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PERSPECTIVE PAPER

Benefits and Costs of the IFF Targets for the Post-2015 Development Agenda

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Post-2015 Consensus

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Understanding Illicit Financial Flows

Illicit financial flows has been around as a policy issue in more or less the same form since 2005, when the publication of Raymond Baker's *Capitalism's Achilles Heel* first brought it to public prominence. What is striking is that we know little more about it than was known back then. Numbers are produced for different countries, regions and for different periods (e.g. Kar, 2012; Kar et al., 2013) but there has been minimal development of any understanding of sources, causes, directions etc. and little serious attempts at empirical falsification tests. To what extent is the phenomenon driven by tax rates and corruption levels? How important are tax havens vs. secrecy jurisdictions as destinations for the funds? These are just examples of questions for which the current analysis is almost nil.

Moreover, almost all of the existing estimates come from a single institution (Global Financial Integrity), which was set up by Raymond Baker after his book appeared. They all derive from a single methodology which relies heavily on gaps in the current national and international financial statistics. This is an inherently fragile approach, as there are many factors that contribute to these gaps, such as errors and omissions in the National Income and Product Accounts. A Google Scholar search on the term "illicit financial flows" shows no reference to the term in the mainstream economics literature and precious few items that are not from GFI or commentaries on GFI estimates, mostly by policy advocates. For better or for worse, then the available estimates are based on a single methodology from a single institution without much publicly known independent peer review. The failure of the economics profession to engage with such an important and interesting macroeconomic phenomenon is surprising, perhaps even scandalous, but that is not the subject of this commentary.

This lack of understanding has not served to deter major international bodies from making pronouncements on the phenomenon. The High Level Panel (HLP) is merely the latest to draw attention to IFFs; the recent G7 also made reference to the need to control IFFs. "We will continue to work to tackle tax evasion and illicit flows of finance, including by supporting developing countries to strengthen their taxbase and help create stable and sustainable states. We renew our commitment to deny safe haven to the proceeds of corruption, and to the recovery and return of stolen assets."[1]

However when undertaking benefit cost analysis, the limited understanding becomes a central concern. Benefit-cost analysis depends on a showing that a particular intervention produces a specific result. It requires estimates of the cost of the intervention and of the benefits (and costs) of the consequences. The state of the art on illicit financial flows is essentially pre-science. It is possible to lay out a logic model that connects various interventions, in particular the three that Cobham (2014) identifies as appropriate targets, to a reduction in illicit financial flows. However there is absolutely no empirical basis for saying whether accomplishing coverage of country-by-country reporting of, say, 50%, would reduce IFFs. Indeed, it is possible, though admittedly unlikely, that full implementation of the three policy goals will have no effect on the level of IFFs.

Setting the Objectives

Cobham does much to improve on the HLP's statement of objective: "Reduce illicit flows and tax evasion and increase stolen asset recovery by $x". As he notes, the measurement of IFFs is so crude that it would take a very large reduction indeed for the current methodology to detect it with confidence, let alone estimate its size. Standard errors are missing from the estimates, for good reason; the principal sources of error are not sampling but non-statistical elements such as the completeness of coverage of specific series such as recorded sources of funds and import and export totals.

Cobham's alternative is stated in terms of precise policy goals; attaining complete coverage of three important reporting programs that increase the transparency of the financial system both to governments (tax collectors and law enforcement) and the public; the creation of an open database of the beneficial ownership of all

[1]http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/143078.pdf

corporations and many other recorded assets, automatic exchange of tax information, country-by-country reporting of financial results by Multinational Corporations. Whereas ten years ago these goals would have seemed near fantasy, there has been real progress on all three fronts internationally. They are ambitious but not dismissable as wholly unfeasible. In particular, the speed with which the G20 and other major international for have moved to endorsement of automatic exchange of tax information is very impressive.

Learning from Anti Money Laundering Efforts

What however would be their consequences for IFFs? One way to approach this is to examine the effectiveness of the international money laundering control regime. This is a relatively well resourced and high profile effort to accomplish many of the same goals that are needed to reduce IFFs, since moving money out of a country often requires use of money laundering techniques.

The Financial Action Task Force (FATF) an OECD affiliate of 34 mostly rich nations, has promulgated a set of 40 Recommendations, far–reaching interventions into the commerce and finance of individual nations. For example, one Recommendation (23(a)) requires that lawyers and some other Designated Non-Financial Businesses or Professions report suspicious transactions, as is required of banks.[2] Recommendation 24 is that the beneficial ownership of corporations be made public, just as Cobham proposes.[3]

All but a handful of countries claim to have implemented the FATF regime. They have submitted themselves to Mutual Evaluation Reviews (MERs), either through

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[2] "Lawyers, notaries, other independent legal professionals and accountants should be required to report suspicious transactions when, on behalf of or for a client, they engage in a financial transaction in relation to the activities described in paragraph (d) of Recommendation 22. Countries are strongly encouraged to extend the reporting requirement to the rest of the professional activities of accountants, including auditing."

[3] "Transparency and beneficial ownership of legal persons *
Countries should take measures to prevent the misuse of legal persons for money laundering or terrorist financing. Countries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities. In particular, countries that have legal persons that are able to issue bearer shares or bearer share warrants, or which allow nominee shareholders or nominee directors, should take effective measures to ensure that they are not misused for money laundering or terrorist financing…."

FATF or through what are oddly titled "FATF Style Regional Bodies" (FSRBs).[4] The 3rd round of MERs, conducted between 2004 and 2012 aimed to assess the extent to which the country had implemented the 40 Recommendations in law and had created institutions to make the laws work. What is striking is that so few countries, even among those that were the progenitors of the system, such as the United States, France and the United Kingdom, had close to a perfect scorecard. For example, as Cobham notes, the U.S. is in gross violation of the beneficial ownership obligation, as states (notably Delaware and Nevada, but they are only the most egregious) readily and massively offer shell corporation services (De Willebois et al. 2011). Nor is this, by any account, a minor violation; for AML purposes ascertaining beneficial ownership is widely accepted as a key condition. A recent assessment of donor country compliance with FATF Recommendations by another branch of the OECD (2013) found that not a single country among the donors was fully Compliant with all the Recommendations on implementation of beneficial ownership registration and 37% were classified as Non Compliant.[5]

FATF is not toothless. It has the authority to put a country on a "black list", officially the list of "High risk and non-cooperative jurisdictions". For those in the highest category (in 2014 just two: Iran and the Democratic People's Republic of Korea) FATF asks " its members and other jurisdictions to apply counter-measures to protect the international financial system from the on-going and substantial money laundering and terrorist financing (ML/FT) risks emanating from the jurisdictions"[6], in other words to apply financial sanctions. Another FATF list, with four counties on it in 2014, is subject to higher scrutiny but not sanctions; this imposes high costs on financial institutions and perhaps on their customers if they are not given easy access to correspondent banking privileges elsewhere.

There is evidence that nations care about the risk that of being placed on the list. In 2000 when the first "black list" was developed, it had 15 jurisdictions on it. Some

[4] Individual MERs can be found at http://www.fatf-gafi.org/countries/

[5] A country could be Compliant, Largely Compliant, Partially Compliant or Non-Compliant for any specific Recommendation.

[6] http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/documents/public-statement-june-2014.html

countries took drastic actions to avoid being on that initial list For example, Austria, with a long tradition of anonymous accounts that facilitated tax evasion, prohibited them in 2001 in order to avoid being blacklisted. By 2006 only Burma was so listed.

The FATF regime has changed the routines of the financial sector, broadly defined, in important ways (e.g. Favarel-Garigues, Godefroy and Lascoumes, 2011). All major banks have large staffs of AML compliance officers. The documentation requirement to become or, in the case of long-standing customers, to remain a customer of a bank has become, in many countries, quite demanding. There is evidence that the major international banks are more cautious in offering correspondent banking services to banks in countries that are regarded as high risk for terrorist finance or money laundering (Economist, 2014). Other financial institutions have also adopted much more elaborate KYC rules than they did in the past and are taking ongoing monitoring of clients more seriously than in the past (though the evidence here is largely anecdotal).

Yet for all this, there is little evidence that opportunities for money laundering have been restricted. Indeed, one astonishing feature is that many major international banks flagrantly flout the regime. Put aside the sanctions violations of banks such as HSBC and BNP Paribas[7]; the sanctions against Iran, Sudan and Cuba were part of US foreign policy and at least some high bank executives in foreign capitals were explicit that they did not feel they should be tools of the foreign policy of another country. But HSBC, Wachovia (now part of Wells Fargo) and JP Morgan Chase, all leading banks, have all been caught laundering money that almost certainly came from Latin American drug dealers[8]. The Financial Services Agency in 2011 found that about three quarters of banks in the UK, most of them private banks serving wealthy customers, did not implement rules to identify Politically Exposed Persons, such as the sons of senior Nigerian officials, whose wealth might come from

[7] On HSBC see http://uk.reuters.com/article/2012/12/11/us-hsbc-probe-idUSBRE8BA05M20121211; on BNP Paribas see http://www.bloomberg.com/news/2014-07-09/bnp-paribas-pleads-guilty-in-u-s-to-violating-sanctions.html

[8] For example on JP Morgan Chase see http://www.publicintegrity.org/2013/04/30/12577/jpmorgan-chase-s-record-highlights-doubts-about-big-banks-devotion-fighting-flow
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misappropriation of publicly owned assets (Financial Services Agency, 2011,). Under FATF rules, such persons should be subject to enhanced due diligence.

What is one to make of such massive indifference to a regulatory regime which has in principle almost universal approval? Using AML to limit the ability of terrorists to finance their operations, to catch and punish major drug dealers or corrupt officials in poor countries is hardly controversial. Yet corporations that are often thought to be of the highest respectability, and to value such a reputation, chose to routinely violate the laws.

Nor do the violations by banks represent the sole way in which the AML system is being undercut. There are a multitude of methods to conceal the criminal origins of money in order to invest in the legitimate economy and thus enjoy the fruits of crime undisturbed. The Egmont Group, an association of Financial Intelligence Units, describes many of these.[9]

The AML system created by FATF thus represents an instance of a carefully designed and universally accepted legal system to control an important method of protecting the fruits of crimes such as bribe taking and tax evasion. No one can point to any evidence that the system has had its intended effects of reducing the underlying crimes. Defenders of the system might point out that no one has tried to assess the effects, in part because it is such a difficult task but that points to another problem, no one knows either the costs or the benefits of the system. The AML system certainly provides prosecutors with additional charges that enable them to bring to justice some miscreants who might otherwise be able to avoid prosecution . It also generates data bases that help investigations. However these are hardly transformative capabilities. Not even FATF dares argue that those with criminal earnings have much more difficulty in laundering them into usable legal forms.

[9] A sense of the variety of money laundering schemes can be found in a description of 100 cases collected by the Egmont Group some years ago: http://www.u4.no/recommended-reading/fius-in-action-100-cases-from-the-egmont-group/

From AML to Increased Transparency

What Cobham proposes is in effect a vast extension of the AML system, covering much more than criminally generated revenues, since it would also strike at that which is illicit (i.e. thought to be immoral), such as transfer pricing abuses, as well as illegal. What he proposes has the merit of being an apparently simpler system of controls than those aimed specifically at money laundering. AML measures are inherently complex and varied, as indicated by the Mutual Evaluation Reports, which are often 300 page documents that cover behavior of a large number of agencies; Treasury, Interior/Justice, bank regulators and insurance commissions to name just a few. There are many legal issues and the institutional arrangements necessary to make them work are elaborate.

Cobham's three proposed rules seem much easier to design, implement and monitor. As he says there has been substantial progress in some countries with respect to requiring registration of beneficial ownership and automatic exchange of information. Country-by-country reporting has not yet been adopted by any country but the European Union is moving toward imposing the requirement that corporations above a certain size provide such information.[10]

Can we assume that the three transparency requirement might be met? The AML experience is instructive. Asking a kleptocratic state to create an effective AML system is to ask the fox to create a better hen house; it is the governing political elite that benefits most substantially from the weakness of the existing system of controls. The FATF experience to date, more than a decade after it put in place the current set of Recommendations, is that nations will meet the letter of the law and regulation without creating any substantial barrier to the movement of moneys out of the country for purposes of money laundering. The experiences of Egypt and Tunisia post-Arab Spring exemplify the problem. Suddenly countries such as Britain and Switzerland were asked to track the stolen assets of the long-time leaders which

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[10] On the European Commission actions see for example. http://ec.europa.eu/internal_market/consultations/2014/extractive-forestry/index_en.htm. On country-by-country reporting generally see Murphy (2012).

were well known to have been taken out of the country [11]even though neither country was on any of FATF's warning lists.

Could the lists that Cobham proposes be so readily undercut? What monitoring systems to ensure real compliance could be put in place in countries where these were really needed?

Benefit-Cost Analysis

Cobham adopts an apparently conservative strategy to estimate the benefit cost ratios for implementing the beneficial ownership recommendation. He uses high end estimates of costs and deliberately cautious estimates of the reductions in IFFs, as low as 10%. He also uses a very limited assessment of the benefits of reducing IFFs, ignoring for example the indirect effects on the quality of government. The lowest BCR generated by this is 13 and many other estimates are in the order of hundreds or even the low thousands.

Yet these calculations involve a very bold and unarticulated assumption, namely that the implementation of the beneficial ownership disclosure requirement will reduce IFFs. The experience with AML regulations surely provides cautions here. There are two relevant questions: (1) can the spirit of the regulations be subverted when the letter of the law is met and (2) even if the transparency measures are properly implemented, are there easy ways to work around the regulations so as to move money out of developing countries through other mechanisms?

The ways in which the spirit of beneficial ownership registration requirements can be subverted has been subject to a good deal of legal analysis in the United States and Britain (e.g. Verret, 2010). Illustrative of the problem in a global economy is the need for local jurisdictions to verify the identity documents of foreign nationals, involving not just language difficulties but also establishing the authenticity of the foreign identity document itself.

[11] See for example http://www.theguardian.com/world/2012/sep/02/scandal-mubarak-regime-millions-assets-uk

For the second question there is a good deal known. The variety of ways in which money is moved across countries has already been mentioned. Informal value transfer systems, the best known of which is hawalas, allow for the unobserved movement of funds across borders (to the extent that funds actually move rather than transactions netted out); though hawalas do not exist in every country, IVTS are quite common (FATF, 2013). It is clear that substantial sums are moved simply by carrying cash across borders, though most countries require travelers to declare if they have more than $10,000 in currency. Trade mis-invoicing is also not prevented by the transparency measures being proposed.

Note however, crime displacement turns out to be far less complete and ubiquitous than expected (Bowers et al., 2011). Douglas Fastow, the comptroller of Enron, moved money to offshore accounts in secrecy jurisdictions under cover of normal activities of large corporations; other modes of moving the money overseas might have been substantially less convenient. Moreover, studies in the Netherlands (van Duyne and Levi, 2005) show that drug dealers are highly conventional in the ways they conceal their assets. Though there is no supporting analysis, the former Nigerian anti-corruption chief claims that once he established that the UK was a perilous location for stolen assets of Nigerian origin, Nigerian kleptocrats brought much of their wealth back to Nigeria, perhaps being uncomfortable with jurisdictions that they did not know so well (Ribadu, 2011). It is important to examine the question of displacement in response to the closing of various channels for moving illicit money out of developing countries with an open mind.

Concluding Comments

The purpose of this comment has been to express skepticism about the plausibility of Cobham's estimates of the benefits and BCR of implementing a set of measures aimed at IFFs. It is not a claim that IFFs are a poor target or that there might not be substantial gains from improving the broadly defined transparency of the international financial system. Instead it is an argument that we need to know more about both the phenomenon itself and about the effects of different interventions. There simply are too many leaps of faith at the moment for this to be high on the list of recommendations for meeting the development challenges of the next 15 years.

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This paper was written by Peter Reuter, Professor at University of Maryland. The project brings together more than 50 top economists, NGOs, international agencies and businesses to identify the goals with the greatest benefit-to-cost ratio for the next set of UN development goals.

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