

# Executive Summary

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This study quantifies and evaluates the volume and significance of illicit financial flows from Russia since 1994, the earliest year for which balance of payments data are available for the country. We use the balance of payments framework, which permits estimation of three types of capital flows—broad capital flight consisting of a mix of licit and illicit capital, legal or licit capital flight, and illicit financial flows. While the World Bank Residual (WBR) method affords a measure of broad capital flight, the net errors and omissions or the Hot Money Narrow (HMN) measure, which is part of the balance of payments, permits a sharper focus on illicit flows. Hence, we use the HMN method in line with those followed by the Central Bank of Russia and used in IMF country reports.

That said, we point out that economists have netted out inflows and outflows of capital regardless of whether they are licit or illicit. They also net out inward from outward capital flight when it comes to the WBR method. We discuss at length why a net measure is logically flawed. For example, deriving a net balance position may make sense when it comes to licit flows like FDI or recorded capital flight, netting out illicit flows makes little sense. This is because when it comes to illicit capital, flows are illicit in *both* directions and netting them out would be akin to deriving a position that corresponds to “net crime” rather than a net benefit or cost to an economy. In light of this argument, we develop estimates of net licit flows, gross illicit outflows, and broad capital flight from Russia. We also introduce the concept of total illicit flows (i.e., illicit inflows plus outflows) to examine the link between the total volume of such flows and underground economic activities in Russia.

The study finds that over the period 1994-2011, outflows consisting of a mix of licit and illicit capital from Russia amounted to US\$782.5 billion or about US\$43.5 billion per annum on average. This compares to outflows of US\$211.5 billion in illicit capital or about US\$11.8 billion per annum. These estimates include outflows due to the deliberate misinvoicing of trade. Because we do not provide estimates of broad capital flight or illicit financial flows on a net basis these estimates cannot be directly compared to those found in previous studies. Nevertheless, we present different estimates of capital flight from Russia in order to afford readers a sense of the variation in estimates, keeping in mind the differences in their underlying methodologies. While there is considerable variation in capital flight estimates, we find that CED+GER estimates are closer to the IMF’s net estimates of capital flight even though the former are on a gross outflow basis. CED estimates correspond to outflows obtained through the WBR method while GER estimates correspond to outflows due to trade misinvoicing.

An important point which emerges from a comparison of estimates is that because illicit flows are a narrower measure of capital flight, cumulative outflow estimates are typically far below any of

the other capital flight estimates for overlapping periods of study. For the period 2000-2005, our CED+GER estimates are again closer to the IMF's estimates than any other. However, for the next six-year period 2006-2011, the difference between the IMF and GFI estimates widens considerably due mainly to an increase in trade misinvoicing outflows, which are not included in the IMF estimates. In general, outflows of illicit capital of US\$14 billion per annum are around two to three times lower than broad capital flight estimates found by previous researchers. We also compare our estimates of gross illicit flows from Russia against the Central Bank of Russia's estimates of broad capital flight, which are on a net basis. Because of the netting process adopted by the CBR, its estimates are generally significantly less than estimates based on the CED+GER measure although the CBR's estimate of cumulative outflows amounting to US\$343.2 billion are significantly more than illicit outflows of US\$211.5 billion noted above.

Regarding illicit inflows, the study finds that, while inflows through the balance of payments are minimal, totaling around US\$9.9 billion over the period 1994-2011, inflows through trade misinvoicing are not. Cumulative illicit inflows through export over-invoicing (perhaps to fraudulently collect export subsidies) amounted to US\$145.8 billion while inflows through import under-invoicing (possibly driven by avoidance of customs duties) amounted to US\$397.1 billion. We strongly recommend that the Russian authorities examine more closely whether such illegal practices are undermining the government's fiscal policies (loss of revenues and increase in expenditures).

To examine the interaction between total illicit flows and the underground economy we begin by estimating the size of the underground economy using the currency demand approach. This approach estimates the difference in currency demand with and without taxes based on the assumption that higher taxes stimulate the underground economy and that the higher use of cash in that economy raises the demand for currency. Comparing the results of our estimates of the underground economy with those found in a recent study at the World Bank based on the multiple-indicators-multiple-causes (MIMIC) model, we find that over the period 1999-2007, the Bank's average estimate of 43.8 percent of official GDP from 1999 to 2007 compared favorably with our average at 46.0 percent of official GDP.<sup>2</sup>

We explain how total illicit flows and the underground economy are generated and test the link between them using macroeconomic, structural, and governance-related variables. Moreover, we found governance to be the most important driver of both illicit flows and the underground economy. The objective here was to obtain the best goodness-of-fit (indicated by the adjusted R<sup>2</sup>) with the lowest number of variables without the presence of serial correlation.

In fact, the underground economy was found to be highly significant at that level in all specifications explaining illicit flows. Using a dynamic simulation model we find evidence that *Russia's*

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<sup>2</sup> Schneider, F. Buehn, A. Montenegro, C.E. (2010). *Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007*. World Bank Policy Research Working Paper WPS5356. Washington DC: The World Bank

*underground economy both drives and is driven by gross illicit flows* confirming that, unlike licit capital, illicit flows in both directions are harmful to the economy. Under the circumstances, the question of netting illicit inflows with illicit outflows does not arise. Rather, the harmful effect of illicit flows on an economy can best be measured by the sum of inflows plus outflows.

Finally, based on our analysis of the drivers and dynamics of illicit flows, the study concludes with a range of policy measures intended to curtail their generation and cross-border transmission. These embrace the entire gamut of policies related to the domestic economy as well as policy actions that need to be taken on a bilateral and multilateral basis. Because macroeconomic instability can also drive out illicit capital, there is a need to maintain price and exchange rate stability and tax structures that are not burdensome or encourage evasion. In light of our finding that overall governance has weakened significantly in Russia, there is also a need to strengthen various aspects of governance ranging from voice and accountability to the rule of law and the control of corruption (there are six aspects to governance). Endemic misinvoicing of trade is a symptom of a weak customs administration that is perhaps in serious need of comprehensive reform. Weaknesses in customs administration were also reported by the Financial Action Task Force (FATF), which noted that such weaknesses can undermine anti-money laundering and terrorist financing efforts. *Hence, there are important and serious security aspects of weak overall governance that the authorities should heed in order to strengthen national security. The massive illicit flows from Russia and how they both drive and are driven by its huge underground economy are symptomatic of weak overall governance. Action on strengthening governance and curtailing illicit flows should therefore be accorded the highest priority by the Russian Government.*

Regarding action on the international front, we outlined (i) measures to curb abusive transfer pricing by multinationals and bilateral agreements such as (ii) Automatic Exchange of Information and (iii) Double Tax Avoidance Agreements that Russia can enter into with other countries in order to curtail tax evasion. At the same time, the Russian government could seek greater transparency and accountability of financial institutions and multinational corporations through international regulatory action under the aegis of the G-20, the G-8 and the OECD.