

Transparency International Anti-Corruption Helpdesk Answer

Illicit financial flows and inequality

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Date: 8 June 2020

This paper reviews the literature on the links between inequality and illicit financial flows (IFFs). While current measures of inequality (such as the Gini coefficient) do not account for illicit financial flows, factoring in the effects of IFFs suggests that rates of wealth inequality between individuals and countries are significantly higher than previously assumed.

In addition to this, IFFs reproduce inequality in several ways. First, IFFs are associated with less efficient economic outcomes, lower rates of poverty reduction and more rent-seeking behaviour. Second, IFFs reduce state capacity and, in particular, the revenues needed to finance development and state building. Third, IFFs are often associated with state capture and deteriorating institutional quality. Fourth, IFFs have disproportionately detrimental impacts on those citizens already most “left-behind”, given their effect in facilitating and exacerbating corruption and conflict in the poorest countries.

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This Anti-Corruption Helpdesk is operated by Transparency International and funded by the European Union.



Query

Please provide an overview of the literature on linkages between illicit financial flows and inequality.

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Caveat

This literature review focuses on evidence of links between inequality and illicit financial flows (IFFs). It is not a review of financial secrecy practices, the structures or methods that enable legal or illegally acquired capital to be transferred illicitly or initiatives to limit IFFs. The review attempts to build on rather than duplicate previous literature authored by Transparency International, notably the recent [Topic Guide on Illicit Financial Flows](#). In addition, this review examines newer literature and does not make use of studies older than a decade.

The sources used in the review come from a variety of disciplines, such as political science, geography and economics, and from academic journals, think tanks, international organisations and NGOs.

In much of the literature, the link between inequality and IFFs is assumed to be self-evident. As a result, not many studies explicitly conceptualise these links or measure their correlation. This review attempts to work around this problem by looking at literature that assesses the broad societal impact of IFFs and then synthesising this evidence in reference to what is known about inequality.

Main points

- IFFs are associated with a consolidation of wealth on a global scale, and evidence suggests that IFFs cause greater inequality both within countries and between developing and advanced economies.
- By enabling the well-connected and super rich to avoid taxes, IFFs deprive the state of domestic revenue. This shifts the tax burden towards the middle and lower classes, and hurts the quality of services.
- Better performing and less corrupt institutions are associated with more equal distributions of income and higher levels of economic development. IFFs have a detrimental impact on the quality of institutions and incentivise state capture and corruption.
- In many of the world's most fragile and conflict-affected settings, IFFs enable the reproduction of negative cycles of corruption and/or violent conflict, which actively undermines the development prospects of many of the poorest citizens.

Background

The term illicit financial flows (IFFs) is an umbrella term that covers various forms of money laundering and tax or market abuse. It includes the laundering of proceeds made through:

- organised criminal markets (such as narcotics)
- corruption (such as embezzled funds)
- tax abuse (such as tax misinvoicing)
- market abuse (such as insider trading)

The term illicit financial flows emerged in the 1990s but was popularised in the 2000s by Raymond Baker and Global Financial Integrity (Kukutschka et al. 2019).

There is no universally accepted definition of the term illicit financial flows, but Global Financial Integrity, which has provided the most widely accepted definition, defines IFFs as “money that is illegally earned, used or moved and which crosses an international border” (Solomon 2019). Alternatively, the definition provided by the OECD posits IFFs as financial flows “generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws”.

While broadly similar, the OECD’s definition is somewhat narrower in scope and focuses more on legal frameworks (Kukutschka et al. 2019). This leaves open the question of whether the OECD definition encompasses practices that are widely considered illicit but not illegal, such as tax avoidance. Indeed, the line between what constitutes illicit and illegal behaviour can be ambiguous, and a substantial volume of financial transactions, particularly transactions by large corporations that engage in aggressive tax planning and transfer pricing, are located in this grey zone (Dolve & Mullard 2019).

Despite this, most analyses of IFFs only include a limited consideration of tax evasion, primarily focusing on financial flows that are both illegal and illicit either because of the way they have been earned or by virtue of their intended purpose, such as terrorist financing (Dolve & Mullard 2019).

While outflows tend to dominate discussions on IFFs, inflows are likewise a serious concern. Illicit inflows are often anonymous, untaxed and fuel criminality and money laundering (Solomon 2019).

Due to the clandestine nature of IFFs, it is difficult to accurately assess their true global scale, particularly because these flows consist of transactions that can be difficult to detect and trace, such as hawala transfers or cash transactions (Solomon 2019).¹ Even those types of flows that can be measured can only be done so indirectly, and these proxies result in very rough approximations (Solomon 2019).

Many estimates rely on discrepancies in a country’s balance of payments and anomalies in the current and capital accounts of countries, which serve as indicators of cross-border financial flows. These errors and anomalies, however, may not necessarily be the result of actual trade misinvoicing, and data mismatches can stem from a variety of trade issues, including reporting errors (Dolve & Mullard 2019) or lacking capacity in the offices that produce trade statistics. As most estimates of IFFs reflect only unexplained trade imbalances in goods alone, they do not cover the real volume of IFFs.

With these caveats in mind, Global Financial Integrity estimates that illicit financial flows (both in- and outflows) had a total value of between US\$1.128 trillion and US\$1.935 trillion in 2015, depending on which data is used (Solomon 2019). Of these numbers, between US\$940 million and US\$1.69 billion stem from trade misinvoicing (Solomon 2019).

¹ *Hawala is an alternative remittance channel that exists outside traditional banking systems. Transactions between hawala brokers are made without promissory notes*

because the system is heavily based on trust and the balancing of hawala brokers' books. Hawala, also known as hundi, means transfer or remittance (Investopedia 2018)

In previous studies, Global Financial Integrity estimated that illicit outflows constitute around 4.2 per cent to 6.6 per cent of the total trade in developing and emerging economies, and up to 9.9 per cent in sub-Saharan Africa.

Countries such as South Africa, Nigeria, Mexico and Brazil reportedly suffer from the highest rates of IFF outflows in the world in absolute dollar terms, whereas countries such as Mozambique, Malawi, Zambia, Honduras, Namibia and Myanmar suffer from very high rates of illicit outflows as a share of total trade with more advanced economies (Solomon 2019). Vietnam, Thailand, Indonesia, Panama, Kazakhstan and Belarus have the highest inflows in total value.

It is worth bearing in mind, however, that these numbers are based on trade gaps in goods based on UN Comtrade statistics and do not fully reflect the true nature of all IFFs, particularly as these relate to criminal markets. They are therefore likely under-estimates. At the same time, however, some tax avoidance may be counted as part of these statistics.

IFFs and wealth inequality

Kar, Schjelderup, Salomon and Baker (2015) tried to determine the net resource transfers between developed and developing countries, using both recorded capital flows, remittances, non-financial transactions, and unrecorded and illicit financial transactions. They show that, since the 1980s, developing countries have been de-facto net creditors to the rest of the world economy. Net resource transfers for all developing countries have been negative both in nominal terms and as percentage of GDP, while 82 per cent of IFF outflows came from developing countries from 1980 to 2012.

IFFs, in other words, constitute a form of reverse distribution mechanism between states – an extraction of wealth from the lower income countries towards middle and higher income countries (Kar et al. 2015).

Not only do IFFs increase inequality between countries, they also contribute to increased wealth inequality within countries. Using the numbers cited above, Kar et al. (2015: 4) argue that the richest of the rich benefit the most, while the poor and middle class stand to lose. The report argues that these numbers also show that “there is perhaps no greater driver of inequality within developing countries than the combination of illicit financial flows and offshore tax havens”. IFFs, when combined with secrecy jurisdictions, enable a form of reverse distribution, meaning that net wealth is transferred from the lower and middle-income countries to high-income states, typically via secrecy jurisdictions (Kar et al. 2015).

One reason why it is difficult to measure the effects of IFFs on inequality is due to a lack of information on the amount of wealth that exists in the world. The size of uncounted or hidden wealth located in secretive accounts in tax havens is unknown, but is believed to have grown substantially alongside the globalisation of wealth management over the last few decades.

In an effort to address this information gap, Alstadsæter, Johannesen and Zucman (2017) estimate the stock of wealth residing in tax havens per country, using relatively newly published bilateral bank deposit data from a range of countries. They estimate that the stock of wealth located in tax havens makes up approximately 10 per cent of the world's GDP.

Alstadsæter et al. (2017) contend that accounting for this hidden wealth would significantly increase the size of the 0.01 per cent richest citizens' share in estimates of wealth distribution in most countries. This wealth, however, is unequally divided between both countries and citizens. For Russia, the Gulf countries and a number of Latin American countries, the total amount of wealth moved offshore makes up a stunning 60 per cent of GDP. For continental Europe, the average is 15 per cent whereas, for Scandinavian countries, the number is in the single-digits.

Alstadsæter, Johannesen and Zucman (2017) also use their estimates to reassess official statistics related to wealth distribution and inequality in 10 countries (Denmark, Finland, France, The Netherlands, Norway, Russia, Spain, Sweden, the UK and the US).

In the UK, Spain and France, it is estimated that between 30 per cent and 40 per cent of the wealth of those countries' 0.01 per cent richest citizens is located in tax havens. Countries such as France and the UK have often been regarded as having slightly higher inequality than the Nordic countries. However, when adjusting for offshore wealth, both France and the UK become significantly more unequal. On the other hand, accounting for the offshore wealth of the US's richest citizens results in a less dramatic increase in inequality, presumably due to the already very high level of inequality reflected in existing measures.

From Alstadsæter et al. (2017) and Kar et al. (2015), factoring in uncounted wealth stashed overseas demonstrates that actual levels of domestic wealth inequality are likely significantly higher than previously thought. In addition, there is a tendency to omit marginalised groups from survey data results, which results in a sizeable amount of "uncounted inequality" (Cobham et al. 2017).

An interesting question is how accounting for this uncounted wealth would affect measures of inequality, such as the Gini coefficient. Cobham, Davis, Ibrahim and Sumner (2017) give a partial answer to this question by incorporating estimates of the value of illicit financial flows into measures of income inequality.

To avoid overstating the issue, their model is built in a scenario where the flow-to-stock estimates of Global Financial Integrity are reduced by 50 per cent. This number of undeclared income is then allocated to the richest 10 per cent of citizens in terms of income distribution based on household expenditure

surveys. The authors justify this rough assumption with reference to the deliberately conservative stock-to-flow IFF estimates. Cobham et al. (2017) then calculate the Gini coefficients and Palma ratios.²

The result is that the overall mean Gini value for all countries covered in the study increases by 0.03 to 0.44. Adjusting income inequality for IFFs will likewise result in an average 0.1 rise on the Palma Ratio, taking it to an average value of 3.07. Of course, these numbers differ substantially from country to country. For instance, in the case of Chad, the Gini coefficient increases by 0.16 after adjusting for IFFs.

It is uncertain exactly which part of the income distribution at the national level accrues the greatest benefit from IFFs. Cobham et al. (2017) initially assumed the benefits accrued to the richest 10 per cent of citizens, but it could also be a broader or more exclusive group. Adjusting these assumptions would have a correspondingly strong effect on measures of inequality.

Cobham et al. (2017) thus also use their model to explore an alternative scenario, in which it is assumed that all the profits from the 50 per cent reduced IFFs accrue to the top 1 per cent. In this case, the mean Gini coefficient rises by 0.06.

Ultimately, further research on the question of which segment of citizens on the national wealth distribution scale captures most of the income accruing from IFFs would improve the accuracy of estimates of national income inequality.

From the research presented so far, two conclusions can be drawn. First, when accounted for in statistics, IFFs result in significantly higher real inequality, both between and within countries. Unaccounted wealth, much of which is presumed to be transferred and hidden through IFFs, appears to benefit the very richest individuals on the income scale. Second, when IFFs are accounted for, developing

² The Palma Ratio is the richest 10 per cent of a country's population divided by the poorest 40 per cent. If a country

has a score of roughly 1 the top 10 per cent owns the same as the bottom 40 per cent.

countries become net creditors to the world economy.

According to the OECD (2018a), the negative consequences of IFFs are multidimensional in nature, and IFFs can undermine both economic, political and social development as well as environmental sustainability.

The next sections of this paper relate to the impacts of IFFs, as well as how the political, social and economic forces that IFFs set in motion affect inequality.

The developmental impacts of IFFs

One of the ways in which IFFs contribute to increased inequality, particularly inequality between countries, is by restricting the ability of the lower and middle income countries to catch up with high income ones.

Relying on mostly secondary data, the Transnational Alliance to Combat Illicit Trade (2019) maps the effects of illicit trade flows in the agri-foods, alcohol, fisheries, forestry, petroleum, pharmaceuticals, precious metals and gemstones, pesticides, tobacco, wildlife and counterfeiting industries on the 17 Sustainable Development Goals (SDGs) as well as selected targets under each goal.

According to the mapping study, the detrimental effects of illicit trade affect the implementation of all SDGs, but negative effects are particularly evident for SDG 16 (peace, justice and strong institutions) and SDG 8 (decent work and economic growth). Illicit trade has a strong negative impact on almost all targets under SDG 16, including reducing violence, ending the exploitation of women and children, promoting the rule of law, ending illicit flows, countering corruption and ending terrorist financing.

Moreover, the Transnational Alliance to Combat Illicit Trade (2019) stresses that illicit trade has a tendency to benefit organised crime, destabilise communities and divert investment into criminal

markets. Illicit trade also deprives governments of much-needed revenue, limiting scope for investment into essential infrastructure and services. In addition, illicit trade skews competition by giving some companies an unfair advantage, allowing some companies to circumvent customs duties, VAT or by allowing cheap, illegal imports. For instance, some countries in Southeast Asia report having lost large parts of their rice industries to illegal and illicit imports and exports of rice. Such unequal competition leads to lost jobs, lost chances for legal and licit export opportunities and lost chances for well-developed agricultural markets (the Transnational Alliance to Combat Illicit Trade 2019).

While illicit flows in the various industries considered by the Transnational Alliance to Combat Illicit Trade (2019) have different developmental effects, illicit flows in all industries studied have significant negative impacts on SDG 1 (no poverty) and 2 (zero hunger) in addition to SDGs 8 and 16.

Likewise, a 2015 report by the expert working group from the UN Economic Commission for Africa (UN ECA) found that IFFs have detrimental impacts on development. The study reports that, using conservative estimates, the African continent as a whole loses somewhere around US\$50 billion annually to IFFs. Overall, this number has risen in parallel to the growth of the African economy as a whole.

First and foremost, IFFs contribute to the undermining of institutions, both directly, because IFFs are associated with measurable increases in corruption and state capture and indirectly, because such corruption weakens the social contract between citizen and state (UN ECA 2015). This association will be explored later in this report.

Economically, UN ECA (2015) estimates that the capital stock of Africa would be 60 per cent larger without IFF outflows and the rate of investment would have increased from 19 per cent to 30 per cent of GDP.

Moreover, the expert group claims that IFFs mask the real balance of payments of a country. Because IFFs and illicit trade are not counted into official balance of payment statistics, the real (that is, unofficial) net exports in African economies may be bigger than they appear. Austerity measures taken to “balance the books” as a result of fiscal deficits stemming from both lower tax revenues and trade deficits tend to result in job losses, lower investment and more sluggish growth in the licit sector.

The UN ECA (2015) report further states that recent economic growth in Africa has been mainly driven by primary sectors, and one of the reasons that growth has not contributed to structural transformation is due to the role played by IFFs in undercutting the domestic revenues that growth would otherwise produce.

In terms of taxation, UN ECA (2015) argues that IFFs lead to an unequal burden of citizenship, in that, by facilitating tax evasion and avoidance by some wealthy citizens, the tax burden falls disproportionately on the less privileged. Such free-riding comes at the cost of those who play by the rules and do not have the means to spirit what little wealth they do have into secretive tax havens.

Finally, like most other studies cited in this paper, UN ECA argues that for private sector actors, particularly for transnational companies, IFFs incentivise a focus on the economic activities that generate the highest amount of pre-tax returns, rather than the ones that lead to increased efficiency for firms over the longer term.

Ultimately, when taken together, these issues result in widening inequality across the African continent. Unfortunately, the capacity of states to respond to the issue varies immensely, with very few revenue services having established dedicated transfer pricing units and few specialised agencies tasked with curbing IFFs.

Even where relevant legal and institutional frameworks have been established, their capacity is reportedly limited, a vulnerability that UN ECA (2015) contends is knowingly exploited by large private sector actors and financial entities who intentionally blur the lines between tax evasion and tax avoidance.

Other empirically based studies tend to reinforce the claims made by the Transnational Alliance to Combat Illicit Trade and UN ECA. In particular, a number of econometric papers have shown how IFFs hinder progress towards the 2030 Agenda by retarding economic performance.

Okezie and Ogbonnaya (2017) apply statistical tests to evaluate the hypothesis that the impact of IFFs on Nigeria’s economic growth and per capita incomes has been insignificant. Their findings strongly reject this hypothesis, implying that, in the case of Nigeria at least, the negative impact of IFFs on growth rates and GDP per capita has been sizeable.³

The particular vulnerability of economies dependent on exporting natural resources with weak regulatory systems to IFFs has been examined in many studies.

Bharoon, Chelwa, Naidoo and Stanwix (2019) discuss the relationship between resource-dependent growth, inequality and poverty reduction. In 2013, the GDP growth for sub-Saharan Africa stood at an average 6 per cent, with 17 countries showing reporting growth rates over 5 per cent. Ideally, such rates of growth would contribute to rapid poverty reduction. However, as pointed out by the ECA expert working group, much of this aggregate growth has been driven by natural resource exploitation. In fact, 14 of the 17 fast-growing economies in sub-Saharan Africa are largely natural resource dependent (UN ECA 2015).

As a result, there are concerns that much of the growth experienced across the continent has not

³ The authors apply an Augmented Dickey-Fuller test of time-series data to test the two null hypotheses that the impact of IFFs on economic growth and per capita incomes have been negligible. Their hypotheses are strongly

rejected with an ADF value of -7 at the 1 per cent critical value (the larger the negative value the larger the rejection of the null hypothesis).

been inclusive and may not lead to long-term gains. Indeed, some data suggest that inequality in many of the countries in question is rising while poverty rates remain stubbornly high. In many cases, resource rents simply do not appear to benefit the poor, even though natural resource exploitation can potentially be both labour and capital intensive (and therefore has significant poverty reduction potential) (Bharoon et al. 2019).

Bharoon et al. (2019) identify a variety of drivers of this scenario of growth without poverty reduction, including the Dutch disease⁴, oligopolistic market structures that entail high entry costs for new firms, a tendency for the extractive sector to create little opportunities in other sectors (so-called backwards and forward linkages) and, most importantly for the purpose of this paper, IFFs.

In their study, Bharoon et al. (2019) demonstrate that resource-rich countries tend to have the highest IFF-to-GDP ratios. In countries where regulation and oversight mechanisms of natural resources have significant gaps, extractive industry revenues are highly likely to leave a country in the form of an IFF. Indeed, when institutions are unable (due to corruption, lack of capacity or something else) to avoid leakages of resource revenues, IFFs as a percentage of spending on health and education tend to be above 10 per cent (Bharoon et al. 2019). In such cases, IFFs clearly drive inequality because they benefit only a very narrow group, while little or no domestic revenue is raised to benefit wider society.

Yikona, Slot, Geller, Hansen and el Kadiri (2011) measure the impact of dirty money on economic development in Malawi and Namibia. While slightly dated, their study makes a useful distinction between the developmental effects of criminal activities and the broader effects of dirty money in the wider economy.

One of the main findings of the report is that spending related to dirty money is spread across four main areas. First, funds accrued from crime or corruption are used to ensure basic consumption in the immediate family. Then, if basic needs are met, dirty money tends to be spent on non-productive consumption and often luxurious spending such as “posh cars and first-class beautiful houses” (Yikona et al. 2011: 84). Third, a substantial but smaller amount of illicit capital is invested in business ventures, although predominantly in unproductive assets such as real estate.

Finally, once these three primary preferences have been satiated, laundered money that has entered the economy may leave the country as an IFF outflow. With the exception of the need to cover basic expenses, very little of this spending or investment is directed towards productive assets. Overall, therefore, the findings of Yikona et al. (2011) underline the implication that dirty money and the associated phenomenon of IFFs undermine poverty reduction and tend to be associated with non-productive allocation of resources.

Villa, Misas and Loayza (2016) attempt to model the effect of laundered assets on economic growth in Colombia from 1985 to 2013. Their findings are somewhat ambiguous, showing that some laundered money can eventually end stimulating “ordinary” economic activities. Despite this, Villa et al. (2016) found evidence that an increase in efficiency in the illicit sector results in a redistribution of income towards actors in the illicit sector, lower levels of savings overall and negative effects on public goods provision. For instance, as the cocaine industry becomes more profitable and more organised, it becomes more attractive to new workers who then opt out of formal employment. The lawful sector suffers because people save less in banks and the state raises less revenue, meaning a lower quality of state-provisioned public services. Colombia’s position as a leading source country of cocaine

⁴ When the growth of one sector (typically natural resources) is associated with a decline in other sectors.

also contributed towards the growth of a large criminal and shadow economy.

Finally, in a literature review of the macroeconomic effects of money laundering, Hendriyetty and Grewal (2017) identify three ways in which money laundering affects the overall economy. First, money laundering is associated with an overall increase in IFFs. Second, it increases the size of the shadow (or informal) economy vis-a-vis the formal. Indirectly, money laundering lowers labour market participation in formal sectors, as was the case in Colombia. Third, money laundering hinders domestic revenue mobilisation, a topic to which this paper will now turn.

IFFs and domestic revenue mobilisation

Perhaps the most self-evident and broadly discussed impact of IFFs is its effect on undercutting state efforts to effectively levy and collect domestic revenues. The UN ECA (2015) expert group, for instance, cited reduced national tax take and narrower tax base as one of the most pernicious effects of IFFs.

Domestic revenue mobilisation is often thought to be one of the primary measures of state capacity and is, together with state expenditure, linked to mutual accountability between state and citizen as part of the social contract.

As such, the inability of states to mobilise domestic revenue is widely recognised as a key constraint to development as well as a driver of inequality. The topic was the subject of the OECD's 2014 Fragile States report, which argued that IFFs constitute probably the largest source of revenue loss, and therefore pose profound challenges to the development of state capacity in fragile states. As further notes in the OECD's 2018 edition of the report, States of Fragility, 80 per cent of the world's extremely poor will live in these spaces by 2030 unless concerted action on the fragility is taken. As such, the effect of IFFs in eroding the ability of low-income states to collect revenues cripples

their capacity to fund the developmental programmes needed to make progress towards the 2030 Agenda targets (OECD 2018b). This echoes the findings of a study by O'Hare, Makuta, Bar-Zeev, Chiwaula and Cobham (2014), which considered how IFFs undermined the implementation of Millennium Development Goal (MDG) 4 on reducing child mortality. Using measures of domestic revenue lost due to IFFs and drawing on previous studies that show the relation between GDP per capita growth and child mortality rates, the authors find that, without IFFs, some countries would have achieved MDG 4 in less than a quarter of the time that it would otherwise have taken. For instance, in a hypothetical scenario in which Cameroon completely curtailed IFFs, it could increase its annual reduction rate in under-five mortality rates from 0.8 to 3.8 (meaning 3 fewer under-five mortalities per 1000 inhabitants every year). Under similar conditions, the Democratic Republic of the Congo could have reduced its under-five mortality rates at a pace more than 10 times those recorded between 2000 and 2011.

In an Oxfam study, Coplin and Nwafor (2019) demonstrate how IFFs not only cause domestic revenue to decline but how IFFs shift the tax burden towards the middle and lower end of the income distribution spectrum. They cite other Oxfam reports that estimate that 82 per cent of wealth generated globally was accumulated in the top 1 per cent of the income distribution, while the bottom 50 per cent gained nothing.

While many developing countries have experienced GDP growth, revenue collection has actually declined, partly as a result of a financial system that makes it easier for rich individuals to circumvent taxes. The response of some governments has been to try to make up for lost revenue through forms of taxation that target household consumption and thus disproportionately affect the poor. In fact, Oxfam claims, many developing countries raise twice as much revenue from consumption taxes, such as value-added tax than from property and corporate income taxes. In this way, Coplin and Nwafor (2019) identify yet another linkage

between IFFs and inequality: IFFs often shift the tax burden from the rich to the less fortunate.

In some countries, the perception that the tax burden is unfairly distributed has caused the middle class to embrace tax cuts over social welfare. Alonso-Terme (2014) illustrates this dynamic using the case of the Philippines. From 1997 to 2011, the tax base of the Philippines shrunk by 4.6 per cent, and the country's tax-to-GDP ratio fell to 12.3 per cent in 2011.

According to Alonso-Terme, during this period, the richest and most powerful citizens became increasingly able to avoid taxes, shifting the tax burden onto the middle class. As a result of this perceived injustice, the middle class has chosen to largely opt out of state services and seems to prefer private service providers, notably in the health and education sectors. As public spending has declined, the services still accessible for the poor are often underfunded and of a very low quality. This "fiscal status quo" has had a negative effect on poverty reduction and overall inequality, Alonso-Terme argues.

According to the OECD (2019), this "squeeze" of the middle class occurs in richer OECD countries too. In many OECD countries, middle-income households (households making up 75 per cent to 200 per cent of the national median income) have experienced little or no income growth in recent decades, and signs are emerging that the middle class is being hollowed out.

Indeed, in every OECD country, with the exception of France and Ireland, the size of the middle class has contracted, while lower and upper-income classes have expanded. There is a strong generational element to this contraction of the middle class; an individual from the millennial generation (people born in the 1980s and 1990s) is significantly less likely to be or become part of a middle-income household than someone from the baby boom generation (born in the two decades after World War 2).

The dynamics behind these trends are many and also involve factors that are not directly

related to IFFs, such as changes in the labour market structure (automatisation and more unstable jobs) and inflated prices in the housing market. Nevertheless, OECD (2019) argues that an important factor in the squeeze of the middle class has been that, as many rich elites have opted out of taxes, the tax burden has increasingly been placed on the middle class. In surveys, the middle class express an increasing sense of injustice, and more middle-class citizens, particularly those at the lower end of the middle-class income spectrum, feel that they receive less in return for their taxes. Just like in many developing countries, the middle class in OECD countries appear to spend more of their income on private services in health and education than previously.

IFFs and state capture

Another recurring theme in the literature is the relationship between illicit flows on one hand and corruption and neo-patrimonial governance on the other.⁵ Because institutional quality is strongly related to inequality (Chong & Gradstein 2004), an increase in corruption caused by IFFs would theoretically lead to increased inequality (and vice-versa). When it is associated with grand corruption, such as large-scale embezzlement or fraud, state capture can also drive inequality directly by diverting resources from the state, where it can help improve service delivery, into private pockets.

A particular concern is where states and/or state-embedded actors are seen not to be passive or impartial arbiters but rather to deliberately further the interests of economic networks that generate IFFs.

Focusing on low-income states "still under formation", Eriksson (2018) points to five intersections between corruption and IFFs:

1. Corruption facilitates the illegal activities that generate illicit funds.

⁵ *Neo-patrimonialism is understood as "a form of organisation in which relationships of a broadly patrimonial*

type pervade a political and administrative system [that] is formally constructed on rational-legal lines"(Clapham 1985).

2. Corruption is itself a source of funds for IFFs.
3. Corruption facilitates illegal transfers.
4. Corruption hollows out institutions that prevent or detect IFFs (such as financial intelligence units).
5. Corruption facilitates the illegal use of funds once IFFs have crossed borders.

Eriksson argues that corruption and organised crime is not diametrically opposed to the process of state formation, but is an inherent part of it, pointing out that most European states essentially began as protection rackets (for more on this argument, see Tilly 1985).

Making a similar argument, Baker and Milne (2015) look into the role that states can play as a driver of illicit economies and IFFs. They examine a number of cases of illicit state financing across Southeast Asia, from Cambodia, Laos, Myanmar, Thailand and Vietnam as well as Indonesia and East Timor.

With some exceptions, the countries analysed by Baker and Milne have generally performed poorly in terms of domestic revenue mobilisation. Even where state expenditure per citizen has been relatively healthy in the past, Baker and Milne argue that a diminishing fiscal base has resulted in falling expenditure rates. As formal revenues have dwindled or dried up in many Southeast Asian countries, state elites have turned to other, more illicit, forms of revenue extraction and criminal enterprises.

While such activities are typically viewed through a lens of corruption or state fragility, Baker and Milne (2015) stress that these states sustain themselves through a conscious strategy of placing themselves at the centre of networks of illicit flows. In fact, rather than being a sign of weakness, Baker and Milne argue that cultivating illicit economies should be viewed as a form of state building.

Indeed, state formation in Southeast Asia has often relied on a nexus between government and crime. This can be understood as a sort of elite pact bound by illicit activities such as illegal logging, illegal artisanal mining, heroin and methamphetamine production and granting concessions in an unaccountable and secretive manner. This symbiotic relationship between various actors engaged in widespread criminality ensures off-budget financing and state territorialisation⁶ in the countries' contested peripheries.

The authors coin the term "dirty money states" to describe regimes that finance (their particular form of) state building through illicit trade. These states are argued to deliberately weaken their capacity in some spheres, such as traditional forms of taxation, while simultaneously strengthening their capacity to raise funds from IFFs (Baker and Milne 2015). In dirty money states, therefore, illicit flows (IFFs and illicit material flows) are part of a conscious process by which elites instrumentalise their own states' weaknesses.

Such forms of state building tend not to be inclusive processes and arguably could increase inequality, both between and within states. As Acemoğlu and Robinson (2012) and many other development economists argue (e.g. Rodrik et al. 2002), the quality of institutions is the primary determinant of economic development. Arguably, states that finance their own consolidation through IFFs are not well-positioned to address rampant inequality. They neither have the institutional infrastructure for accountability needed for sustainable poverty reduction nor for holding potentially kleptocratic rulers to account for illicit enrichment. In other words, state-embedded criminality likely fuels inequality.

The role of state capture and corruption have also been prominent in other regional studies of IFFs. For instance, Lain, Nouwens, Moiseinko, Campbell and Oliveira (2017) analyse IFFs in eight diverse Asian countries: Afghanistan,

⁶ *The process of building state authority in spaces where it is contested.*

Bangladesh, India, Kyrgyzstan, Pakistan, Myanmar, Nepal and Tajikistan. One of the findings of their study is that the nature of IFFs is generally defined by unique circumstances and the specific political economy in the country in question.

Nevertheless, a common feature of IFFs for all eight countries is that these flows require a nexus of groups to work together, directly or indirectly, by turning a blind eye. These groups typically include border officers, tax officials, political elites, the private sector and/or criminal groups. For instance, in Tajikistan, state-embedded actors control the opium and heroin trade, while in India and Nepal, the issue of corruption among border guards is a central issue (Lain et al. 2017). In Afghanistan and Pakistan, airport security has often allowed vast sums of cash to be moved by air. As witnessed in the Kabul Bank scandal, criminals also influence financial institutions. Where grand corruption is rife, political elites and criminal groups often converge and collude and often depend on each other, such as in Nepal where, according to Lain et al. (2017), criminal groups pay off politicians in return for impunity.

Institutional quality and development exist in a mutually reinforcing relationship (Chong & Gradstein 2004). Hence, in cases where state-embedded actors benefit from IFFs, they indirectly contribute to inequality, both between and within countries.

A 2018 OECD study on West Africa argues that, in addition to undermining state capacity, IFFs erode the social contract and provide incentives for state and non-state actors alike to engage in criminality. This is because IFFs often benefit local powerbrokers, armed non-state actors and criminal gangs, who use their wealth to fill the void left behind by the state and build parallel and rival sources of authority (OECD 2018a).

At the same time, those profiting from IFFs are able to invest their wealth to obtain increased political clout and then leverage this influence to benefit their client networks. Such corruption ensures that public officials become ensnared in

larger patron-client networks that are often involved in criminal markets, with a resulting disregard for these officials' formal duties.

As a result, IFFs can increase state fragility, as they weaken state capacity and result in the proliferation of a range of actors (including insurgents, self-defence groups and violent extremists) who impose socio-economic costs on local communities, including insecurity, failed institutions and inter-group strife. When IFFs stem from the illicit, potentially criminal, extraction of a finite good, such as illegal and unregulated fisheries, they leave a large net loss that can potentially lead to displaced livelihoods and increased poverty in local communities (OECD 2018a).

Adeleke (2019) studied the case of the extractive industry in Zimbabwe. While the sector used to constitute over a third of the economy, over the last decade it has shrunk to just 10 per cent of its former size. While this has been attributed to mismanagement and international isolation, illicit financial flows have also been pivotal to the decline of the industry.

These flows are estimated to have cost the country an astonishing estimated US\$12 billion over the last decade, made possible through a combination of poor governance, weak oversight mechanisms, corruption and complicity by government officials. The result, according to Adeleke (2019), is a very unequal distribution of wealth, whereby a narrow political and economic clique as well as transnational corporations accrue profits from the remnants of the extractives industry.

As such, the case neatly encapsulates the manner in which IFFs in the context of state capture are firstly central to the maintenance of a highly unequal social order designed to cater to powerful vested interests, and secondly obstruct a broad-based development trajectory that could help alleviate mass poverty.

Finally, IFFs and secrecy jurisdictions make it easier for kleptocrats to hide and invest embezzled funds. For example, in 2018, the

Sentry Foundation warned that the global financial system is used for laundering the unexplained wealth of key corrupt actors in South Sudan. South Sudan has suffered from the disappearance of vast amounts of money believed to have been stolen by high-level government officials. The Sentry Foundation (2018) believes that the funds obtained through corruption and looting have been transferred out of the country into secretive accounts from where they are used to buy real estate in upscale neighbourhoods in Nairobi and Kampala.

As the case of South Sudan shows, IFFs and secrecy jurisdictions enable kleptocrats to steal from their countries' citizens, invest money in luxury real estate and reproduce extreme inequalities along the way. The case is far from an isolated incident. For instance, C4ADS (2018) have explored how luxury real estate markets are key pathways for laundering illicitly amassed wealth and how, in many of the world's richest cities, lax regulations, lack of transparency and limited information about beneficial ownership facilitates the laundering of embezzled funds through real estate markets.

Relying on information relayed from anonymous real estate professionals and Open Source Intelligence, the C4ADS report looks at how systemic vulnerabilities in the luxury real estate market in Dubai provide an entry point into the legal economy for IFFs such as proceedings from conflict, crime and corruption.⁷

While Dubai's real estate sector has long been identified as a high-risk sector in a high-risk jurisdiction, it is far from alone, and there is a relatively sizeable literature exploring the role of real estate money laundering and enabling IFFs (see, for instance, Martini 2017; Simone 2015).

IFFs, fragility and conflict

⁷ Among other findings, the study identifies 44 properties belonging to sanctioned individuals, including some connected to the Ataf Khan Money Laundering Organisation, the Islamic Revolutionary Guards Corps,

Another pathway through which IFFs contribute to inequality (particularly between countries) is by enabling violent conflict. Armed conflict is often described as "development in reverse" as it leads to economic contractions, destroys the social fabric of societies and has devastating consequences for public health, education and many other services (Nygård & Urdal 2015). Indeed, for this reason, armed conflict is one of the most significant development constraints and a key driver of global inequality.

Many armed actors finance their armed operations through IFFs (Ardigo 2014). At the same time, and for reasons already explored in this paper, illicit flows make it more difficult for the state to finance development that could sustain peace. This could result in the erosion of public trust in institutions and political processes, feeding grievances and undermining peace (Ardigo 2014).

Cobham (2016) argues that IFFs can contribute to two distinct vicious cycles: the cycle of the absence of negative security and the cycle of absence of positive security.

In the vicious cycle of negative security, states are unable or unwilling to prevent insecurity and conflict. Illegal and Illicit flows undermine state legitimacy while stimulating a growing criminal economy, allowing cartels, insurgents, violent extremists or other groups to grow at the expense of the state. This gives rise to increased insecurity, which the state may lack the resources to counteract. In such environments, constraints on IFFs are further diminished and the return to illegal capital may also increase.

In the vicious cycle of positive security, states are unable provide the conditions necessary for sustainable peace (such as food security, health, education and environmental regulation). In this cycle, IFFs stemming from legally acquired capital (notably tax evasion) undermines the state's capacity to exercise authority, to govern

Hezbollah, various Mexican cartels and the Syrian regime. As such, according to C4ADS (2018), Dubai's real estate sector facilitates corruption, crime and the financing of conflict and terrorism globally.

and to deliver quality services and its capacity to appear responsive to the needs of its citizens. This weakens the state-citizen relation and erodes state authority, which, in turn, limits the capacity of states to prevent IFFs.

Cobham's argument echoes many of the points put forward by other studies reviewed for this Helpdesk Answer. These include that IFFs accelerate the neo-patrimonialisation of politics, the redirection of funds towards unproductive activities and the deliberate undermining and criminalisation of the state apparatus.

Recent work by the OECD (2018b) conceptualises resilience as the capacity of state and societal structures to deal with systemic shocks that could potentially cause conflict. Illicit financial flows undermine this resilience and enhance fragility by producing effects (including increased inequality) that exacerbate underlying grievances (Cobham 2016; Ardigo 2014). In turn, these grievances reduce state legitimacy in the eyes of citizens, while the erosion of state capacity that facilitates IFFs also undermines state authority. In the worst-case scenario, it seems that IFFs can trigger strife that chips away at the social contract and ultimately threatens to overwhelm countries' coping mechanisms.

Indeed, in the countries furthest behind on the Sustainable Development Goals, IFFs are clearly associated with human insecurity. The 2018 World Atlas of Illicit Flows, compiled by researchers at the Global Initiative against Transnational Crime, Interpol and Norwegian Center for Global Analyses, finds that natural and environmental crimes form the largest criminal market generating IFFs in the world. The report estimates that (Nellemann et al. 2018):

- 38 per cent of all illicit flows to non-state armed actors engaging in conflict come from natural crimes (including extraction of natural resources, logging, charcoal production and so on)
- 28 per cent from narcotics
- 26 per cent from extortion, looting and protection racketeering

The study also follows the money from these criminal markets to seven violent extremist organisations, including ISIS, Al-Shabaab, Boko Haram and Hayat Tahrir al-Sham and estimates that US\$1.39 billion a year ends up in the hands of these seven organisations through IFFs. The harmful consequences, the report argues, can be felt across environmental, structural, physical, social and economic dimensions. This is to the detriment of the poorest in those regions and to the enrichment among those who benefit from the illicit and criminal activities. Criminal economies, it may therefore be argued, create both winners and losers and should therefore be seen as another IFF-enabled driver of inequality.

Conclusion

Synthesising the evidence from the literature on IFFs more broadly, it can be concluded that IFFs are associated with, firstly, negative development outcomes that are disproportionately felt by the world's poorest and, secondly, more unaccounted wealth belonging to the most wealthy.

The consequences of IFFs are multidimensional in nature. For society at large, IFFs are associated with substandard and more unequal economic outcomes, lower levels of public service provision and a more unequal tax burden. In other words, IFFs not only exclude the poorest and most marginalised groups from the benefits of economic growth and development but actively harm them, actively contributing to heightened inequality.

IFFs are also associated with a vicious and self-reinforcing cycle of state capture, neo-patrimonial governance, decline in state legitimacy and accountability, and ultimately increased fragility, criminality and conflict.

There are potential links between IFFs and inequality that have not been covered in this literature review. These include areas such as environmental damages caused by IFFs and

how they affect inequality. Gender-specific impacts have also not been covered directly. Moreover, there are a number of unanswered questions, for instance, around the links between IFFs and horizontal (or group-based) inequality.

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