

**Illicit Financial Flows within a broader Governance,
Anti-Corruption and Developmental Perspective:
Some analytics and implications from empirics**

**Daniel Kaufmann & colleagues, World Bank
www.worldbank.org/wbi/governance**

The Global Financial Integrity program at the Center for International Policy and the
Hills Program on Governance at the Center for Strategic and International Studies

Illicit Financial Flows: The Missing Link in Development

Thursday, June 28, 2007

CSIS Conference Center – 1800 K St. NW, Washington, DC

An Uneven Trajectory on the global Anticorruption (A-C) drive - *the early days*

- **Pre-nineties: ‘Ostrichism’, and among IFIs even Prohibitionism (the C...word)...**
- **1990-1993: TI, Eigen, a few WBankers start**
- **Mid-nineties: Wolfensohn, IFIs involved in A-C**
- **Early stages of A-C: Mid-to-Late Nineties: Awareness raising; focus on bureaucratic bribery & petty corruption**
- **Major push on GAC data: indices & diagnostics**
- **Policy focus: ‘Fighting corruption by fighting corruption’. Still today: residual of this approach**
Cont.

An Uneven Trajectory on the global Anticorruption (A-C) drive - *the recent days*

- **Early 2000s: More operational and concrete focus – on the how to; projects & initiatives.**
- **Operational focus during that period is on:**
 - i) the upstream in the corrupt transaction ‘cycle’ – *e.g. how to lower procurement bribery; permits, etc., &***
 - ii) the legal & organizational: *laws, codes & commissions***
- **Then post 9/11 and post Enron more focus on: AML; financial sector corruption, SoX, etc.**
- **Has corruption around the world declined? *Sobering***

Traversing Downstream: From AML to StAR

- **At present, progression on the focus from the upstream (procurement) to downstream (AML) has substantially taken place**
- **Yet a major missing link still today–the ‘last’ stage downstream: Asset Recovery– *the forgotten link***
- **Recognizing Asset Recovery as a major prevention tool – not merely for restitution purposes**
- **Hence StAR: Stolen Asset Recovery initiative...**

Illicit Financial Flows Associated with Corruption involving public sector officials in emerging economies:

A large and important development problem

- **Estimate of worldwide annual bribery transactions: US \$1 trillion**
- **Similar estimates for world's money laundering** (*Baker*)
- **Unbundling: Laundered funds from public officials in emerging economies to financial centers: about \$20-40 billion (20-40 percent of ODA flows)**
- **Assets stolen by corrupt leaders at the individual country-level are frequently of staggering magnitude (estimates by TI):**
 - **Suharto (1967-98) \$15 - \$35 billion**
 - **Marcos (1972-86) \$ 5 - \$10 billion**
 - **Abacha (1993-98) \$ 2 - \$ 5 billion**

World Bank & UNODC's Stolen Asset Recovery (StAR) Initiative

- **Objective: to assist developing countries recover stolen assets**
- **Recovering stolen assets: deters future corruption**
- **Frees funding for social sectors & infrastructure**
- **To bring in “the other side” of the corruption equation: stolen assets tend to be stashed in developed countries financial centers**
- **At the planning stage, aiming to implement within international (UNODC, etc.) and GAC frameworks**

Potential Development Impact of StAR

- The *development payoff* is expected to be significant. Recovered assets can be used to *finance poverty reduction programs or badly needed infrastructure* in developing country.
- However, the *total long run benefits* are likely to be much bigger.
 - Deterrent effect on Corruption;
 - Improved Governance, and;
 - Better financial and public financial management institutions.

International Legal Framework for Asset Recovery.

- **The *UN Convention against Corruption* (UNCAC) recognizes asset recovery as a fundamental principle.**
- **UNCAC is the first legally binding international agreement against corruption.**
- **Key principles behind the Convention are:**
 - **Criminalization of a comprehensive set of offenses.**
 - **Framework for Mutual Legal Assistance and Cooperation between State Parties.**
 - **Unconditional return of assets once confiscated,**

GAC: World Bank's Framework for the StAR Initiative

- **The GAC paper includes asset recovery as part of its strategy. It mentions that the World Bank...**
 - **...has *an important advocacy role to play* in this regard and it should use its convening power to place this issue higher on the international agenda.**
 - **...should *support efforts by advising on capacity* to freeze and confiscate corruption proceeds.**
 - **...can also *provide important assurance that the restituted assets will be put to good use.***

Learning about potential intervention points from Obstacles to Asset Recovery (from case studies)

- Limited legal, investigative and judicial capacity and financial resources to prosecute corrupt government officials**
- Lack of Institutional Capacity to file international requests for Mutual Legal Assistance**
- Jurisdictions abroad where assets are not always responsive to requests for legal assistance**
- Lengthy legal process usually hamper the credibility and the necessary political support needed to endure this task**

Lessons that arise from Country Experiences *(cont.)*

- Lack of transparency and public accountability facilitate the looting of public assets.
- Domestic and international vested political interests need to be addressed -- international cooperation is essential
- Civil Forfeiture: critical? Yet largely missing?
- Use of recovered funds has usually fallen short of sound international practices in PFM system.

Challenges that arise from Country Experiences

- *Need for strong domestic anti-corruption legislation and institutions* to keep corrupt leaders in check;
- *Countries need to ratify and implement the UN Convention Against Corruption*
- *Need to strengthen transparency in international movement of funds* and make doing business with corrupt government officials less attractive.
- *Need for a framework for monitoring the use of recovered assets* that is consistent with unconditional return principle defined by UNCAC.
- *Help developing countries build the necessary institutional capacity.*

StAR's Action Plan

- ***Reduce barriers in developed countries to recover stolen assets:***
 - **Formation of a Friends of Asset Recovery (FStAR) advisory and advocacy group.**
 - **Help build a Global Partnership on asset recovery that could...**
 - **...put pressure on countries serving as havens for stolen assets to ratify and implement UNCAC;**
 - **...promote compliance with FATF 40+9 recommendations, and;**
 - **...persuade countries to establish clear guidelines regarding the treatment of Politically Exposed Persons (PEPs)**

StAR's Action Plan (cont.)

- *Strengthen the ability of developing countries to recover stolen assets:*
 - Provide 5-6 pilot countries with the technical assistance that could help...
 - ...*build institutional capacity* of anti-corruption agencies, law enforcement institutions and Financial Intelligence Units (FIUs);
 - ...*implement UN Convention against Corruption*, and;
 - ...offer countries alternatives for *monitoring recovered assets*.

Illicit Funds within a broader Governance framework

- **Analytical Integration**
- **Empirical Integration**
- **Evidence-driven policy-making**
- **Operational Integration**

Analytical Rigor for studying Illicit Funds

- Capital Flight \neq Illicit (Cross-Border) Funds
- Illicit Funds \neq Laundered Stolen Assets
- To analyze and measure with rigor, it is crucial to Unbundle:
 - i) Capital Flight into what is Licit vs. Illicit (*the former simply reflects differential incentives in source vs. destination country*)
 - ii) Illicit funds unbundled into those that are an economic response by rational private economic agents to over-regulated national environments vs. truly illicit under accepted international norms and practice
 - iii) Illicit Funds under recognized international norms also needs to be unbundled into: Tax Avoidance/Evasion; Private proceeds of organized crime/drugs, etc.; Stolen Assets by officials from public purse and proceeds of corruption/bribery by officials. Distinguishing among these types is fundamental because very different: i) 'actors' involved; ii) developmental impact of each type (latter type most costly), and, iii) remedies for each type (and expertise required)
- Need for better estimates of i) size of the problem; ii) developmental cost; iii) deterrence value of StAR & the likes

Challenging Convention about Emerging Markets

7 'popular' tenets

1. **Good Governance = Anti-Corruption?**
2. **Governance Measurement Skepticism:**
 - **It is Unmeasurable; *or*, Measurable, but so imprecise**
 → Useless; *or*, Cannot Assess Trends; *or*,
 Irrelevant for assessing emerging markets prospects
3. **Evidence: *Governance improved globally?***
4. **Good Governance: outcome of development and growth? – & *emerging economies are corrupt...?***
5. **The trouble with Public Sector & officials in LDCs?**
6. **Corporates as passive 'Investment Climate Taker'**
7. **Country Governance & Financial Markets: *Unlinked?***

Evidence-based approach, empirics

- 1. Data Matters--*on Governance & Institutions*: data can be gathered, analyzed, and used judiciously**
- 2. Governance matters for a country's: growth, competitiveness, investments & financial markets**
- 3. On average stagnation on Governance – yet high variance --*some countries improve in short term***
- 4. Behavior of the Firm and Investor also Matters**
- 5. Global collective responsibility**

The ‘Power of Data’: progress in measurement

- 1. The ‘Macro’/Aggregate Level of Measurement:**
Worldwide Aggregate Governance Indicators: 200 countries, 6 components, periodic.
- 2. ‘Mezzo’: *Cross-Country Surveys of Enterprises***
- 3. ‘Micro’: Specialized, in-depth, in-country Governance and Institutional Capacity Diagnostics: Includes surveys of: i) user of public services (citizens); ii) firms, and, iii) public officials**

On ‘Aggregate/Macro’ Level first...¹⁹

Six Dimensions of Governance Measured

Governance as the set of traditions and institutions by which authority in a country is exercised -- specifically:

- **The process by which those in authority are selected and replaced [Political Governance]:**
 1. **VOICE AND ACCOUNTABILITY**
 2. **POLITICAL STABILITY & ABSENCE OF VIOLENCE/TERRORISM**
- **The capacity of government to formulate & implement policies, and deliver services [Economic Governance]:**
 3. **GOVERNMENT EFFECTIVENESS**
 4. **REGULATORY QUALITY**
- **Respect of citizens and state for institutions that govern interactions among them [Institutional Governance]:**
 5. **RULE OF LAW**
 6. **CONTROL OF CORRUPTION**

2006 Worldwide Governance Indicators: *Key Features after a decade of Governance Data*

- **Widely used by policymakers and researchers to study causes and consequences of good governance**
 - **biannual data since 1996, now annual data**
- **Based on 31 data sources from 25 organizations, capturing views of thousands of informed stakeholders**
- **Covering over 213 countries & territories, estimate of 6 dimensions of governance and of margins of error**
- **Now also: access to individual data underlying the construction of the aggregate indicators**
 - **hundreds of individual indicators over past decade**
 - **very large on-line governance data resources, at www.govindicators.org**

Sources of Governance Data

- **Cross-Country Surveys of Firms:** Global Competitiveness Survey, World Business Environment Survey, World Competitiveness Yearbook, BEEPS
- **Cross-Country Surveys of Individuals:** Gallup International Voice of the People, Latinobarometro, Afrobarometer
- **Expert Assessments from Commercial Risk Rating Agencies:** DRI, PRS, EIU, World Markets Online, Merchant International Group, IJET Travel Consultancy, PERC
- **Expert Assessments from NGOs, Think Tanks:** Reporters Without Borders, Heritage Foundation, Freedom House, Amnesty International, Bertelsmann Foundation, Columbia University, International Research and Exchanges Board
- **Expert Assessments from Governments, Multilaterals:** World Bank CPIA, EBRD, AFDB, ADB, State Dept. Human Rights Report, Trafficking in Persons Report

Building Aggregate Governance Indicators

- **Benefits from Aggregation**
- **Use Unobserved Components Model (UCM) to construct composite governance indicators, and margins of error for each country**
- **Estimate of governance: *weighted average* of individual scores for each country, re-scaled**
- **Weights are proportional to *precision* of underlying data sources, and *precision* based on extent of ‘consensus’ among sources**
- **Margins of error reflect (a) *number of sources* in which a country appears, and (b) the *precision of those sources***

Control of Corruption

Selected Countries, 2005

Good
Governance

2.5

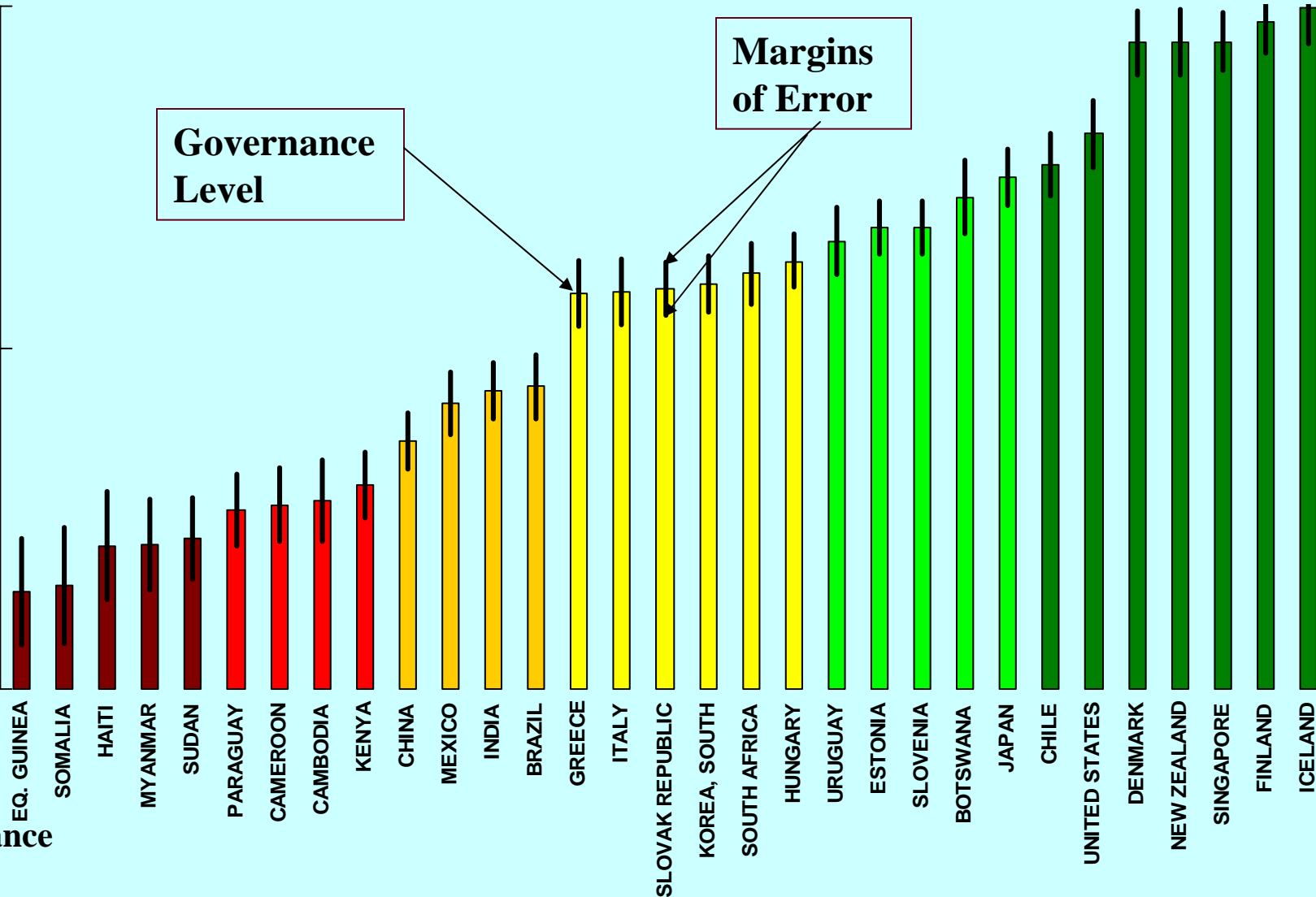
Governance
Level

Margins
of Error

0

-2.5

Poor
Governance



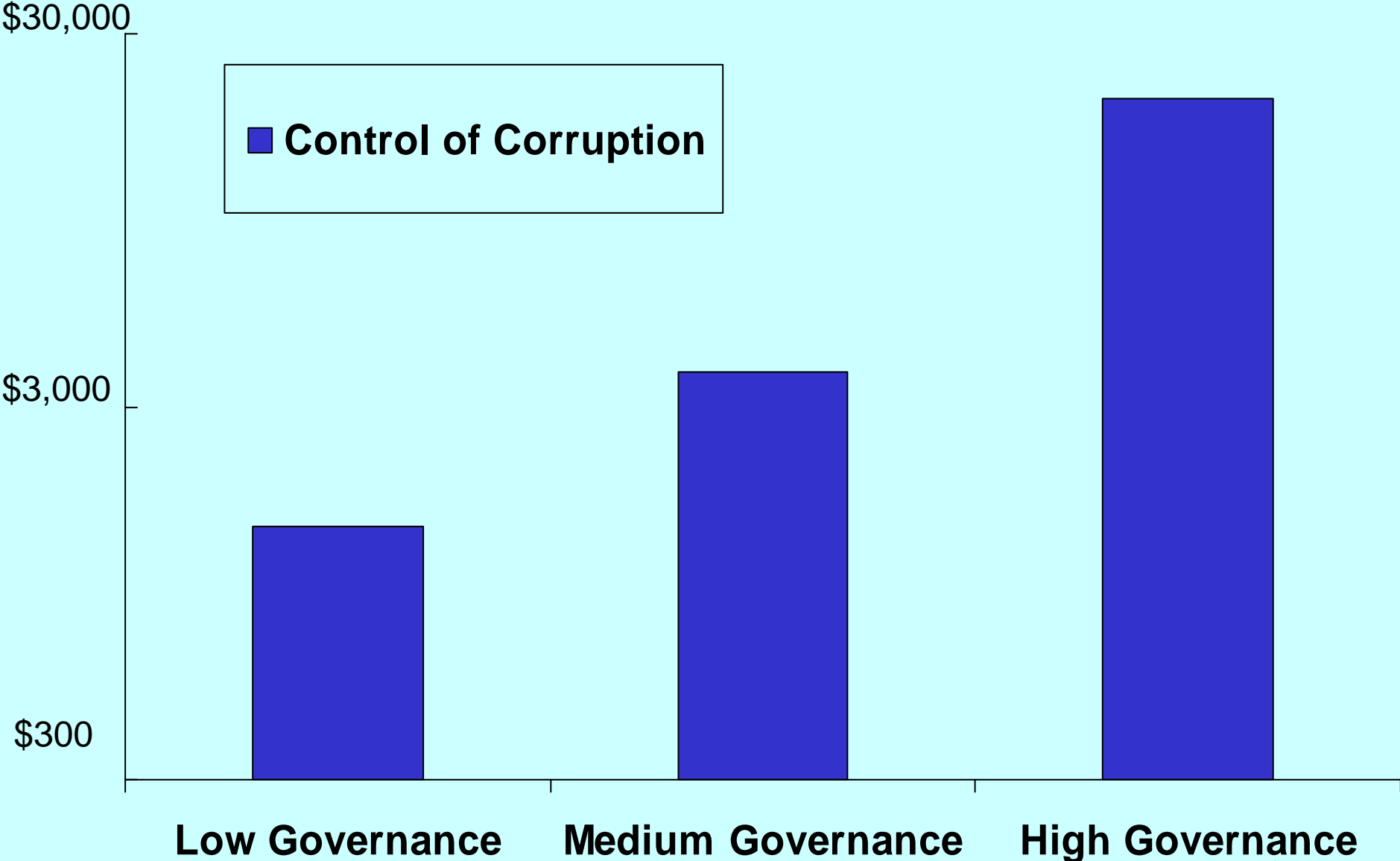
Source for data: 'Governance Matters V: Governance Indicators for 1996-2005', D. Kaufmann, A. Kraay and M. Mastruzzi, September 2006.

Note: Colors are assigned according to the following criteria: Dark Red, below 10th percentile rank among all countries in the world; Light Red between 10th and 25th; Orange, between 25th and 50th; Yellow, between 50th and 75th; Light Green between 75th and 90th; Dark Green above 90th.

Governance Matters: The 300% 'Dividend'

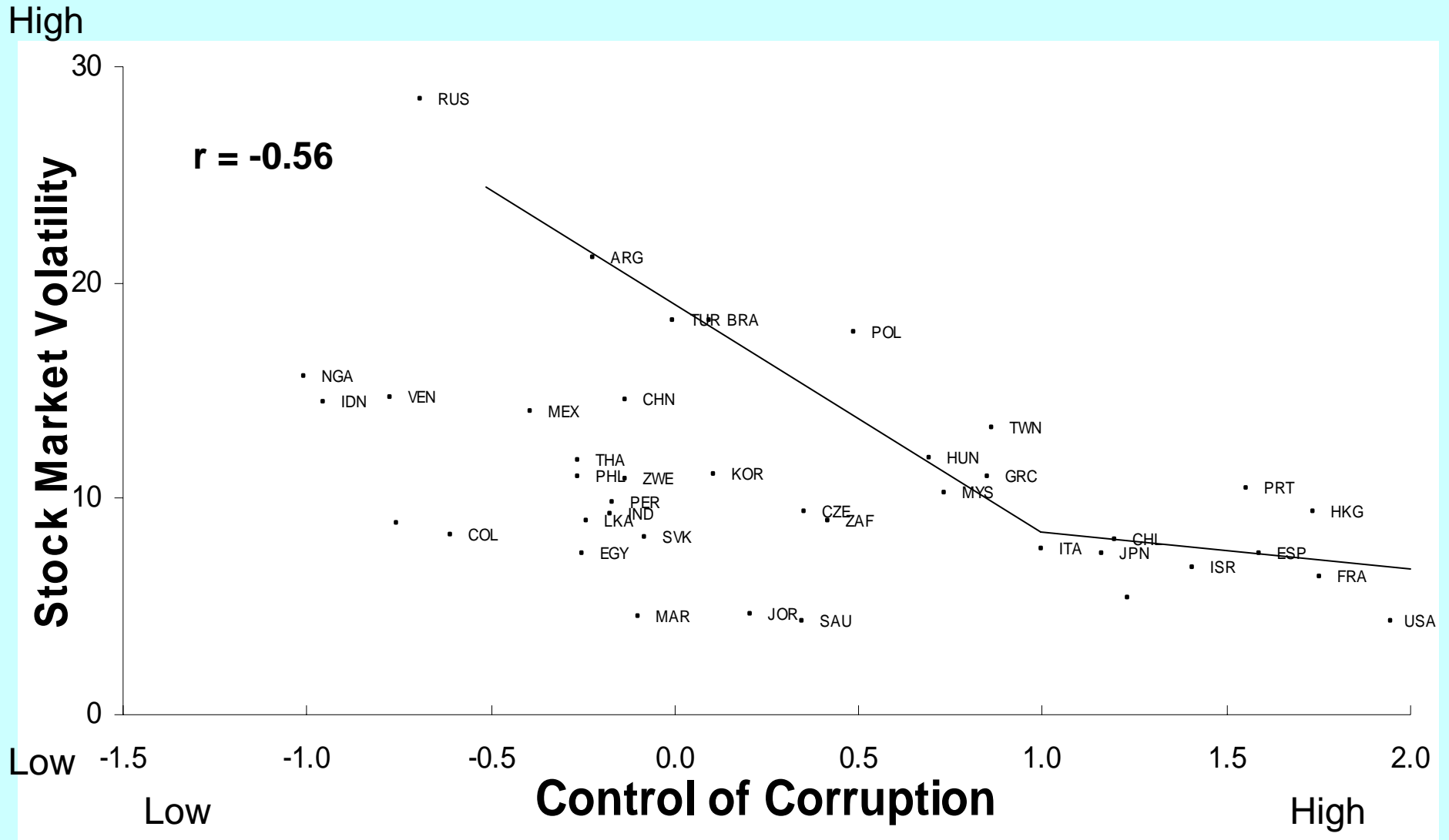
1. Large Development Dividend of Good Governance: *a one-standard-deviation improvement in governance raise incomes per capita in a country by about 300% in long-run*
2. But is such a decline in corruption unrealistically large?: **NO -- One S.D. is the difference from: Eq. Guinea → Iran or Uganda → Mauritius → Portugal → Finland or New Zealand**
3. The impact is from governance to incomes, and not viceversa -- *higher incomes alone will not do*
4. Urgency of interventions to improve governance

Development Dividend From Good Governance



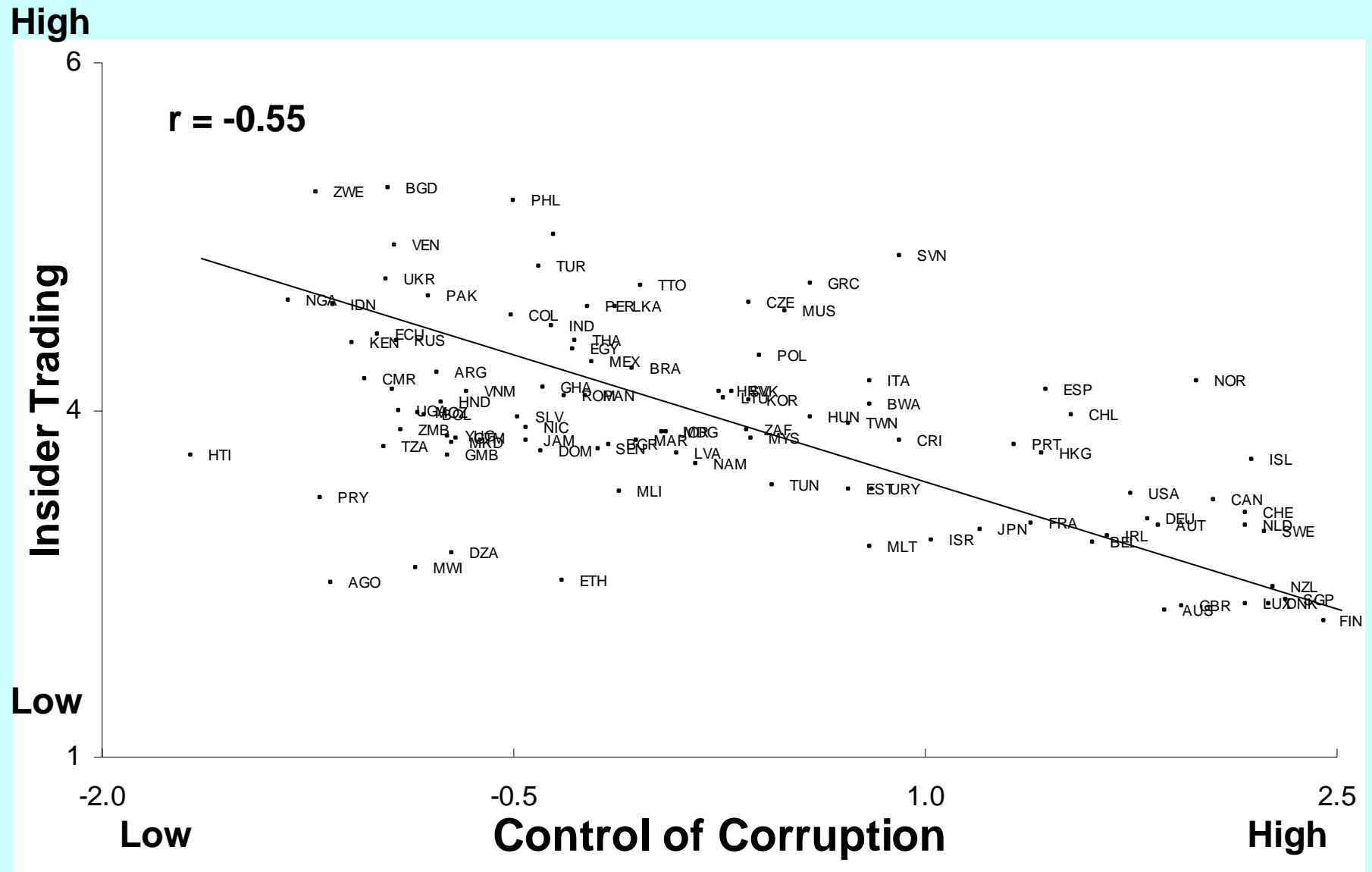
Data Source for calculations: KK 2004. Y-axis measures predicted GDP per capita on the basis of Instrumental Variable (IV) results for each of the 3 categories. Estimations based on various authors' studies, including Kaufmann and Kraay.

Stock Market Volatility vs. Control of Corruption



Sources: KK 1998 and Morgan Stanley Capital International Dataset and Emerging Markets Database (1998). Stock volatility defined as the standard deviation of monthly returns over December 1984 to December 1998, multiplied by 100.

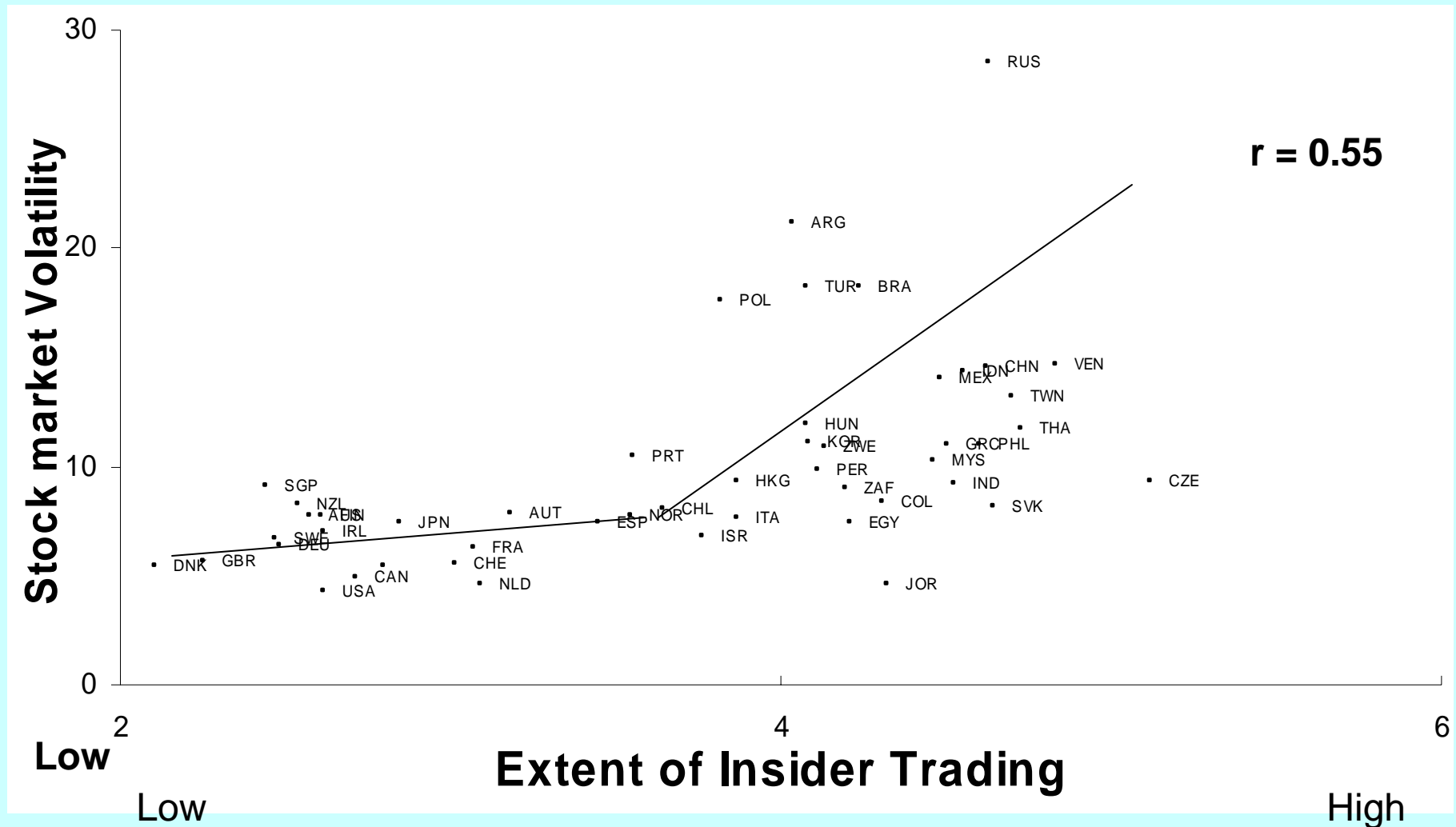
Extent of Insider Trading vs. Control of Corruption



Source: EOS firm survey, WEF2003, and KK 2002. Question to firms on insider trading: "Insider trading is not common in domestic stock markets", 1=strongly disagree, 7=strongly agree."

Stock Market Volatility vs. Extent of Insider Trading

High



Sources: EOS firm survey, WEF (1998) and Morgan Stanley Capital International Dataset and Emerging Markets Database (1998). Question for insider trading: "Insider trading is not common in domestic stock markets", 1=strongly disagree, 7=strongly agree. Stock volatility defined as the standard deviation of monthly returns over December 1984 to December 1998, multiplied by 100. Based on Du and Wei (2004)

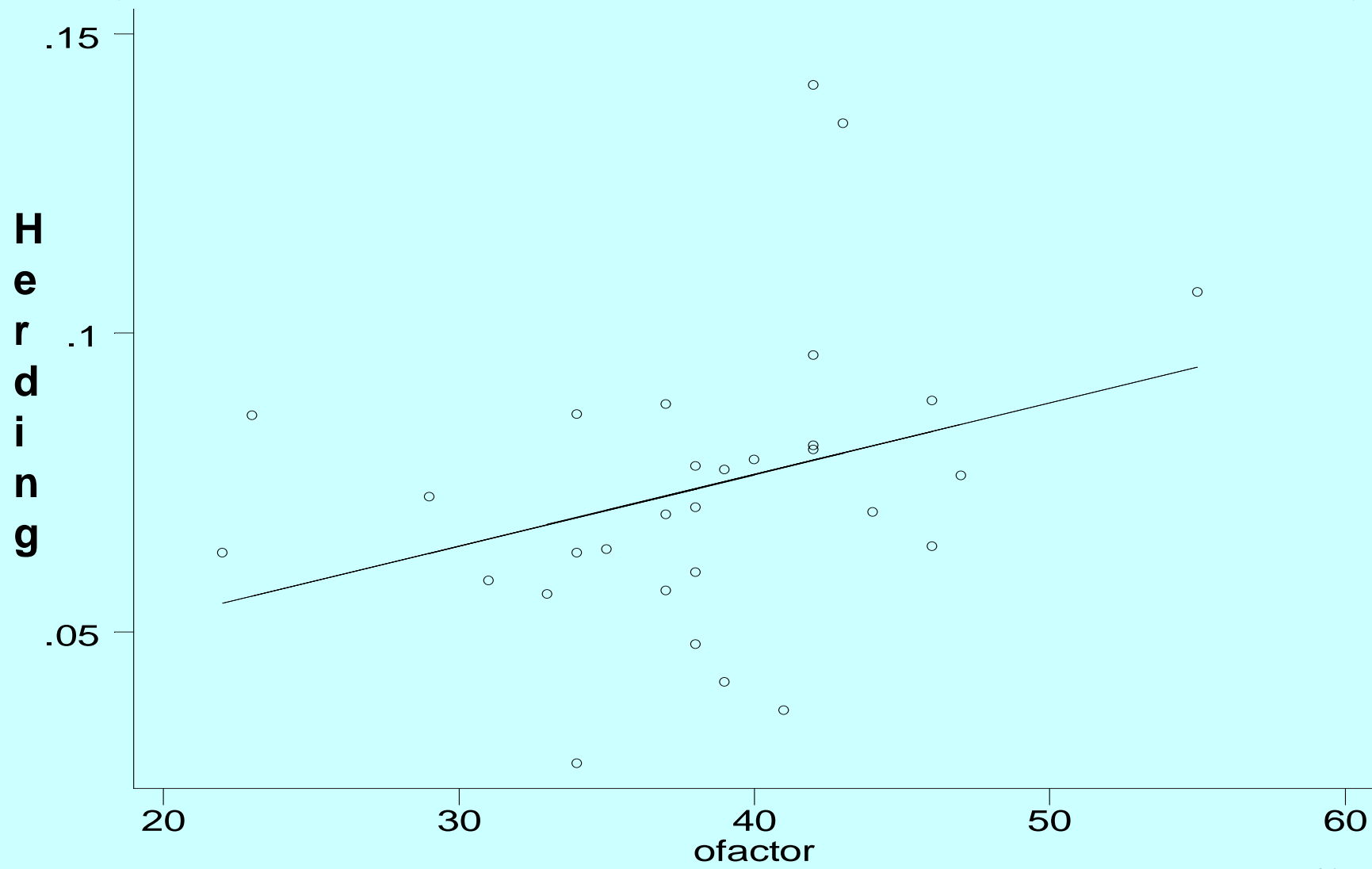
Insider Trading Significantly Affects Stock Market Volatility: An Example from Du and Wei (2004)

	US (1)	China (2)	Difference (3)=(2)-(1)	Increase in mkt Volatility
Insider Trading Output Volatility	2.62 1.7%	4.62 3.0%	2.00 1.3%	245 bp 103 bp

More volatility effect
from an ↑ in insider
trading

> The volatility effect from an
↑ in output volatility

Opacity (or misgovernance) affects Herding (investors mimic each other's behavior)



Gelos and Wei, 2005

Opacity (Misgovernance)

Findings on Governance & Emerging Financial Markets

***Du and Wei (2004):* Insider trading → higher market volatility**

***Gelos and Wei (2005) find that* in opaque countries:**

↓ FDI, ↑ herding intensity, &, ↑ capital flight during a crisis

***Wei (2000):* short term flows 'intensity' in corrupt countries**

***Mehrez and Kaufmann (1999):* financial crisis more likely
in less transparent countries (liberalizing)**

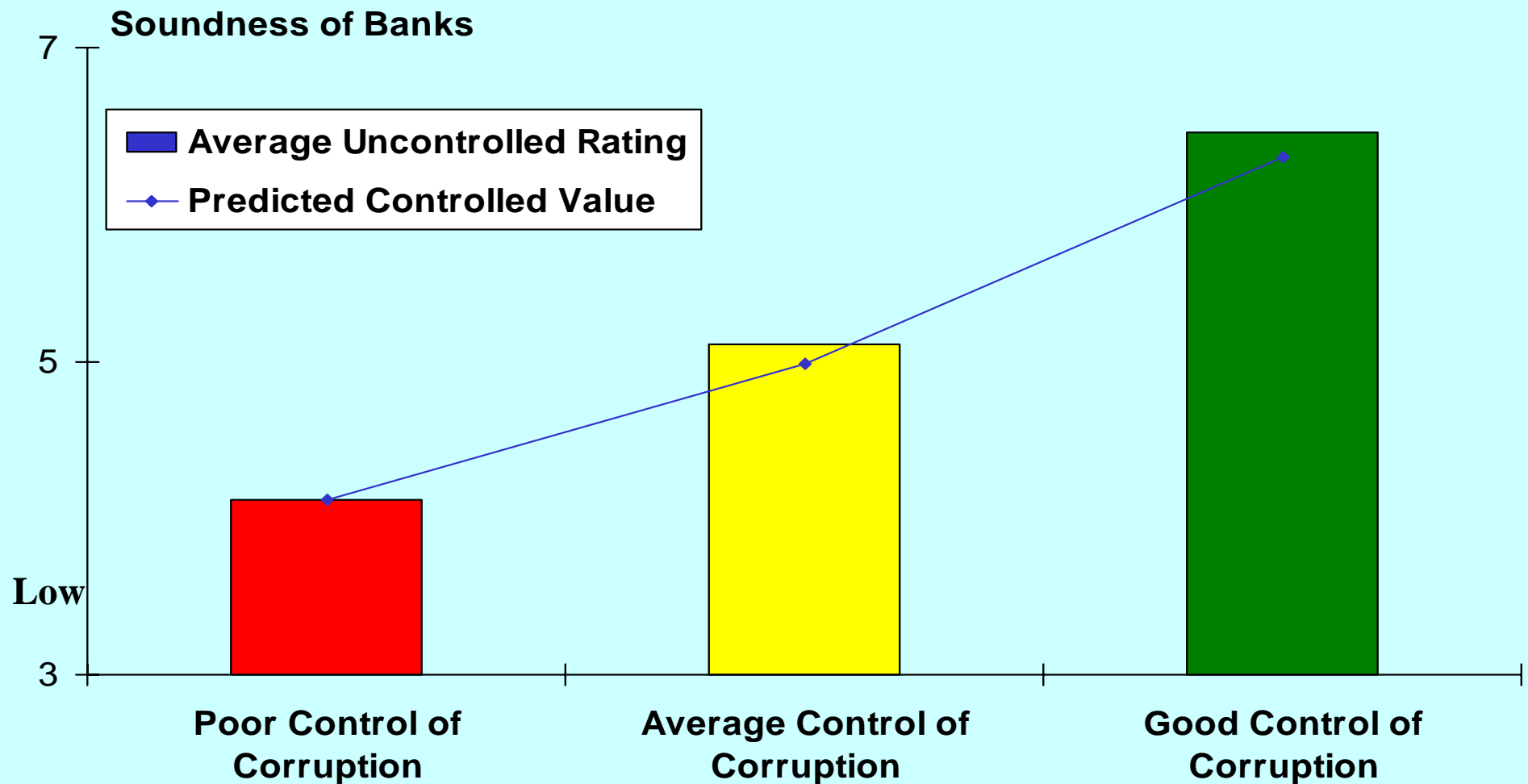
***Acemoglu & Johnson (2004):* property rights institutions
matter for growth, I, Financial Market Development**

***Kaufmann, Mehrez & Schmuckler (1999):* Listening to
data from firms matters for predicting crises**

Misgovernance → Higher Fragility of Financial Sector

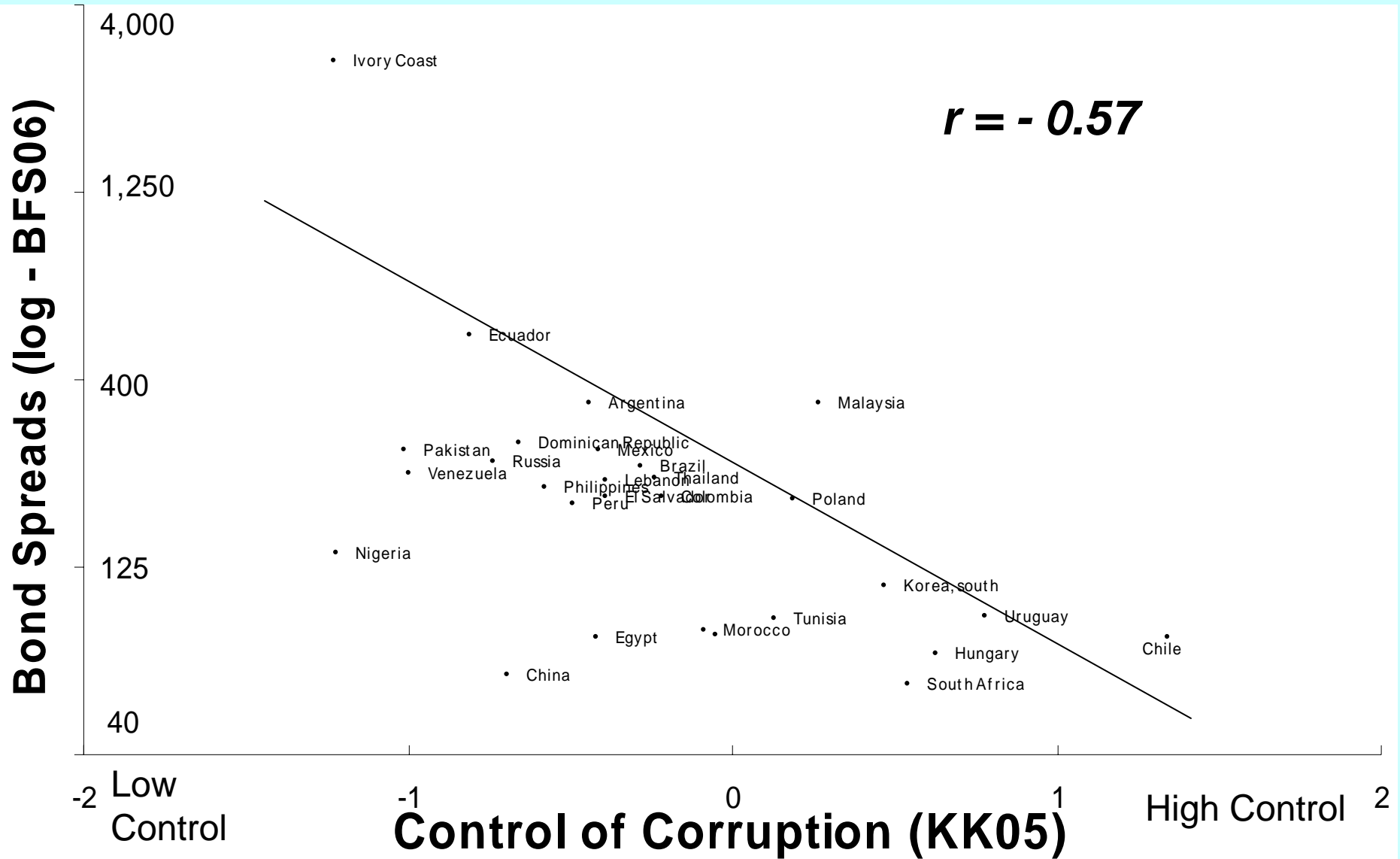
Soundness of Banks vs. Control of Corruption

(View of the firm, GCS 2001)



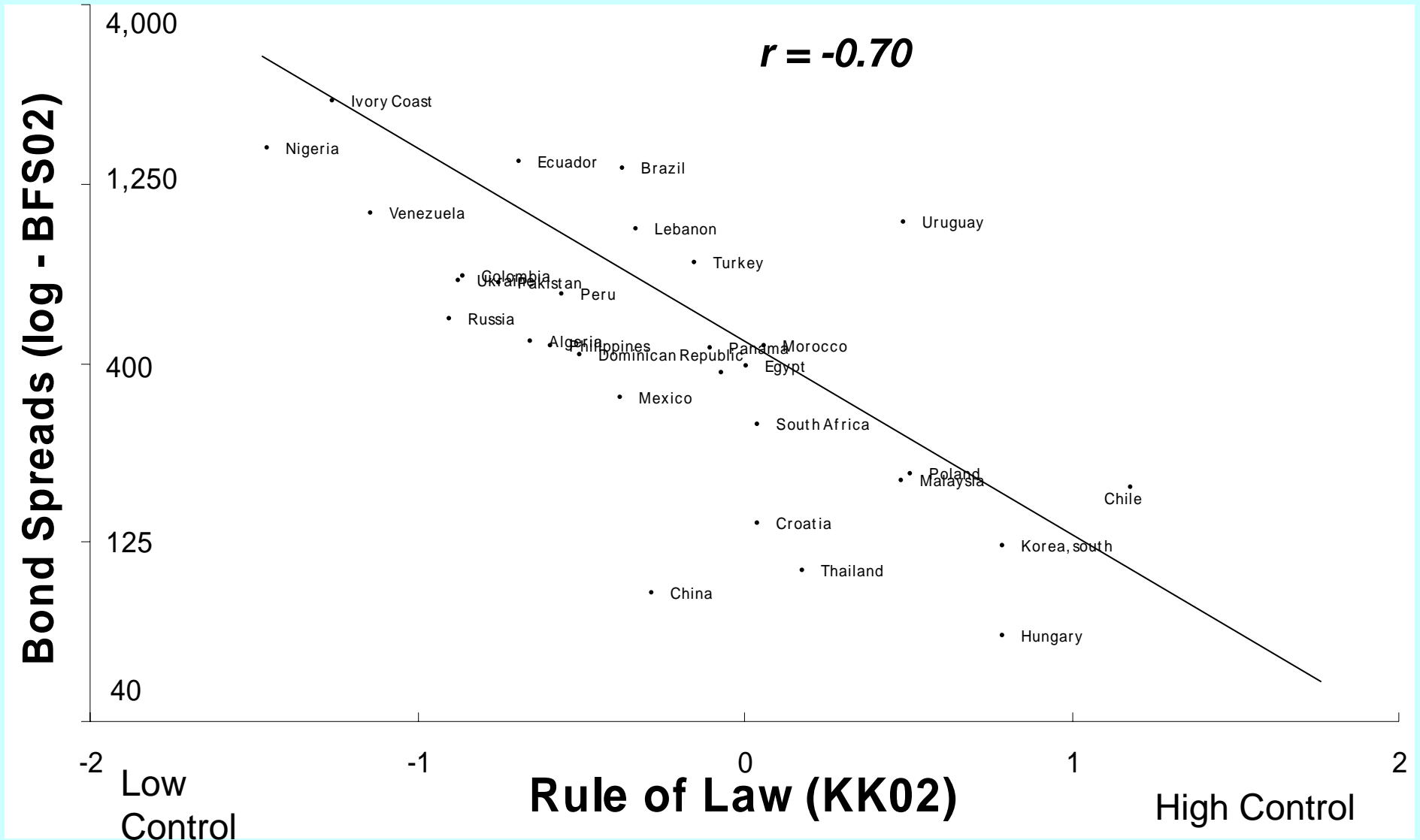
Source: Global Competitiveness Survey, 2001, KK Governance Indicators

2006 Bond Spreads vs. Corruption Control



Sources: Bloomberg Financial Services & WBI. Bond spreads are drawn from the Global Emerging Market Bond Index (EMBIG) produced by JP Morgan on 33 emerging economies.

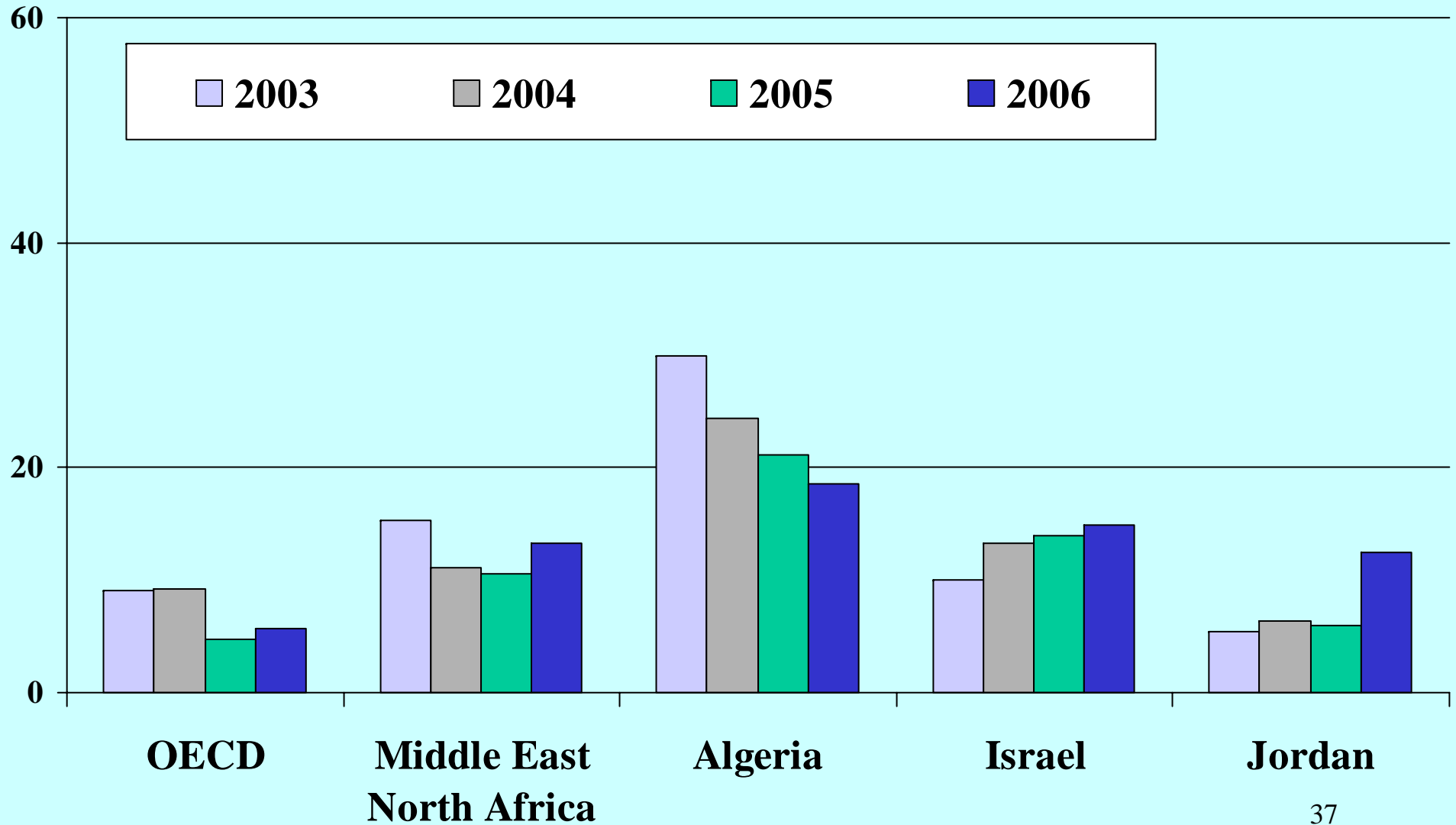
2002 Bond Spreads vs. Rule of Law



Sources: Bloomberg Financial Services & WBI. Bond spreads are drawn from the Global Emerging Market Bond Index (EMBIG) produced by JP Morgan on 33 emerging economies.

Money Laundering, EOS 2003-2006

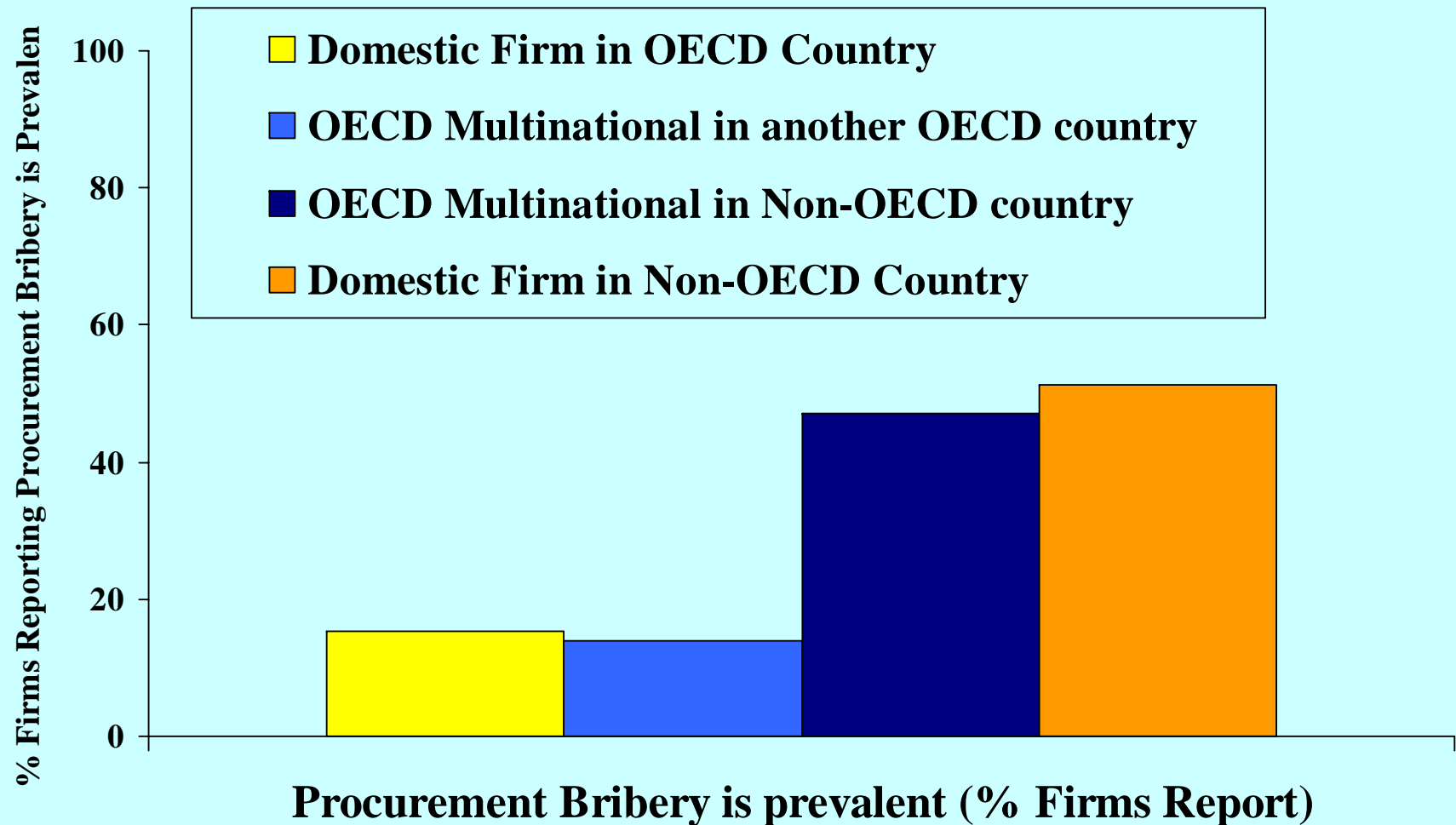
% of Firms report dissatisfaction (1-3)



Source: EOS firm survey, WEF2003-06.

Multinationals Bribe Abroad?

% Firms Reporting Frequent Procurement Bribery, EOS 2005



Source: EOS, preliminary. Question: In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with the following: permits, public utilities, tax payments, loan applications, awarding of public contracts, influencing of laws, policies, regulations and decrees to favor selected business interest, and judicial decisions. Any firms reporting answers 1 through 3 were considered to be reporting at least high frequency of bribery, while answers 4 through 7 were not.

A few summing up points for debate...

Attention to illicit flows highly important, now much needed:

- Better integration within overall governance and corruption framework – analytical challenge
- Focus on measurement challenge: how and what to measure
- Utilizing empirical analysis for evidence-driven policy making
- This is likely to lead to:
 - i) improved prioritization on what are first order issues, vs. third order problems: kleptocrats siphoning billions vs. illicit pirate CDs...or transfer pricing, taxes), and,
 - ii) Use of Incentive-driven measures (vs. overly legalistic)
- Hence, initiatives like StAR, civil forfeiture, VDPs, all require particular attention (*vs. another refinement in anticorruption legislation, code of conduct, or A-C commission*)
- The power of data as an important incentive: raising the reputational costs and benefits, including regarding the₃₉ financial centers in rich countries

Summary and Implications

1. **Governance measurement skepticism challenged**
2. **Misgovernance as one binding constraint nowadays**
3. **Beyond corruption: governance more broadly**
4. **Beyond administrative corruption -- *influence peddling and state capture by firms is also key***
5. **Governance Matters for country growth prospects, for Investments, and for financial markets**
6. **Misgovernance affects: fragility of financial markets & banks, volatility of equity markets; investor herding behavior (& lower I); bond market spreads**
7. **Capital Market Development: Disciplining for GG**
8. **Assessing & Measuring Governance key for Political Risk assessment**
9. **Good Governance & Transparency at Sectoral Level**
10. **Global Challenges and Responsibility**

Country Governance and the Stock Market

1. *Measurement, Indicators and Analysis:*

- **Assessing country Governance (incl. transparency & corruption) matter for emerging equity market prospects**
- **Integrity (insider trading) of the equity market as well**
- **Understanding Prevalence and Role of Elites and Capture**

2. *Some Implications for Emerging Equity Markets*

- **In the short-term: *important for volatility – risk***
- **In the longer term: *for sustained growth prospects***

3. *Thus, governance indicators & their analysis matter for market prospects & for optimal portfolio allocation*

Data for Analysis and Informing Policy Advice, Not for Precise Rankings

Any data on Governance, Institutions, and Investment Climate is subject to a margin of error. It is not intended for precise country rankings, but to highlight relative strengths and weaknesses and draw analytical and policy lessons. The data and indicators do not necessarily reflect official views on rankings by the World Bank or its Board of Directors. Errors are responsibility of the authors.

Further materials & access to interactive data:

General: www.worldbank.org/wbi/governance

Data: www.govindicators.org