its 190 member countries, with periodic in-depth analysis into the stability of members' financial sectors through its FSAPs. The Fund's broad membership allows it to engage with countries (including source, transit, and integration jurisdictions for IFF), many of which are not within the purview of other international organizations undertaking work related to IFF, such as the OECD.

27. In its multilateral surveillance, the Fund focuses on issues that may affect the effective operation of the international monetary system (IMS), Under the Integrated Surveillance Decision (ISD), an AIV consultation is a vehicle for both bilateral and multilateral surveillance. In AIV consultations, staff could, in particular, discuss outward spillovers arising from a member's policies where the member is not promoting its own domestic or balance of payments stability, or where the spillovers may potentially have an effect on global movement of IFF. Integration of IFF considerations in multilateral surveillance would result in an additional focus on spillovers across jurisdictions, also due to the effects arising from the member's AML/CFT policies on other countries. The potential for abuse of vulnerabilities and loopholes is particularly high in emerging and advanced economies attractive to the integration of criminal proceeds and financial centers specializing on provision of non-resident professional and financial services, as ineffective AML/CFT policies in these countries provide ML opportunities for criminals from other countries.

[42] IMF, "Fiscal Monitor: Fiscal Policy from Pandemic to War" (Washington, 2022).

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