How to assess commodity-trade related illicit financial flows?

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Developing countries are expected to mobilise greater domestic resources to pay for the Sustainable Development Goals (SDGs). In this context, illicit financial flows (IFFs) have become a critical development policy issue, in particular for commodity-exporting countries. IFFs are broadly understood as cross-border flows of financial capital which are earned, transferred and/or utilised in contravention of existing laws (illegal activities) or through normatively wrongful acts that may still be technically lawful, if unregulated (illicit activities). Resource-rich developing countries are particularly concerned about the erosion of their tax base due to commodity trade-related IFFs through trade mispricing and abusive transfer pricing, since they generate a significant share of public revenues from the production and sales of commodities. Therefore, curbing IFFs and promoting fair and effective taxation of the natural resource sector is critically important to mobilise domestic revenues and reduce dependence on foreign aid.

In late-2017, we launched an international research project comprising of economics, legal, and political science experts as part of the Swiss Programme for Research on Global Issues for Development (R4D.ch). Motivated by SDGs 16.4.1 (curb IFFs) and 17.1 (strengthen domestic resource mobilisation), our economics research aims to estimate the actual magnitude of IFFs, while the legal and political science research aims to identify and rigorously analyse the regulatory loopholes and governance challenges driving this global phenomenon. The project aims to provide empirical clarity and evidence-based policy recommendations to countries involved in the commodity value chain, initially focusing on Ghana and Laos as exporters, and Switzerland and United Kingdom as trading hub. Our project consortium consists of The Graduate Institute (Geneva), Center for Development and Environment (University of Bern), NADEL - Center for Development and Cooperation (ETH Zurich), as well as the University of Ghana (Accra, Ghana) and National Institute of Economic Research (Vientiane Capital, Laos).

During the first stage of our research, we analysed the limitations in applying existing empirical methods to credibly estimate IFFs since they rely on asymmetries in bilateral trade-partners' aggregate exports and imports. Our research identified a number of data and methodological limitations associated with missing and/or misclassified customs data from exporters, transit trade activities by trading firms, and use of intermediate shipping, storage and marketing hubs which complicate this analysis. To advance the empirical research on IFFs beyond these limited methods and data sources, we are developing more sophisticated approaches which rely on highly disaggregated trade data to estimate abnormal pricing in exports and imports of individual commodities, i.e. the magnitude of trade valued outside an assumed arm's length price range based on free-market prices from commodity exchanges or defined statistically using the central tendency of the observed price distribution. For example, we compare the observed pricing patterns of gold and copper exports and imports to the benchmark commodity exchange prices from the London Bullion Market Association and London Metals Exchange, respectively. However, the validity of this methodology relies on incorporating a sophisticated understanding of each commodity being analysed, specifically in the selection of free-market reference prices and the magnitude of normal price variation due to product quality or purity and transportation costs. This implies an important need for ongoing dialogue between academic researchers and industry experts, as well as collaborations with stakeholders in other commodity exporting and trading hubs to facilitate rigorous analysis to inform evidence-based policymaking.

This research will inform a number of ongoing national and international policy initiatives aimed at curbing IFFs in commodity exporting countries and trading hubs, while helping resource-rich developing countries implement regulatory reforms and capacity-building to improve natural resource governance and strengthen domestic resource mobilisation. A selection of these initiatives include tax and customs capacity-building, specifically relating to commodity valuation systems and improved statistical infrastructure, as well as regulatory reforms relating to transfer pricing rules and tax transparency initiatives. ■

STSA leads the way on responsible business

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The commodity trading activity, being business-to-business in nature, has wrongly been perceived as opaque. This has made it the subject of increasing global demands for greater transparency and governance in commodity trading activities, by civil society, NGOs and politicians alike. Such pressures often overlook the strict standards to which commodity trading companies must already adhere, and their proactive efforts towards improved transparency, disclosure and accountability.

STSA and its members support transparency and traceability across the commodity value chain, and welcome the continuation of ongoing multi-stakeholder dialogue in this area. STSA has been proactively involved in various initiatives to contribute their expertise in view of formulating pragmatic solutions. In 2014, STSA supported Switzerland in the establishment of the Extractive Industries Transparency Initiative (EITI) Working Group on commodity trading, which focuses on how governments are selling oil, gas and minerals. Since then, it has continued to participate in and support the Working Group. Together with its members, it has accompanied the process, ensuring the consistency of exchanges and the possibility for its members to provide expertise on technical aspects of commodity trading and institutional mechanisms that support the implementation and adherence to the EITI standard. This Working Group has made huge progress, developing a Guidance for producing governments to disclose payments of first trades, together with reporting templates. In addition, STSA is a member of the Advisory Board of the ongoing research project 'Curbing Illicit Financial Flows (IFFs)', working with the research team to provide access to industry actors, and expertise to aid the practical implications of the research.

The emerging and potential impacts of new technological developments, such as blockchain and distributed ledger technologies (DLT), in commodity trading provide an important new dimension to transparency discussions. STSA and its members are at the forefront of these changes, participating in initiatives such as VAKT, komgo and TRAFEC. Though still under discovery, new technologies will undoubtedly provide opportunities to further increase transparency and traceability. The question is not 'if' but 'how'. ■