Stanching the Flow
Developing Countries and Ill-Gotten Gains

BY RICHARD MESSICK AND PETER REUTER
The Arab Spring revealed how easy it is for the autocrats of the developing world to rob their countries blind and squirrel the gains away in Western financial institutions.

Egypt’s Hosni Mubarak, his family and associates reportedly socked away millions – if not billions – in banks in Britain, Switzerland, Lebanon, Dubai and the United States. The late Muammar el-Qaddafi deployed an army of mostly Western “investment advisors” to stuff Libya’s oil revenues into accounts that he and his sons treated as little more than personal piggy banks. And though the ex-Tunisian president, Zine el-Abidine Ben Ali, agreed in July to surrender some $60 million that Swiss authorities found rattling around in their bank vaults, he is in little danger – thanks to what are said to be billions more stashed elsewhere – of becoming a public charge during his enforced retirement in Saudi Arabia.

While these rulers and many others amassed incredibly large fortunes – Sani Abacha in Nigeria, Alberto Fujimori in Peru, Ferdinand Marcos in the Philippines and Mobutu Sese Seko in Zaire come to mind – the development community was wrestling with the problem of how to finance development assistance. For years, estimates of what is needed to support health, education, infrastructure and the other critical components of growth in poor countries have exceeded what the developed world was willing to provide. And as the kleptocrats have fallen, one solution to the development-finance gap has become all the more obvious: stanch the outflow of illicit funds and repatriate what has escaped.

Although the grand corruption of the Mubaraks and Mobutus of the world gets most of the media attention, corruption is only one activity that produces the torrent. Falsifying trade invoices to evade customs, taxes and capital-control laws is another. A third includes trafficking in narcotics, counterfeit goods and human beings. Finally, schemes by multinational corporations to escape taxes levied by developing states probably cost billions. Indeed, they may account for the largest share of surreptitious outflows.

The flood of escaping money has been dubbed (illicit) financial flows, rather than illegal financial flows, because tax avoidance comes in two forms: outright criminal evasion – for example, by failing to report income – and various types of tax planning. As Americans were reminded during the presidential campaign, arranging one’s affairs to minimize taxes is perfectly legal. But not all legal tax planning has been created equal. When a battalion of accountants and tax specialists rely on the ignorance or understaffing of an impoverished country’s tax authority to stretch the law to the edge, they may have room to claim that what they do is legal. But they cannot deny that it merits the opprobrium “illicit.”

HOW MUCH FLOWS OUT?

Raymond Baker, now director of Global Financial Integrity, a Washington-based nonprofit organization, was the first to take a stab at a number. In his 2005 book, *Capitalism’s Achilles Heel: Dirty Money and How to Renew*
the Free Market System, he put the total outflow at somewhere between $540 billion and $780 billion annually. Baker drew on his own experience in business, as well as interviews with executives from both the developed and developing worlds. More recently, researchers at his institute (using admittedly heroic assumptions) have put the figure at closer to $1 trillion. These figures are startlingly high, dwarfing the roughly $100 billion in official development assistance that developing countries receive annually.

Global Financial Integrity staff members agree that better numbers are likely to come only with painstaking work at the country level. They are now working—as are researchers from the World Bank, the OECD and the United Nations Economic Commission for Africa—to come up with more precise estimates. Yet, despite the importance of the issue for development and the attention it has garnered from policymakers around the globe, academic researchers have paid it scant attention. Indeed, Draining Development? is, to our knowledge, the only academic treatise on the subject.

HOW IT LEAVES
It’s not hard to move illicit cash across borders; much of it travels without the slightest subterfuge. Sani Abacha simply ordered Nigeria’s central bank to wire money in multi-million dollar chunks to his personal accounts—a twist on the technique of Haiti’s Jean-Claude Duvalier, who wrote checks against the central bank as if it were his own private bank. For those without a central bank ready to do their bidding, there are hawalas—informal, trust-based networks that move large sums outside the regulated financial sector in much the way that letters of credit facilitated transfers through correspondent private banks in earlier centuries.

And then, of course, there is the suitcase full of money; seizures at airports suggest this approach is still quite popular.

More sophisticated methods also exist. When Colombian drug dealers want to repatriate revenues, they turn to the black-market peso exchange, where they use dollars from drug sales in the United States to buy U.S.-based assets for a Colombian business or individual investor. The recipient then transfers the corresponding amount of Colombian pesos to the drug dealers’ designated accounts back home.

Fraudulent pricing on international trade transactions, known to be a widespread phenomenon first revealed in the pioneering work of Jagdish Bhagwati of Columbia University in the 1960s, is another way that illegal money can travel abroad. The Bangladeshi tax evader can move his money to Singapore easily by asking a local merchant either to overprice imports (presumably the ones not subject to import duties) or underprice exports involving Singapore.

WHY STANCHING THE FLOWS IS IMPORTANT
Even if illicit financial flows equaled only $100 billion in annual development aid, this sum is certainly large enough to command serious attention. Controls may generate a reduction in illicit and illegal activities. More plausibly, they help to prevent the proceeds from being moved abroad.

Bottling up the illicit funds at home might, ironically, help strengthen the rule of law in places not known for that institution: if the rich no longer had sanctuaries for their assets overseas, they would have a greater interest in the security of property in their own countries. Stemming the flow might also enlarge the national patrimony. If Mobutu Sese Seko, the longtime absolute ruler of what is now the Democratic Republic of Congo, had been
unable to buy villas in Nice, perhaps he would have spent some of the money he appropriated in ways that aped those of Cardinal Richelieu. Richelieu’s legacy from his legendary corruption, you may not remember, included the Académie Française and the Palais Royal. If that seems too grand, at least Mobutu might have imitated Andrew Carnegie and left public buildings that would have had some enduring value for Congo’s citizens.
WHAT CAN BE DONE
Transparency in Resource Extraction

One of the earliest attempts to arrest outflows is the Extractive Industry Transparency Initiative, an international coalition of governments, civil-society organizations and corporations that aims to curb grand corruption in the production of minerals and fossil fuels. By the late 1990s, the failure of so many developing countries (and the multinational firms they hired) to use mineral wealth to build prosperous economies led analysts to speak of the “resource curse.” Not only had the exploitation of natural resources failed to lift many countries out of poverty, but as the Nigerian example sadly illustrates, the result had also often been to leave the citizenry worse off than before the resources were discovered.

Oil and gas development in Nigeria has despoiled the environment, fed tribal conflict and political violence, and created a class of crooked politicians and bureaucrats. Much the same can be said for Equatorial Guinea, and with ongoing discoveries of natural resources in Uganda, Ghana, Kenya and Tanzania, there’s every reason to fear the curse will spread.

The medicine prescribed by the Extractive Industry Transparency Initiative is transparency. The 36 countries now participating have agreed to disclose all funds received from the production of petroleum and minerals in their territories, while the companies that gain the rights to extract the resources have agreed to disclose what they pay governments in return. Matching what governments say they received against what firms say they paid should reveal “leakage,” and the publicity from mismatches should serve as a prod to governments to patch the holes through which monies leak.

One of the challenges of containing illicit financial flows is that it requires action by parties far removed from the traditional development-policy arena. Indeed, the most recent advance with the Extractive Industry Transparency Initiative is the result of a measure taken by the U.S. Securities and Exchange Commission, which issued a rule in the fall of 2012 requiring all companies it oversees to detail payments made to governments to develop oil, natural gas and minerals.

Until the rule was issued, companies’ participation in the Extractive Industry Transparency Initiative was voluntary, so they controlled how much detail they provided. Thanks to the new requirement, the 1,100-plus natural resource firms subject to SEC jurisdiction must disclose all payments – unsavory or not. Disclosures must be disaggregated to include payments as small as $100,000 and be provided in a form that allows for easy analysis. The SEC action is expected to spark a similar reform in the European Union.

Reform Transfer-Pricing Rules

Actually, the most significant impact of the SEC’s action is being felt elsewhere, in the precedent it sets in requiring multinational corporations to break down financial data by country. Country-by-country reporting (the idea of Richard Murphy, founder of the Tax Justice Network, a London-based non-profit) is ground zero in the battle to reduce the flow of illicit funds from developing countries.

What scanty evidence there is suggests that a significant portion of illicit financial flows manage to cross borders with the aid of tax and accounting rules that permit multinationals to shift profits earned in developing countries to countries or jurisdictions with a low tax rate or no taxes at all (e.g., the Cayman Islands, a British dependency). Disclosure of companies’ financial data by country would thus both reveal the extent to which this illicit channel is used and pinpoint the rules that facilitate the sleight of hand.
While the development community backs country-by-country reporting, most business and accounting groups remain staunchly opposed. They raise technical and operational reasons why it would be impossible, or impractical, or unfair, or useless. For example, they point out that corporations in other countries that lack U.S. subsidiaries would not have to follow the rules.

But now that the SEC, the world’s foremost regulator of corporate accounting and disclosure practices, has put its imprimatur on country-level disclosure for extractive industries, lawmakers elsewhere are likely to follow suit. SEC action makes it almost certain that the European Union will adopt an expanded version of the rule early next year. A British Parliamentary committee has joined the European Parliament in urging that all multinationals, whether resource producers or not, report revenues and expenditures on a country-by-country basis.

A 2010 study of SABMiller’s activities in Ghana by ActionAid, a British-based nonprofit nongovernmental organization, shows what country-level reporting can reveal. SABMiller, the gigantic brewer whose headquarters are in Britain, does not disclose financial data by country. However, using information the company does report, ActionAid estimated how much of SABMiller’s earnings from the brewery it owns in Ghana were shifted to subsidiaries in low-tax jurisdictions.

As ActionAid pointed out, SABMiller appears to have acted legally; national tax laws leave plenty of wiggle room to make judgments about where and how to allocate revenues and expenses. The U.S. Internal Revenue Service, for example, allows multinationals to apportion senior executives’ pay and other firmwide expenses among its subsidiaries in any “reasonable” manner. When a company is subject to the tax laws of several nations, it is hardly surprising that the sum of the many judgments about what is reasonable results in minimizing the firm’s total tax bill.

According to ActionAid, one method SABMiller used to shift taxes from Ghana was to pay royalties for rights to the brand names under which it markets beer in Ghana to one of its subsidiaries in the Netherlands. The royalty payments reduce its tax bill in Ghana, and because of the way royalty income is treated under Dutch tax law, the subsidiary pays little tax on this income in the Netherlands.

ActionAid found that SABMiller was also able to move profits from Ghana by requiring the Ghanaian brewery to pay a management fee to a SABMiller subsidiary in the Swiss canton of Zug, by taking a large loan from another subsidiary in Mauritius and by purchasing malt, maize and other supplies through the same Mauritian subsidiary. The Ghanaian subsidiary is entitled to deduct the management fees, interest payments and materials costs from its Ghanaian income taxes. And although the Swiss and Mauritian subsidiaries are taxed on the income received from the Ghanaian subsidiary, their tax rates are very low – 7.8 percent for fee income in Zug and 3 percent on income of any kind in Mauritius.

The case study also illustrates how the patchwork of national tax laws that together constitute the rules governing the taxation of multinationals interact to produce sometimes anomalous results. The Dutch government is one of the largest development-aid donors and is at the forefront of multilateral efforts to help developing countries. Yet an obscure provision of its tax law drains development funds from some of the world’s poorest nations.

The study further suggested the power of information. ActionAid estimated that Ghana lost somewhere between $750,000 and $1.1
million annually in revenues thanks to the way SABMiller structured its relations with its brewing subsidiary. Responding to the study, the Ghanaian government is now revising its transfer-pricing rules and training its tax agency personnel in the intricacies of transfer-pricing law; similar reforms are being pursued throughout Africa.

Hanging over the debate on tax-shifting and illicit flows is the question of whether existing law governing transactions between subsidiaries of multinationals is simply too complex to be workable in developing countries (and perhaps even in developed ones). The law is based on the principle that purchases and sales between subsidiaries should be conducted as if the two subsidiaries were stand-alone companies – as if the transactions were conducted at arm’s length. While that seems straightforward in concept, as more and more companies have established operations in multiple countries, application of the arm’s-length standard has become ever more complex in practice. Part of the problem is that many internal transactions are unique. For example, there is no objective, market-based guide for judging whether rights to use the brand name “Miller” were priced at arm’s length.

Crack Down on Money Laundering
For more than two decades, the governments of virtually every nation in the world have pledged to enact laws that, if effectively enforced, would sharply limit the conversion of income from criminal activities into assets that cannot be traced back to the underlying crime. Examples of such money laundering include depositing the proceeds of a crime into a bank account opened under an assumed name or into the account of a corporation, or using the proceeds to buy real estate in the name of someone other than the criminal. Thanks to the work of the Financial Action Task Force, an international body comprising most advanced economies, all nations but Iran, North Korea and a few other international scofflaws have criminalized schemes to disguise the fruits of criminal activities. They have also pledged to require banks, securities dealers, real estate agents and other financial intermediaries through whom dirty money can easily be washed to take precautions to prevent its cleansing.

Under those laws, financial intermediaries must exercise enhanced due diligence when opening accounts, processing transactions or conducting business of any kind with senior government officials, their family members and close associates. But, to date, compliance has been poor. A few notable examples:

• In 2004, the U.S. Senate’s Permanent Subcommittee on Investigations reported that Riggs Bank had flouted the rules in pursuit of doing business with both the former Chilean dictator Augusto Pinochet and the ruling
family of Equatorial Guinea, and in 2012 it found a similar pattern of willful blindness to the rules by global banking giant HSBC.

• In 2009, the British-based nonprofit group Global Witness reported that officials from Equatorial Guinea, the Democratic Republic of Congo, Gabon, Liberia, Angola and Turkmenistan had no trouble opening accounts at some of the world’s premier financial institutions – despite their countries’ reputations for grand corruption.

• In 2011, The British Financial Services Agency found that one-third of the London boutique banks that specialized in managing the assets of the wealthy were willing to take on rich customers without serious assessment of whether they were high-ranking government officials, and that it was likely that “some banks are handling the proceeds of corruption.”

Nor does it take the subpoena power of a Senate subcommittee or a British regulator, or the pluck of a canny nonprofit group to uncover examples of noncompliance. Our own casual empiricism (a hallway chat with a colleague) recently revealed a case involving one of Canada’s largest banks. It had accepted a check for hundreds of thousands of dollars from a hawala for deposit into the account of an Iranian national – no questions asked.

Perhaps the most frequently used method for laundering illicit funds is the creation of an anonymous shell company, a corporation created for no valid business purpose, where the identities of those owning and managing it are kept secret. The Financial Action Task Force recommendation for handling anonymous shell companies is simple: they should be banned. Countries should ensure there is “adequate, accurate and timely information” on the people who own or control any corporation registered in their territory.

This is a second rule, the flouting of which makes it easy to hide illicit financial flows. The extent was revealed by a study last year. The authors measured compliance with the ban on anonymous shell companies by sending e-mails to law firms, accountants and other professionals in 182 countries to ask what type of information the recipients would require to establish a corporation in their country. Countries were ranked on whether those queried requested information sufficient to comply with the Financial Action Task Force’s rule. The countries at the bottom include the United States, Canada, Australia and the United Kingdom. Besides sharing the English language, all have robust economies with many investment opportunities and strong protection of property rights – in other words, all are ideal destinations for illicit financial flows.

RETURN THE MONEY THAT HAS LEFT
More transparency in resource extraction and tighter rules on transfer pricing would limit activities that generate illicit financial flows, and a crackdown on money laundering would curb their outflow. But even when (if?) such improvements come to pass, some illicit or illegal money will always be generated and some share of that will be spirited abroad. The third component of an effective international policy on illicit financial flows is thus a system for finding where the funds have come to rest, and then returning them to their country of origin.

The headline-grabbing sums that the Marcoses, Mobutus, Duvaliers and the like were able to stash in the United States, Switzerland and other developed Western nations embarrassed the leaders of those countries into action. At a September 2004 meeting, ministers of justice and home affairs of G8 governments promised to accelerate efforts to help developing countries recover stolen assets.
This high-level attention has not been without effect. In 2007, the World Bank and the UN Office of Drugs and Crime created the Stolen Asset Recovery program, or StAR, to assist developing states with asset recovery. Along with raising the visibility of the issue through an active publication and training program, it has provided tangible assistance to Haiti in ensuring that Duvalier funds located in Switzerland were not made accessible to him as a result of Haitian inaction.

The Haitian experience prompted a second notable achievement, the passage of Swiss legislation allowing its courts to facilitate asset return in situations where the state of origin could not conduct the requisite legal proceedings in its own courts. Passage was timely, making it possible for Switzerland to move swiftly during the Arab Spring to freeze fallen rulers’ assets stashed in Swiss banks.

Despite these bright spots, though, asset recovery efforts lag. As a 2011 joint report of StAR and the OECD notes, only four countries – Australia, Switzerland, Britain and the United States – managed to return any stolen funds to developing countries between 2006 and 2009. Nor have the returns from these four been all that large. As of mid-2012, Switzerland had repatriated $1.83 billion in total, the lion’s share of which came from the seizure of funds in accounts controlled by the late Nigerian dictator Sani Abacha. The United States is a distant second, with less than a third that amount back in the hands of the governments from which it was stolen.

WHAT NEXT?

Tackling illicit financial flows has two advantages beyond the immediate help it promises to developing countries that are starving for resources. Western, developed states are the locus of many reforms, from tightening money-laundering regulation to improving efforts to locate and return stolen assets. And in the process of helping stanch the flow of illicit funds, they will be helping to curb tax evasion in their own countries as well.

But so far, the rhetoric of reform has outpaced action. One reason is that special interests are blocking change where change is a must. The United States, for example, continues to be one of the easiest places in the world in which to create anonymous shell corporations, thanks to the stake that Delaware and Nevada have in the fees they earn from registering and maintaining corporations – and the power their representatives exercise in Washington.

Probably the best hope for the immediate future is to raise the profile of the illicit financial flow problem in developing countries, publicizing who is cheating and who is (or isn’t) doing something about it. In the long run, we hope, the political incentives to stopping these leakages – the potential benefit from relatively modest efforts – will catalyze action.