

Commentaire

Hiver 2008-2009

Volume 31/Numéro 124

« Il n'y a pas de bonheur sans liberté, ni de liberté sans vaillance », Thucydide

THE ISSUE OF ILLICIT FINANCIAL FLOWS

By Raymond Baker and Eva Joly

The role and importance of illicit financial flows are poorly defined and not well understood. Yet, a large part of the proceeds of cross-border crime and corruption and a significant portion of international trade and capital movements transit through tax havens, secrecy jurisdictions, and other elements of a global illicit financial structure. This structure assures the opacity necessary to enable circumvention of laws, regulations, and norms in both industrialized and developing countries.

The Quantitative Bias

In many ways this reality is the end product of the split in political economy that arose across the last century. The framework for political economy was laid out by, among others, Adam Smith and Jacques Turgot in the 1700s. William Stanley Jevons at Manchester produced *The Theory of Political Economy* in 1871, and Henry Sedgwick at Cambridge continued with *Principles of Political Economy* in 1883. Sedgwick's pupil Alfred Marshall at Cambridge marked the shift toward pure economy with *Principles of Economics* in 1890, and his successor Arthur Cecil Pigou followed with *The Economics of Welfare* in 1920. Thus economics began to carve out its place as a separate discipline from the realm of political theory. While sophisticated analytical techniques remained to be developed, Pigou envisioned the future: "[T]he range of our inquiries becomes restricted to that part of social welfare that can be [correlated to] the measuring rod of money."¹

Following the dominance of the Cambridge school and in particular after World War II, preeminence in economics shifted to the United States and became almost wholly mathematized. Paul Samuelson, Kenneth Arrow, Robert Solow, and others marked the transformation of economics into a highly technical regimen characterized today by theorems, proofs, statistics, and testing of hypothesis. Econometrics is the highest order of sophistication on the field's intellectual scale. Nontechnical approaches to the subject are shunned.

This comes at a price. The quantitative bias of the discipline essentially rules out serious treatment of aspects of the subject that cannot be readily measured. Corruption, money laundering, illicit financial flows—huge realities—are notoriously difficult to assess and have accordingly been given inadequate treatment in the professional literature. The paucity of reliable data on these overarching problems means that economists interested in what is happening around the world have missed a large swath of everyday practice.

Alan Blinder at Princeton University recognizes this shortcoming in his field and sums it up nicely:

Economic science cannot afford the luxury of intellectual purity; our theories are simply not that good. Economics should not be as insular and self-referential as parts of it have unfortunately become—because the source of both ideas and observations is (or should be) the crass real world. . . . I lament the loss of worldliness.²

Paul Krugman, another economist and *New York Times* columnist, says that he has come to understand “. . . the remarkable extent to which the methodology of economics creates blind spots. We just don’t see what we can’t model.”³

The separation of economics from political science and the scrupulous organization of economics around credible and testable data contributed to creating a vacuum that fostered the rise of an integrated financial structure facilitating transfers of illegitimate money. Inadequately understood by political scientists and essentially unexamined by professional economists, this structure attracts and shifts trillions of dollars, undermining security and growth.

Global Illicit Financial Structure

Money that breaks laws qualifies for the term “illicit.” If it is illegally earned, transferred, or utilized it merits the label. Cross-border illicit financial movements are originated in one of three ways, as the proceeds of i) bribery and theft, ii) criminal activities including drug trading, racketeering, and terrorist financing, and iii) commercial tax evasion and trade mispricing.

Beginning in the 1960s (coincident with the quantification of economics based on modeling of collectable data) a multifaceted structure has been created to handle the movement of illicit money. Minor parts of this structure were available earlier, but the 1960s marked the takeoff point for two reasons. First, it was the decade of independence. From the late 1950s through the end of the 1960s, 48 countries gained their independence from colonial powers. Many of the political and economic elites in these countries, sometimes influenced by risks attendant to the Cold War, wanted to take money out by any means possible, and the West serviced this desire with creative arrangements for capital flight. Second, the sixties marked the spread of multinational corporations. Prior to then an international oil or trading company might have operations in 12 or 15 foreign locales. But from the 1960s forward, multinational corporations widened their presence to hundreds of locations across the globe, frequently utilizing aggressive tax evading techniques in head offices, subsidiaries, and branches. Thus, decolonization and the worldwide reach of corporations propelled the expansion of the global financial structure catering to shifts of illegally generated money.

This structure now comprises a number of elements:

Tax havens, charging little or no tax on accumulated profits derived from transactions beginning and ending elsewhere. There are now 91 tax havens around the world, multiplying from only some four or five in the 1950s.

Secrecy jurisdictions, allowing entities that accumulate such profits to be masked behind nominees and trustees so that beneficial ownership is unregistered and inaccessible. Such secrecy is available for purchase in most tax havens.

Disguised corporations, now in the millions across the globe, kept from view by nominees for hire.

Redomiciliation provisions, authorizing nominees to relocate disguised entities from one secrecy jurisdiction to another in the event of inquiries attempting to determine beneficial ownership.

Anonymous trust accounts, also protected by trustees and able to function in many ways as corporations.

Fake foundations, receiving and disbursing money behind a supposed benign façade.

Falsified pricing in trade transactions, by far the major instrument in the illicit financial structure, usually accomplished by underpricing exports and overpricing imports.

Money laundering techniques, taking in illegitimate funds at one end and giving them the appearance of legitimacy at the other end.

Holes left in laws and enforcement efforts of Western countries, facilitating the movement of money through the accommodating financial structure and ultimately into Western economies.

Falsified pricing, usually referred to as abusive transfer pricing, has become normalized in international trade. Whether within multinational corporations or between collusive unrelated parties, a decision is made to add or subtract, say, 15 percent to normal pricing for the purpose of creating an amount that cannot easily be seen but which serves to evade taxes or shift capital across borders. Such mispricing is done in one of two ways. The invoice from the exporter is sent to a tax haven entity where it is rewritten with the 15 percent pricing anomaly included, and then the new invoice is forwarded on to the importer. This type of mispricing can be seen in Direction of Trade Statistics compiled by the International Monetary Fund but seldom analyzed. Alternatively, mispricing can occur within the invoice sent directly by the exporter to the importer after they have agreed to the 15 percent mispricing and disposition of the anomalous amount upon completion of the transaction. This form of mispricing is invisible in Direction of Trade Statistics but can be detected by comparing major and consistent deviations from normal world market prices. By either means, such mispricing usually violates tax laws in the country from which money is being surreptitiously withdrawn. Multinational corporations in particular, supported by major accounting firms, utilize such mispricing in managing trillions of dollars of global trade.

Tax havens and secrecy jurisdictions together create the space in which these and other clandestine mechanisms are used to shift unseen and unrecorded proceeds across borders. Their operations are characterized by two features. First, legislation is adopted permitting transactions conducted “offshore,”

which have no content within the haven itself, to be passed through the tax haven with little or usually no taxes thereon. Such legislation enables circumvention of regulations that would affect transactions conducted directly between buying and selling countries. Second, a network of company agents, accountants, bankers, and lawyers creates the disguised corporations, trust accounts, and foundations through which transactions are routed. Designating themselves as an “offshore financial center,” they earn fees for fronting on behalf of beneficial owners. The combination of low or no taxes, little or no financial reporting requirements, lax regulation, and well defended secrecy attracts trillions of dollars into such jurisdictions, functioning ostensibly as cleansing operations before the accumulated money is transmitted on into usually Western economies.

Various tax havens and secrecy jurisdictions cater to particular market niches. Serving largely geographical needs, Jersey provides an entrée into the London market, Panama the U.S. market, and Vanuatu the Australian market. Mauritius is a channel for investments into India, Cyprus is a preferred Russian money laundering center, and the British Virgin Islands have become especially favored by Chinese shifting the proceeds of flight capital in and out of their home country. Providing the highest level of impenetrability are Liechtenstein, Singapore, Dubai, and the Turks and Cacaos Islands. Bermuda and Guernsey accommodate billions in reinsurance funds with favorable tax treatment. Cayman Islands, with liquid external assets approaching \$2 trillion, is home to more than 10,000 collective investment schemes such as hedge funds.⁴ Serving high net worth individuals, Switzerland and London excel, along with New York directing transactions through more than 20 Caribbean havens.⁵

Western efforts to address illicit financial flows are quite inadequate, characterized by gaps in preventive laws and poorly enforced anti-money laundering regimes. The United States, for example, bars only the incoming proceeds of drugs, terrorist financing, bribery and theft by foreign government officials, and bank fraud. Not covered under “specified unlawful activities” are proceeds generated abroad from handling stolen property, counterfeiting, contraband, slave trading, alien smuggling, trafficking in women, environmental crimes, tax evading money, and more. Most European nations designate knowingly dealing with the proceeds of “major crimes” a money laundering offense, although major crimes differ substantially across EU member nations. Several years ago, U.S. Treasury Department officials reckoned that 99.9 percent of the money U.S. law seeks to block instead gets easily deposited on first presentation. Swiss and German officials suggested similar percentages for their nations. Quite simply, no Western nation provides a strong wall between ill-gotten gains and its financial institutions. As a result, all three forms of illicit money—criminal, corrupt, and commercially tax evading—use the same financial structure to shift across borders.

Unseen Trillions

That cross-border illicit financial flows are largely hidden and difficult to measure does not detract from their reality. In fact, estimates are reasonably well clustered in a range of \$1 trillion to \$3 trillion annually. The World Bank quotes figures of \$1 trillion to \$1.6 trillion annually, of which half—\$500 to \$800 billion a year—is estimated to come out of developing countries.⁶ John Walker, an Australian criminologist, puts his figure for global money laundering at \$3 trillion annually.⁷ Friedrich Schneider, an Austrian economist, puts yearly money laundering in just 20 OECD countries at \$600 billion annually, suggestive of much higher figures for the world.⁸ An ongoing study by Global Financial Integrity in Washington, DC, utilizing IMF Direction of Trade Statistics and the World Bank Residual Method, is indicating illegal drainages out

of developing countries at some \$800 billion annually.⁹ While analytical techniques vary and available data sets have limitations, these results are, surprisingly, within a fairly narrow range.

The OECD finds that some 60 percent of international trade is conducted within multinational corporations, buying from and selling to their own subsidiaries and branches. Other researchers including Ronan P. Palan figure that 80 percent of international banking is done through offshore arrangements.¹⁰ While these numbers are in the tens of trillions of dollars, the illicit component is that portion which is mispriced or misidentified for the purpose of evading taxes or shifting capital, amounting to hundreds of billions of dollars annually.

The antics of kleptocrats such as Mobutu of the Congo, Suharto of Indonesia, Marcos of the Philippines, Abacha of Nigeria, and others grab media attention. Cross-border stolen money generated by corrupt government officials is about three percent of the global total and contributes to stimulating other forms of unlawful behavior. The criminal component arising from drugs, racketeering, and terrorist financing is about 30 to 35 percent of the total. By far the largest part of the problem is the commercial component, at some 60 to 65 percent of the global total.

There is a reason why this is so. Trade mispricing provides the only mechanism for moving money out of a country where no one else in the country needs to be aware of the shift of wealth. All that is required is a willing buyer and a willing seller agreeing to the mispricing arrangement, usually verbally, whether in arms length or related party transactions. Every other mechanism requires someone else in the country from which money is being withdrawn to be aware of the transaction, even if unclear as to its intent. With over- and under-invoicing, agreed mispricing percentages are simply included in invoiced amounts, almost always accomplished without raising suspicion.

If the World Bank figure of \$500 to \$800 billion a year passing out of developing countries is a reasonable approximation, consider the magnitude of what has been shifted from poor to rich across the decades. Illegal flight capital from needy nations has been evident for a half century. Just the most recent ten years suggests an outflow of \$5 to \$8 trillion. With multiple decades, the figures become truly staggering.

The motivation for shifting illicit money is the hidden accumulation of wealth, and what powers this phenomenon is secrecy. For individuals, it is about amassing and shielding riches. For multinational corporations it is about concealing profits from country tax collectors. And with the enormous, integrated financial structure expediting this cross-border repositioning, the problem is growing, not declining.

Consequences: Security

Any thorough cost-benefit analysis will show that illicit financial flows come at a heavy price to global security. The structure that welcomes such funds makes the drug problem virtually insolvable. Eradication of crops and seizures at borders have failed to change the economics of the crime. Drug dealers are concerned with the end game—getting their illegitimate gains finally into the legitimate financial system. Beginning in the late 1960s and 1970s, they stepped into the illicit financial structure and were immediately and almost always successful in laundering their proceeds. Curtailing drug trafficking was the reason the G-7 meeting in 1989 authorized establishment of the Financial Action Task Force in Paris to coordinate anti-money

laundering policies. Now nearly 20 years on, if AML efforts should have worked anywhere it is on the drug trade. Yet supply has not been cut and prices are largely stable, except in Europe where soaring demand has elevated trafficker's receipts.

Seeing how easily drug dealers accomplished their money laundering, other types of racketeers stepped into the same mechanisms in the 1980s and 1990s. Counterfeiting of pharmaceuticals, cigarettes, software, CDs, and brand-name consumer goods is the second biggest type of global crime. Alien smuggling and trafficking in women now move some 800,000 people a year across borders, often utilizing the same paths and networks as drug dealers. Other forms of smuggling—arms, endangered species, tropical woods, gold, gems, antiquities—add tens of billions of dollars to the annual toll of felonious financial movements.

Al Qaeda was funded by way of the illicit financial structure. An estimated \$30 to \$50 million a year passed through fake foundations, disguised corporations, and bankers cowering in tax havens during the decade prior to 9/11. Hezbollah has engaged in cigarette smuggling in the United States and diamond smuggling in West Africa. Hamas is active in crime and money laundering in the tri-border region of Latin America where Brazil, Argentina, and Paraguay meet. The Iranian Revolutionary Guard is suspected of extensive smuggling activities.

Iraq is especially noteworthy. Approximately \$10 billion in illegally amassed funds passed into Saddam Hussein's control during the decade after the first Persian Gulf War ended in 1991, via the Oil-for-Food scandal, smuggling, and kickbacks on trade transactions. This and earlier illicitly accumulated funds allowed the rebuilding of his arms and munitions and led the United States, Britain, and others to believe that he had the capability to acquire weapons of mass destruction. Military groups are often stunned to realize that, if it were not for this \$10 billion plus that refinanced Saddam through the illicit financial structure, Western forces might not be in Iraq today.

A. Q. Khan, the Pakistani nuclear scientist, used the same structure to operate his network across the continents. Buying and selling nuclear materials and components, dealing with European corporations, North Korean, Iranian, and Libyan government officials, Dubai middlemen, and a string of cooperating bankers, he contributed more to nuclear proliferation than any other individual, with the cost of his perfidy still to be reckoned.

No new money laundering mechanisms or secrecy arrangements were invented by drug kingpins, criminal syndicate heads, or terrorist organizers. They merely stepped into the channels earlier created in the West for moving flight capital and tax evading money across borders.

Consequences: Economic Development

Through the 1990s and into the current decade, overseas development assistance has been running about \$50 to \$80 billion a year from all sources, bilateral and multilateral. It has edged up over the last three years, partly as a result of adding debt forgiveness to aid totals. Compare \$50 to \$80 billion of aid into poorer countries to the estimated \$500 to \$800 billion of illegal flight capital out of poorer countries. In other words, for every \$1 generously handed out across the top of the table, the West has been receiving back up to \$10 under the table.

Russia has experienced what is probably the greatest theft of resources ever to occur in a short period of time, some \$200 to \$500 billion since the early 1990s. Almost all of this was accomplished by underpricing exports of oil, gas, diamonds, gold, tin, zinc, nickel, timber, and other resources. Oil was sold abroad for as little as \$10 a metric tonne, with the balance of the real value accumulating in European and American bank accounts of the oligarchs.

China has experienced a similar drainage, again accomplished with underpricing of exports of, at first, consumer goods and now a widening range of technology manufactures. Recent “round tripping” of funds is flight capital that had previously gone out returning in anticipation of a yuan devaluation. China’s extraordinary growth rate has also produced what is likely the fastest separation between rich and poor ever seen, with attendant risks for the nation’s future stability.

Nigeria has probably had the highest percentage of its gross domestic product stolen and deposited externally of any major country. Up to \$400 billion is believed lost due to corruption, with \$100 billion shifted out of the country. Of the population of about 150 million, some 100 million live on \$1 to \$2 a day. Unrest in the poverty-ridden Niger Delta is so severe that oil production has dropped from 2.5 million to 1.8 million barrels a day.

Congo has experienced the longest exploitation of any country. The only colony owned by an individual, King Leopold of Belgium from 1885 to 1905 and thereafter administered by the Belgian government until independence in 1960, Congo is today still being looted through underpricing and smuggling of copper, gold, silver, diamonds, cobalt, tin, tungsten, zinc, uranium, lead, coal, iron ore, and more. Congo’s situation is unchanged since a council of prelates in 1980 described commerce in their country as “le pillage organisé au profit de l’étranger et de ses relais.”¹¹ The fierce competition for plunder contributes to an estimated five million deaths above normal mortality rates in eastern Congo over the past decade, the heaviest toll in this new century. In 2006, Congo’s officially reported output from its huge and diversified mining sector was less than \$1 million. Compare this to a nation such as Norway, which in the same year had petroleum exports alone of €63.88 billion.

Venezuela’s state-owned oil company *Petróleos de Venezuela, S.A.* has abused transfer pricing to shift enormous wealth offshore. Crude oil is underpriced and sold to its 23 foreign refineries, which produce petrol and other products sold at normal prices, with profits thereon largely kept outside the country. Hugo Chavez is now on his sixth managing director as he attempts to wrest control of the state’s principal provider, while at the same time running a government as corrupt as its predecessors.

By far the greater portion of illicit financial flows from developing countries constitutes a permanent outward transfer, upwards of 80 to 90 percent. The small percentage that may come back into countries of origin almost always does so as FDI—foreign direct investment. In other words, while domiciled externally the money acquires a foreign nationality as a corporation, trust fund, or other account and returns with that foreign identification, of course intending to go out again as dividends on share investments or principal and interest on loan investments.

The estimated \$500 to \$800 billion a year of illicit money passing out of developing countries is the most damaging economic condition hurting the poor. It drains hard currency reserves, increases inflation, reduces tax collection, widens income gaps, forestalls investment, stifles competition, and undercuts free trade.

The community of development experts has failed to ask the right questions, has failed to put the whole of the financial equation for development on the table. However such an equation is formulated, it must include total capital in, total capital out, what is left over. Until this is incorporated into development thinking, aid will continue to be an underachieving effort offset by a larger counterforce undermining aid's potential for good. Nothing else so impedes poverty alleviation and economic growth for scores of nations as massive shifts of illicit wealth permanently abroad. This reality may finally come to be seen as an affront to human consciousness on a par with slavery two centuries earlier.

Consequences: Human Rights

The Universal Declaration of Human Rights adopted by the United Nations in 1948 proclaims that "Everyone has the right to a standard of living adequate for the health and well being of himself and of his family, including food, clothing, housing and medical care and necessary social services" No part of the Declaration has been more consistently violated than this. Today, there are more people living on \$1 to \$2 a day than constituted the whole of the world's population in 1948.

For 60 years the human rights community has focused on deprivations of civil and political rights, producing thousands of studies and reports from every corner of the globe. This has led to the concept of a "responsibility to protect"—R2P, the responsibility of the global community to intervene, despite sovereignty, in situations of gross violations of civil and political rights. Hotly debated in the UN and elsewhere, R2P has yet to produce a willingness to forcefully address obvious violations in, for example, Darfur and Zimbabwe.

Perhaps the uphill battle for small gains explains why many activists argue that the human rights movement cannot be all things to all people and should not dilute its efforts by taking on another aspect of human rights concerns—economic deprivation. But skirting this agenda leaves a gaping hole in the human rights movement.

Thomas Pogge, a philosopher at Yale University, and Sanjay Reddy, an economist at Barnard College, estimate that 18 million people a year die of economic deprivation and of causes directly stemming from such deprivation. If correct or even remotely approximate, then economic deprivation kills far more people than all other forms of human rights violations combined.

In recent years some human rights groups have begun to address corruption as a rights issue, among them Global Witness, Human Rights Watch, Christian Aid, Action Aid-UK, and Open Society Initiative. The environmental group Greenpeace's recent report on "Conning the Congo" is an example, criticizing a Swiss-based logging group for "using an elaborate profit laundering system designed to move income out of Africa and into offshore bank accounts."¹²

How do you protect human rights in an economy that cannot afford to defend human rights? It is to this question and this issue that the human rights community needs to turn its attention.

Consequences: Democratic-Capitalist System

There is a grand bargain in the linkage of democracy and capitalism. Democracy offers an equal measure of political liberty to its people. Capitalism is expected to offer a fair measure of economic opportunity and economic prosperity to its people. Globally, capitalism has not been holding up its end of the bargain, has not done an adequate job of spreading the benefits of development to all.

Capitalism works best where the disparity between rich and poor is within a fairly reasonable range. When ranked in quintiles—20 percent groupings—this range between top and bottom quintiles is about 3 to 1 up to perhaps 10 to 1. Japan is about 3.5 to 1, most European countries are 5, 6, or 7 to 1, and the United States is 8.5 to 1. Globally, the disparity ratio is 30 to 1 between top and bottom quintiles and has remained very close to this level for a decade. Growth in China and India has reduced the ranks of those living below poverty lines but has not affected worldwide quintile separation. Ultimately, it is massive disparity coupled with lingering poverty that poses capitalism's greatest challenge.

Two major forces are at work in the world economy. One is globalization pushing capital and trade into developing countries. The other is the illicit financial structure, pulling money out of those countries back into Western coffers. Comparing foreign direct investment inflows to illicit financial outflows, there is, on this basis, little question which is the more powerful force—the one shifting money into, principally, North America and Europe.

There is a third wave that needs to be recognized. The secretive financial system contributes to the shift of taxes off of capital and onto labor. This assures rising incomes for the wealthy and visibly stagnating incomes for the middle class. Income disparity within countries, rich and poor nations alike, is growing, a process that cannot long continue without generating strong voter discontent.

Political analysts have largely missed how a capitalist system increasingly operating outside the rule of law affects the ability to spread the rule of law. The idea that we can, on one hand, extend democracy while, on the other hand, beggar the poor is unworkable. Harmony within our chosen economic system requires that capitalism move closer to democracy's commitment to justice, transparency, and the rule of law rather than democracy moving closer to capitalism's secrecy and disequilibrium.

The Way Forward

Given the extraordinary range of consequences stemming from illicit financial flows, can anything be done? Two points toward this end are fundamental. First, the goal is to curtail this activity, not to try to stop it. Stopping it would be impossible and the effort required excessive. Substantially curtailing the problem is within reach. Second, what is required is political will. This is important to understand because some argue that curtailing illicit transfers is an effort of extreme complexity. It is not; it is a matter of selected and straightforward steps broadly adopted and consistently applied.

The European Union Savings Tax Directive is a model for information distribution across jurisdictions. It requires automatically shared tax information between 24 countries and phased in cooperation by Austria, Belgium, and Luxembourg. Ten overseas territories associated with the UK and the Netherlands are participating. Currently, the agreement requires reporting of payments to individuals of interest earned on deposits, corporate and government bonds, negotiable debt securities, and investment funds. Under discussion is extension of coverage to corporations, shell companies, trusts, and foundations, and expansion of what is reported to include dividends, realized capital gains, income from pensions and insurance, and interest on other types of bonds. Annual reporting of such earnings will go a long way toward curtailing tax evasion by citizens and corporations in EU member states. The same automatic sharing of information should become the global norm, even for developing countries which may not yet have the capacity to use such information but will steadily improve their capability.

The European Economic and Monetary Affairs Committee of the EU Parliament has approved a proposal to require country-by-country reporting of profits by corporations operating in the EU. Corporations currently compile these figures for internal control but do not report such information to state regulators. Country-by-country accounting for revenues, costs, and profits is thus of no burden to corporations but hugely beneficial to tax authorities and goes far toward reducing the usefulness of tax havens. The UN Conference on Trade and Development supports the proposal.

Financial institutions should be required to know the beneficial owners of every entity with which they do business, going past proffered nominees and trustees to the names of individuals or publically quoted parent companies. The U.S.A. Patriot Act took such a step regarding foreign shell banks operating behind cloaks of secrecy. It required that no U.S. financial institution could receive money from a foreign shell bank, no other financial institution anywhere in the world could send money to the United States that had been received from a foreign shell bank, and that even wire transfers of such funds momentarily touching New York City correspondent banking accounts before speeding off elsewhere were barred. In other words, with a stroke of the legislative pen, the threat posed by foreign shell banks has been removed from the global financial structure.

In the United States, Senator Charles Grassley (Republican, Iowa) has offered a bill that would eliminate all the holes in U.S. anti-money laundering law mentioned earlier. It does so by specifying simply that it is a felony offense to knowingly handle the proceeds of a crime, including tax evasion, whether committed in the United States or similarly abroad. Senator Carl Levin (Democrat, Michigan) and other endorsers have offered a tax haven abuse act aimed at substantially curtailing tax evasion by U.S. citizens and corporations. At first somewhat behind Europe, momentum is now building in the United States to tackle these issues.

A step available to developing countries to curtail abusive transfer pricing is, simply, two signatures. On the standardized commercial invoice form covering foreign trade, importers and exporters each sign a paragraph confirming that prices accord to world market norms, constitute no violations of anti-money laundering laws anywhere, and contain no element of mispricing for the purpose of manipulating customs duties, VAT taxes, or income taxes in the exporting or importing countries or jurisdictions through which the transaction passes. Multinational corporations will not likely ask employees to sign such a statement if patently false. With two signatures, the bulk of abusive transfer pricing can be curtailed by developing countries acting

independently in their own interest, a step recently recommended, for example, to the Democratic Republic of the Congo.

Countries with adequate banking sectors but severe transfer pricing problems, such as Russia, can require imports and exports above a certain value to be covered by confirmed, irrevocable letters of credit containing a provision that 100 percent of export proceeds must be remitted by the importer's bank to the exporter's bank. Such letters of credit can likewise task banks to verify prices on invoices, as is now required in the United States under standards set by the Federal Financial Institutions Examination Council.

For the World Bank it is imperative that the whole of the financial equation for economic development be placed on its analytical and action agenda. Illicit outflows from developing countries undermine the Bank's ability to meet its mission of reducing poverty and promoting growth. Cutting the illicit drainage by even 25 percent, a modest goal, would leave more money in poor countries than the total of overseas development assistance provided by rich country donors. Far greater than a 25 percent reduction in such outflows is readily within the realm of political will.

Recent scandals are widening the perception that illegal, hidden dealings are burdening the global economy with huge costs. Enron, WorldCom, and Parmalat; Liechtenstein and UBS involvement in tax evasion; Elf Aquitaine and alleged BAE Systems corruption cases; unseen drivers of the subprime mortgage crisis and rising fuel and food costs— these and many more confirm the destructive role played by a structure secreting trillions of dollars from accountability. But the growing perception is not yet matched with the political will to act.

Neo-classical economics posits three requirements for optimal operation of free markets—equal access to capital, equal access to market outlets, and equal availability of perfect information. The illicit financial structure undercuts all three. Corporations and individuals operating through tax havens and secrecy jurisdictions i) acquire tax-minimized capital at lower cost, ii) obtain access to markets at preferential prices compared to smaller competitors, and iii) secretly restrict access to information necessary for informed free-market operation. The largest and wealthiest corporations and individuals prosper at the expense of the middle class and poor, driving income disparity and hurting democracy itself.

The solution is straightforward: Substitute rule of law for subversion of law; substitute transparency for secrecy.

A Systemic Problem

Illicit financial flows; a global structure facilitating such flows; much of international trade and capital utilizing such structures; drug dealers, racketeers, and terrorists using the same channels to shift their money; consequences to the security of nations and the stability of the world economy— these realities present us with a systemic problem, a problem confronting the democratic-capitalist system. It is not a problem that can be left to treasury officials, corruption fighters, the corporate social responsibility movement, or human rights advocates. This is an issue requiring the attention of governments and private sectors in every nation. Cleaning up the global financial system is a matter of the first order of importance in 21st century political economy.

-
- ¹ Arthur C. Pigou, *The Economics of Welfare*, 4th ed., (London: Macmillan, 1932), 23.
- ² Alan S. Blinder, "Economics Becomes a Science—Or Does It?," Princeton University Center for Economic Policy Studies working paper no. 57 (June 1999), 3, 8.
- ³ David Warsh, *Knowledge and the Wealth of Nations: A Story of Economic Discovery*, (New York: W.W. Norton & Company 2006), 186.
- ⁴ Cayman Islands Monetary Authority, "Regulatory Framework: Statistics," (June 2008), www.cimoney.com.ky/section/regulatoryframework/sub/default.aspx?section=PD&i.
- ⁵ Tax Justice Network UK and Richard Murphy, "Tax Havens: Creating Turmoil," (2008), 24.
- ⁶ World Bank, "Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan," (2007), 1, 9.
- ⁷ John Walker, "How Big is Global Money Laundering," *Journal of Money Laundering Control*, Vol. 3, Issue 1 (1999), 25-37, updated by author 2008.
- ⁸ Friedrich Schneider "Money Laundering and Financial Means of Organized Crime: Some Preliminary Empirical Findings," Johannes Kepler University of Linz working paper (July 2008), 24.
- ⁹ Global Financial Integrity, "Mapping the Fault Lines," (Washington, DC), forthcoming.
- ¹⁰ R. Palan, R. Murphy, and C. Chavagneux, *Tax Havens at the Heart of Globalisation*, (Ithaca: Cornell University Press), forthcoming.
- ¹¹ *Le Monde*, "L'épiscopat dénonce les injustices sociales," (July 28, 1981), 4.
- ¹² Greenpeace International, "Conning the Congo," (July 2008), 2.