

**CRIME &
GLOBALISATION**

DEBATE PAPERS
DECEMBER 2009

Countering Illicit and Unregulated Money Flows

**Money Laundering, Tax Evasion and Financial
Regulation**

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TRANSNATIONAL INSTITUTE
TNI Briefing Series

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PRINTING:

Drukkerij PrimaveraQuint
Amsterdam

FINANCIAL SUPPORT:

Ministry of Foreign Affairs
(The Netherlands)

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Amsterdam, December 2009
ISSN 1871-3408

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Countering Illicit and Unregulated Money Flows

Money Laundering, Tax Evasion and Financial Regulation

By Tom Blickman

In July 1989, the leaders of the economic powers assembled at the G7 Paris summit decided to establish a Financial Action Task Force (FATF) to counter money laundering as an effective strategy against drug trafficking by criminal 'cartels'. Here began an international anti-money laundering (AML) regime. Since then it has expanded its scope to fight transnational organized crime and counter the financing of terrorism. During that time other illicit or unregulated money flows have appeared on the international agenda as well. Today, tax evasion and avoidance, flight capital, transfer pricing and mispricing, and the proceeds of grand corruption are seen as perhaps more detrimental obstacles to good governance and the stability and integrity of the financial system. Other international bodies were tasked to tackle these 'public bads'.

Tackling tax evasion is still in its infancy, and there is a growing awareness that the AML regime is not working as well as intended. Experts still ponder how to implement one that works. Tax havens and offshore financial centres (OFCs) were identified as facilitating these unregulated and illicit money flows. The 2007-2008 credit crisis made only too clear the major systemic risk for all global finance posed by the secrecy provided by tax havens and OFCs. They were used to circumvent prudential regulatory requirements for banks and other financial institutions and hide substantial risks from onshore regulators. After twenty years of failed efforts, the G20 (having supplanted

the G7) has again pledged to bring illicit and harmful unregulated money flows under control.

This briefing looks at previous attempts to do so and the difficulties encountered along the way. Can the G20 succeed or is it merely following the same path that led to inadequate measures? What are the lessons to be learned and are bolder initiatives required? In brief, the paper concludes that current initiatives have reached their sale-by-date and that a bolder initiative is required at the UN level, moving from recommendations to obligations, and fully engaging developing nations, at present left out in the current 'club'-oriented process.

This paper is a follow-up to the seminar on Money Laundering, Tax Evasion and Financial Regulation organized by the Transnational Institute (TNI) in Amsterdam, June 12-13, 2007, which brought together experts on money laundering and tax justice and the Wilton Park Conference Curbing Money Laundering: International Challenges, September 10-12, 2007. Just after these meetings the 'credit crisis' came about, which added significantly to re-think the discourse on money laundering and financial regulation. The inputs of the seminars have contributed significantly to the development of this paper but responsibility regarding its content is the author's alone.

Inputs for the TNI seminar can be found at <http://www.tni.org/archives/act/16954>

The report of the Wilton Park Conference is available at <http://www.wiltonpark.org.uk/documents/conferences/WP869/pdfs/WP869.pdf>



Construction of the international AML regime

The AML regime was the first attempt at an international level to get a grip on dirty money flows. The primary objective was to go after the earnings from drug trafficking, in an effort to remove both the incentive (profit) and the means (operating capital) to commit crimes – the so-called ‘follow the money’ approach that had become popular during the 1980s. Concretely, this translated into identification, tracing, freezing, seizure and forfeiture of drug-crime proceeds. The concealment or disguise of the nature, location, source, ownership or control of crime proceeds through ‘laundering’ in legitimate financial channels was identified as an obstacle to seizure and confiscation. Removing the banking system and financial institutions from the money laundering equation was seen as an effective strategy to cut the supply of drugs to the streets and foil their cultivation and production.

The initiative of the G7 followed intense policy attention on illegal drug trafficking in the 1980s. At its inception the AML approach was primarily domestic, the United States leading the charge. A crack cocaine boom there led to a wave of violence on the streets many cities. In Colombia, Peru and Bolivia, where the raw material coca was cultivated and refined into cocaine, fragile state institutions nearly collapsed. Powerful drug trafficking ‘cartels’¹ and rebel guerrilla organisations that derived part of their war chest from taxing coca cultivation challenged the state, corrupted both state officials and politicians. Huge amounts of criminal wealth threatened to undermine the integrity of financial in-

stitutions, compromise the judicial system, undermine general prosperity, corrupt legal business and subvert national security by exposing countries to the perceived ravages of crime ‘cartels’ (Naylor, 1999). Something had to be done.

The Reagan administration reinvigorated Richard Nixon’s ‘war on drugs’. In 1970, the Currency and Foreign Transactions Reporting Act, better known as the Bank Secrecy Act (BSA), was adopted following Nixon’s ‘get tough on crime’ presidential campaign (Naylor, 1999; Naylor, 2007). It is effectively the first effort to detect and sanction money laundering. The BSA required financial institutions to maintain certain records and report certain currency transactions, in an effort to prevent banks from being used to hide money derived from criminal activity or tax evasion.

The purpose was not to outlaw money laundering directly, but to create a regulatory structure that provided an audit trail allowing law enforcement to track large currency transactions (Cuéllar, 2003). Banks had to report all financial transactions exceeding US\$ 10,000 deposited in or withdrawn from financial institutions, and imports and exports of more than US\$ 5,000. Notwithstanding great expectations, over the following fifteen years the reporting requirements were widely ignored and very little resulted from these laws. Meanwhile, the ‘follow-the-money’ law enforcement policy gained in popularity, fed by the wide-held beliefs that ‘criminals should be hit where it hurts most: in their wallet’, and popular notions that ‘crime should not pay’. In light of the failure of conventional law enforcement strategies against drug trafficking and crime, seizure of criminal proceeds seemed an

1. Referring to drug-trafficking organisations as ‘cartels’ is confusing and controversial as it implies the existence of two or more cartels in the same market, which is a contradiction. However, the word is now in common usage to describe large-scale cocaine trafficking organisations in Latin America.

attractive panacea. The Reagan administration revived the AML approach and money laundering was criminalized in 1986 with the passing of the Money Laundering Control Act (MCLA).

With the increase of control measures, money laundering grew more sophisticated, hence requiring more and more complex regulations. Since drug trafficking was a transnational business the AML regime needed to expand internationally, not in the least because US banks felt at a disadvantage due to less rigid legislation in other jurisdictions. Nations with tougher regimes might lose financial business to those with lax rules. A drive began to establish a global 'level playing field' via a global regime. The opportunity arose with the negotiations in Vienna for the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances.

Despite the absence of any reference to 'money laundering', provisions against it were included in Article 3 of the convention. The content and wording owed much to US legislation (UN, 1998). Most importantly, the creation of money laundering as a criminal offence was made mandatory for all parties to the convention. That same year, the Basel Committee on Banking Supervision (BCBS), comprising bank and government representatives from ten major industrialized nations, drafted a statement on the 'Prevention of criminal use of the banking system for the purpose of money-laundering,' specifying ethical standards for banks (Basel Committee, 1988). Among the due diligence standards is the 'know your customer' rule, which urges banks to determine the true identity of clients.

At the 1989 Paris summit the G7 leaders issued a firm statement supporting and advocating ratification of the 1988 UN Convention. They

nevertheless chose to set up a separate body, the FATF, to implement the AML regime (Levi, 2005). Since the G7 had no secretariat or statute, the FATF office was established at the Organisation for Economic Co-operation and Development (OECD). The G7 established the FATF specifically because they saw a deficiency in the UN's ability to fight drugs. Contrary to the G7/8, the UN has worldwide membership, but reaching consensus is often difficult. Its bureaucratic structure and lack of resources make the organisation ineffective. Rivalries between groups of nations complicate efficient execution of tasks and collective management (Rudich, 2005).

An American policymaker explained why the UN was rejected as the watchdog: "Any strategy had to be global and multilateral, since unilateral actions would only drive dirty money to the world's other financial centres. Yet Washington could not afford to take a 'bottom-up' approach of seeking a global consensus before taking action; if the debate were brought to the UN General Assembly, for example, nations with underregulated financial regimes would easily outvote those with a commitment to strong international standards" (Wechsler, 2001).

Although the 1988 UN Convention was essential for creating the international legal framework against money laundering, the implementation of concrete measures was hijacked by a small group of like-minded free-market economies. The AML regime flourished because of the financial backing provided by the G7/8 and the show of consensus and cooperation of its members. The G7/8's strength is its unique institutional capacity, enabled by its small size, selected membership, flexible structure, shared values and belief in democracy and liberal capitalism (Rudich, 2005).

An alternate view is that "great powers were able to cajole, coerce, and enforce a global



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anti-money laundering standard into existence” that fit their interests best. The UN with its consensus decision-making would be ineffective to enact the kind of financial regulation the G7 wanted to counter money laundering. Even the International Monetary Fund (IMF) and World Bank with their weighted voting mechanism were ill suited, because of their strong consensus norms. Therefore, the great powers relied on their own ‘club organisations’ such as the OECD and the FATF to promulgate regulatory standards – leaving out the vast majority of nations worldwide (Drezner, 2005).

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In 1990, less than one year after its creation, the FATF drafted Forty Recommendations to counter money laundering (see FATF website). Instead of creating international law the recommendations targeted harmonisation of domestic laws through ‘soft law.’ These quasi-legal instruments do not have binding force, but when a sufficient number of nations adopt them they have sufficient political, institutional and moral backing to evolve into international norms. The FATF’s role is to issue regularly updated AML recommendations aiming to set legislative and regulatory standards and refine those measures through research and guidelines. In 1996 the Recommendations were revised to reflect the evolving methods of money laundering. The regime broadened from focusing on drug trafficking to fighting overlapping issues such as transnational organized crime and corruption. The FATF and its recommendations were strengthened by the provisions in the 2000 UN Convention against Transnational Organized Crime and the 2003 UN Convention against Corruption, which called

upon parties “to use as a guideline the relevant initiatives of regional, interregional and multilateral organizations against money-laundering.”²

After the 9/11 terrorist attacks in 2001 in the US, the FATF mandate was expanded to combat the financing of terrorism (CFT), evolving into an AML/CFT regime.³ The AML regime became ever more sophisticated and accepted internationally. The 2003 FATF Forty Recommendations are today endorsed by more than 170 jurisdictions and are the current international AML standard (FATF, 2008). It has provided the basis for a system to monitor and police the behaviour of countries, including both members and non-members. In contrast, the 1988 UN Convention is a binding treaty, establishing formal legal obligations for all signatories. Unlike the FATF system, however, the UN Convention does not establish an enforcement system that generates useful information about compliance, because the Convention’s provisions regarding the detection of criminal financial activity are extremely vague (Cuéllar, 2003).

The AML regime developed during a period of rampant free market capitalism, characterised by deregulation of financial markets and diminished regulatory powers of states and international institutions over the financial system and its institutions (Levi & Reuter, 2006). Ironically, the relaxation and ultimately abandonment of exchange controls and the liberalization of financial services facilitated money laundering. What arose was the increase of tax havens and OFCs offering low tax, lax regulation, bank secrecy and high-level

2 . Article 7 of the 2000 UN Convention against Transnational Organized Crime and article 14 of the 2003 UN Convention against Corruption.

3 . In October 2001, an additional Eight Special Recommendations for combating the financing of terrorism were included. The Forty Recommendations and Special Recommendations were updated again in 2003. In 2004 a Ninth Special Recommendation was added, further strengthening the agreed international standards.

confidentiality trusts and corporations. These not only benefited money laundering but acted as conduits and shelters for flight capital, transfer pricing, tax evasion and tax avoidance.

The secrecy and lax regulations of OFCs and tax havens played a major role in undermining both the AML regime and measures against tax dodging and evasion (Blum et al, 1998).

The AML/CFT regime

The AML/CFT standard is a combination of the following measures: (1) criminalisation of money laundering and terrorist financing; (2) setting up freezing, seizure and confiscation systems; (3) imposition of regulatory requirements on certain businesses and professions; (4) establishing a Financial Intelligence Unit (FIU) for the collection, analysis and dissemination of financial intelligence data based on suspicious transaction reports from financial institutions; (5) creating an effective supervisory framework; (6) setting up channels for domestic and international cooperation.

The regime's objectives are: (1) removing profit out of crime through confiscation; (2) detecting crime by following the money trail; (3) targeting third-party or professional launderers, who through their services allow criminals to retain the proceeds of crime; (4) targeting the upper echelons of the criminal organization whose only 'visible' connection to the crime is the money trail; and (5) protecting the integrity of the financial system against abuse by criminals (Carrington & Shams, 2006).

PREVENTION	ENFORCEMENT
Administrative/ Regulatory Sanctions	Civil and Criminal Confiscation / Forfeiture
Regulation and Supervision	Prosecution and Punishment
Reporting	Investigation
Customer Due Diligence	Predicate crimes

The AML regime (source: Reuter and Truman)

The AML regime developed on two fronts, prevention and enforcement. Prevention is designed to deter criminals from using institutions to launder the proceeds of their crimes, and to create sufficient transparency to deter institutions from aiding and abetting laundering. Enforcement is designed to punish criminals (and their money-laundering associates) when, despite prevention efforts, they manage to successfully launder crime proceeds. Prevention concerns the role of regulatory agencies and has four key elements: customer due diligence (CDD); reporting; regulation and supervision; and sanctions. Due diligence requires the identification of not just the nominal account holder but also the beneficial owner; providing proof of identity and address; and ongoing monitoring to verify that the behaviour of individual and corporate customers conforms with the bank's knowledge of their circumstances and work. Reporting concerns information that the institution or professional must provide to enforcement authorities. External supervision is the active monitoring of compliance with CDD and reporting requirements. Finally, sanctions (generally administrative and civil rather than criminal) punish individuals and institutions failing to implement the prevention regime (Levi & Reuter, 2006).

The enforcement pillar also has four key elements: a list of underlying offences or predicate crimes; investigation; prosecution and punishment; and confiscation. The list of predicate crimes establishes the legal basis for criminalizing money laundering, hence only funds from the listed crimes are subject to these laws and regulations. The other three elements are common in the criminal justice system, except for confiscation of proceeds, where often the burden of proof shifts following conviction. Enforcement may



be triggered or facilitated by information from the prevention mechanism, but it is usually carried out by criminal investigative agencies. In practice, the AML regime is primarily a regulatory one focused on prevention. Although regulation and enforcement have different objectives and mandates their roles can be difficult to distinguish. For instance, there is growing concern that bank employees are being turned into private detectives when performing their due diligence and reporting requirements.

At the core of the AML regime are the Suspicious Activity Reports (SARs) or Suspicious Transaction Reports (STRs) as the primary source of information from financial institutions and other reporting sources. Produced by the prevention pillar, they are used by enforcement agencies. SARs are the link between the two main pillars of the system (prevention and enforcement). The proportion in high-reporting jurisdictions seriously followed up is low. Whether this is inherent or merely resource-constrained remains unclear (Levi & Reuter, 2006). Defensive reporting to avoid potential penalties (and reduce internal review costs) seems to be commonplace, leading to a deluge of reports impossible to act on. A recent study indicates excessive reporting fails to identify what is truly important by diluting the information value of reports (Takáts, 2007). There are also serious doubts about private-sector institutions taking on (unpaid) an important and unconventional law enforce-

ment role, for which their customers and shareholders pay, as well as serious privacy implications. SARs result not from an objectively determined threshold but from something in the transaction or transactor, which raises suspicion in the minds of bank personnel. The system puts a premium on rumour, bias and stereotyping according to critics, since the information is strictly subjective and the client remains uninformed. An even more intrusive system was introduced with the 'know your customer' (KYC) rules, which seeks information about the client prior to any transaction with, once again, the client remaining unaware. Here the financial institution is no longer passive or even reactive as with the SARs, but proactive (Naylor, 2007).

To reduce over-reporting and cost and resource constraints there is a shift from a 'rule-based' to a 'risk-based' approach, the former considered ineffective.⁴ High administrative burdens for financial institutions and other reporting and supervisory agencies involved costs neither compensated by catching more criminals or finding more illegal money. Judgments have to be made regarding which kinds of business represent a lower-than-average level of risk and accordingly require fewer resources for their management.⁵ In that banks can set their own internal rules regarding the risk nature of the transaction, understanding the ways in which SARs are filed is all that more difficult, and regulation moves away from the state towards the financial institutions themselves.

4. The rule-based approach is essentially passive and static. Professionals apply a set of rules in all contexts and all cases: if something meets the conditions specified in the rule, then the action (also specified in the rule) is taken. Apart from leading to over-reporting, another problem can arise. Since money launderers can have a complete knowledge of an AML regulation set up on a rule-based approach, they may be able to adjust and adapt their money laundering techniques in order to comply with the codified rules, consequently making illegal operations indistinguishable from legal ones.

5. The risk-based approach is not new as both supervisors and supervised institutions have always had to make judgments on how to best employ the limited resources at their disposal. Making a big distinction between risk-based and rule-based approaches may be misleading, the existing system in the U.S., for instance, having a mix of both. For that matter, one may confuse the risk of being sanctioned by regulators or prosecutors with the risk of actual laundering (Carrington & Shams, 2006; inputs from Peter Reuter and Brigitte Unger at the seminar on Money Laundering, Tax Evasion and Financial Regulation, Transnational Institute, June 12-13, 2007).

In order to improve the effectiveness of the AML regime some countries, the US, the Irish Republic and the UK for example, introduced non-conviction-based confiscation to facilitate forfeiture of proceeds of crime. Although the approach is actively advocated in the international arena, a significant number of jurisdictions oppose it as incompatible with their legal systems of due process and laws requiring convictions prior to confiscation.⁶ Critics consider that the 'collateral damages' of the regime, in particular the issue of civil liberties, outweigh the positive aspects.⁷

Though the regime also targets terrorist finances, modern terrorists need little money

for their operations. Substantial funds financing terrorist acts are derived from lawful activities, including charitable donations, which make them difficult to detect. The final stage is the financing of the terrorist act rather than the criminal realising his profits. Terror dollars can only be defined after the commission of the act for which they have been used. Any evasion occurs before a terrorist act; and the money is certainly not intended to resurface in the legal economy (Naylor, 1999). But even if AML controls are unlikely to cut off terrorist funds they may yield useful intelligence (Levi & Reuter, 2006).

6. See, for instance, the discussion at the United Nations Commission on Narcotic Drugs on the review of the progress achieved and the difficulties encountered by member states in meeting the goals and targets set out in the Political Declaration adopted by the UN General Assembly Special Session on the World Drug Problem in 1998 (UNGASS). In the Plan of Action, member states are asked to consider, "where compatible with fundamental principles of domestic law, non-conviction-based confiscation" (CND, 2008; CND, 2009).

7. In particular the intrusive regulatory apparatus that has turned the domestic, and increasingly the international, financial system into a global espionage apparatus. It puts financial institutions in a position of conflict of interest between their responsibilities to clients and shareholders and their duties to the police and national security agencies. There is an emerging tendency of civil forfeiture, which condones the seizure of assets on increasingly loose criteria, without the safeguards of the criminal justice system. The offence of money laundering is unnecessary, according to some. Existing legal concepts of aiding and abetting or accessory-after-the-fact or even criminal conspiracy could apply just as well. Alternatively, underlying offences could be rewritten to attribute handling the money to the primary crime. Ordinary fiscal procedures are and have long been the most effective way to handle illicit financial flows: "Using tax law to seize unreported income produces the desired result with few if any of the undesirable side-effects. There is no need in fiscal procedures to suggest that unreported or misreported income is criminal in origin to justify taking it away – it suffices that it exists. Thus there is no need to tar someone with the brush of criminality without the right to a criminal trial to determine truth or falsehood" (Naylor, 2007).



Effectiveness of the AML regime

The illegal and secretive nature of money laundering makes assessments of the effectiveness of the AML regime problematic. The absence of data, on money laundered and terrorist financing activities or effectiveness in terms of prevention or enforcement, severely limits any assessment of the regime. A cost-benefit analysis is hampered by the lack of evidence of the benefits of the regime (Tsingou, 2008). Regarding the curbing of drug trafficking, organized crime or terrorism the results are disappointing.

Despite the regime's original impetus to cripple the international drug trade, seizures of drug-related assets have been minor in all countries relative to what is believed to be the scale of the trade (Reuter & Truman, 2004). The Report on Global Illicit Drugs Markets 1998-2007, commissioned by the European Commission, found no evidence that the global drug problem had been reduced during the period 1998-2007. Given the limitations of the data, a fair judgment is that the problem became somewhat more severe (Reuter & Trautmann, 2009).

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In order to know what the impact of money laundering is, one needs to have a sense of its actual volume, but attempts to come up with reliable estimates have failed. In 1998, Michel Camdessus (1999; FATF-OECD, 1999) of the International Monetary Fund (IMF) calculated that the annual aggregate size of money laundering in the world could be between 2 to 5 percent of the world's GDP. Using 1996 statistics, these percentages would indicate that money laundering ranged between US\$ 590 billion and US\$ 1.5 trillion. The lower figure is roughly equivalent to the total economic output of Spain. The factual basis of this claim is unclear, and may be little more than a wild guesstimate. The FATF failed to produce an estimate (Reuter & Truman, 2004),⁸ and now concedes that a reliable estimate of money laundered is absolutely impossible to produce and therefore does not publish any figures in this regard (FATF Money Laundering FAQ).

Most studies rely on weak data and flawed assumptions. They consider criminals rational cost-benefit calculators and presume that money laundering is a profession unto itself. While that may be true in some rare occasions, evidence from criminology indicates that criminals are motivated by a complex mix of psychological, social, and economic factors, as well as cultural alienation, criminal lifestyles and other factors. They might launder less than is assumed and spend their money on luxury items or finance new ventures without going through official bank channels. There are many unanswered questions, such as whether money from crime is transferred into production factors, real estate, high value assets or durable valuables which can be traded. A significant

proportion of cash assumed to be laundered may simply be hoarded (Van Duyne, 2003).

What is known is the amount of identified laundered money in the largest economy in the world, the United States, where approximately half of the world's laundering occurs (Schroeder, 2001). According to the 2007 National Money Laundering Strategy, seizures amounted to US\$ 1,256 million in money-laundering-related assets and US\$ 767 million in forfeited assets in 2005 (NMLS 2007). Combined, that would amount to about 0.02 percent of the 2005 GDP of US\$ 11 trillion in the US. Applying the lower end of Camdessus' range (2 percent), that would mean only 1 percent of all criminal assets is seized. A US Treasury Department official estimated that 99.9 percent of criminal money presented for deposit in the United States gets into secure accounts. A German and a Swiss banker reckoned it was 99.99 percent in their respective countries (Baker, 1999; Baker, 2005: 173-74). These estimates are more likely illustrations of frustration with the current process than precise assessments. Nevertheless, they indicate that either the estimates of hundreds of billions of dollars laundered annually are exaggerated or that the AML regime is doing a poor job.

In his book *Capitalism's Achilles Heel*, Raymond Baker estimated that global cross-border flows of dirty money range between US\$ 1.06 trillion and US\$ 1.6 trillion annually, of which US\$ 539 billion to US\$ 829 billion comes from developing and transitional economies. He estimates that two thirds of this flow is driven by commercial motives (including reducing or eliminating the payment of taxes through transfer pricing and fake transactions) and

8. Scholar and former Inter-American Development Bank and the World Bank official Francisco Thoumi said he spent two days at IMF headquarters to no avail, trying to find someone who could explain the basis of the 2-5 percent of world GDP figure. Not only is there no real basis, but also since no one can really estimate the denominator, the world GDP, the entire exercise is questionable (TNI, 2003).

about one third is related to 'criminal flows'. Drug trafficking alone would amount to 12.5 percent of the illicit money flows.⁹ The estimate does not include tax evasion by individuals nor the more impressive tax avoidance. The US Inland Revenue Service (IRS) estimates that the annual tax gap in the US is about US\$ 345 billion, which was considered a significant underestimate, without even considering offshore tax-sheltering schemes (TJN, 2007). The Tax Justice Network (TJN) estimated an annual tax loss of US\$ 255 billion due to individuals' use of tax havens. The estimate is based on US\$ 11.5 trillion of offshore assets of high-worth individuals, and conservative assumptions on estimated rates of return and possible tax paid. Offshore holdings of corporations are not included in the calculation (TJN, 2005).

In 2007, two retired IRS investigators decided to put the AML system to the test in the United States. Over the course of a month and spending US\$ 4,000, they established anonymously owned companies in Florida, New York and Panama, and then wired money between the firms' bank accounts, using their real names throughout the process and obeying all laws. The transactions would be almost impossible to trace, the agents said. Ironically, it was more difficult to create an account in Panama, a notorious money-laundering haven, than it was in the US (USA Today, 2007). The exercise confirmed the findings of the IMF's report on the observance of standards and codes on money laundering in the US. The evaluation showed non-compliance on crucial issues such as the beneficial ownership of companies in some states and trusts in most states as well

as little attention to due diligence requirements regarding casinos (IMF, 2006).¹⁰

According to IMF and World Bank officials, there is no clear formula to assess whether the AML/CFT system has been effective in achieving its objectives: "In the absence of a reliable measure of how much money is being laundered or how much terrorist funds are circulating, the question of effectiveness becomes even more elusive when it is couched in terms of 'curbing' money laundering and terrorist financing. It is therefore impracticable to try to measure the success of an AML/CFT measure by attempting to establish the extent to which this measure has contributed to reducing the amount of money being laundered or terrorist funds being funnelled" (Carrington & Shams, 2006).

One of the few attempts to set out a framework within which to measure the effectiveness of the AML regime, by Levi and Reuter, concluded that, except at an anecdotal level, the effects on laundering methods and prices, or on offenders' willingness to engage in various crimes, are unknown. If any indication exists in the available data, it is that the AML regime has not had major effects in suppressing crimes. The regime does facilitate investigation and prosecution of some criminals who would otherwise evade justice, but fewer than expected by advocates of 'follow the money' methods. It also facilitates the recovery of funds from core criminals and from financial intermediaries. However, the volume is minor compared to the income or even profits from crime (Levi & Reuter, 2006).

In the Netherlands the Court of Audit investigated the AML/CFT policy and concluded

9. Baker (2005: 172) estimates the annual money flow from drug trafficking to be US\$ 120-200 billion. Peter Reuter makes the rough calculation of about US\$ 150 billion in consumer expenditures on illicit drugs. In that case the trade flow would be down to just US\$ 20-25 billion since most of the street value is not being laundered (TNI, 2003).

10. Publication of the ROSCs requires agreement of the country concerned.

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that the results “were disappointing in view of the many measures ... taken to combat money laundering and terrorism financing.” The audit found that “money laundering and terrorism financing were still inadequately prevented, that the probability that money laundering and terrorism financing would be detected and punished was low and that the investigation services and the Public Prosecution Service made little use of their powers to seize the assets of criminals.” These results were disappointing considering the ambitions of past Dutch governments and the priorities set in the preceding ten years to combat money laundering and terrorism financing. The lack of results was mainly due to limited capacity and expertise; deficiencies in the exchange of information; and absence of system-wide management (NCA, 2008).

How effective the system is may be even more difficult to judge as there has been a lack of systematic examination of the goals of the system. Some fear that compliance with the standards – looking at the outputs instead of the outcomes – has become an end unto itself, which by no means constitutes a credible measure of success. Some argue that no one effectively owns or provides strategic leadership on the AML regime internationally (Wilton Park, 2007). Whatever their benefits in theory, the controls in practice appear to do little to accomplish crime-fighting goals or to combat terrorism, while imposing a substantial burden on various financial and non-financial businesses and banking institutions as well as regulatory agencies in those nations (by now the vast majority) having introduced them (Levi & Reuter, 2006). Despite its constant updating and numerous

mutual evaluations between countries, there is a growing awareness that the regime is not working as well as intended (Carrington & Shams, 2006). Under the AML regime money laundering has not become a dangerous or even costly, procedure. Officials at the US General Accounting Office remarked that: “no one would actually design [the regime] as it is; but it would be counterproductive to introduce something new” (Tsingou, 2005). After two decades, experts still ponder how to implement an AML/CFT regime that works.

Tax evasion

Back in 1989, the G7 members, a coalition of convenience, all with their own specific reasons, decided to keep tax issues out of the AML regime. There was no international consensus even within the OECD members, who set up the FATF (Levi, 2005). Because its main concern was the ‘war on drugs’ it was important for the United States to have Switzerland join (Levi & Reuter, 2006). Swiss banks were often identified in money laundering cases, but they also handled the overwhelming majority of the world’s lucrative offshore wealth management – not infrequently accumulated by tax evasion and avoidance, and capital flight. Switzerland with its sophisticated financial services sector and strict bank secrecy laws did not ratify the 1988 UN Convention precisely because of the AML provisions could jeopardize the country’s bank secrecy laws.¹¹ Likewise, the UK government could only convince the British Banking Association back in 1985 to agree to the regulatory system by keeping taxes outside the

11. Switzerland ratified in 2005, with the reservation that money laundering offences be so defined that their classification as criminal be compatible with Swiss legislation and policy on criminal matters. Although people traditionally speak of bank secrecy, one should note that this duty of discretion is not intended to protect the bank but the client. In that sense, the term “bank-client confidentiality” or “bank customer secrecy” is more appropriate.

domestic AML regime.¹² The financial services industry in the City of London and the tax havens and OFCs in its overseas territories and crown dependencies were not keen on including tax regulation.

The AML regime emerged to roll back deregulation in the non-tax sphere, combating ‘the dark side of globalisation’, such as transnational organized criminals and eventually corrupt officials and politicians. Nonetheless, only in 2001 did France and the UK agree to criminalize transnational bribery used to ‘sweeten’ overseas contract bids, and the former’s political ‘slush funds’ that were used for domestic clientelist purposes (Levi, 2005). Consistent with the FATF’s mandate, the Forty Recommendations did not and do not include tax evasion on the list of predicate offences for money laundering. Hence financial services and professional staff are not obliged to report suspicions to the authorities. Both in Switzerland and the US, for example, foreign tax evasion is not a crime. The French government had a strong interest in money-laundering regulation, driven by its disapproval of financial deregulation and concern about tax evasion in offshore finance centres, in particular those connected to the UK. France’s domestic legislation listing tax evasion as a money-laundering offence is undercut because the offence is not reportable by financial institutions (Levi & Reuter, 2006).

The international tax system differs fundamentally from the AML regime. While the AML regime has the 1988 UN Vienna Convention as a basis for international regulation, tax regulation was never internationalised by way of a multilateral agreement, but rather established between states in an ever-increasing

number of bilateral Double Taxation Agreements (DTAs) – or what many observers consider double non-taxation treaties. DTAs were designed as a mechanism to ensure that companies would not see their foreign-source income taxed twice. While commendable in some respects, the bilateral system of DTAs is fraught with dilemmas for national authorities and rich in opportunities for transnational corporations and citizens, in particular ‘high wealth individuals’ (HWIs) with access to the technical expertise of the private banking sector.

Tax havens and OFCs profit from the bilateral system. Through an ever-increasing number of DTAs, transnational corporations and HWIs take advantage of diversity in types, rates, and definitions of tax. Due to poor design and enforcement of the double tax treaties taxes are often paid in neither state. Aiming to reduce the attractiveness of OFCs, OECD countries responded by introducing ever more complex legislation, such as Controlled Foreign Corporation (CFC) rules, which attempt to bring into their tax net the ‘passive’ income channelled into subsidiaries in tax havens. However, that has simply exacerbated the problem by creating new opportunities for transnational corporations and HWIs to engage in arbitrage and reduce their tax liabilities. In particular, OECD countries have been reluctant to characterise as ‘passive’ the income from financial transactions and investments. This explains, for example, why 40 percent of hedge funds are organised through entities formed in the Cayman Islands. A narrow view of sovereignty is central to why taxation has so far been left out of the international arena, the resultant separate national taxation systems costing states dearly. Most nations would gain from stronger international



12. Lessons for Tax Regimes from the War on Money Laundering, input from Mike Levi at the seminar on Money Laundering, Tax Evasion and Financial Regulation, Transnational Institute (TNI), June 12-13, 2007.

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tax cooperation, but establishing a common policy to address tax issues at an international level appears to be more difficult than instituting a common policy against money laundering. Also, in the field of taxation the lines between legitimate, illegitimate, and clearly illicit or criminal activities are often blurred, and highly paid advisers are eager and ready to exploit any ambiguities. Picciotto (2007) remarks that the failure to achieve any substantial progress regarding taxation is a clear example of the deficiencies of international political governance. Cooperation in this field would greatly strengthen national states.

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Excluding tax evasion from the AML regime was an important watershed. Non-payment of tax is not as culturally resonant as 'crime' and even less so than 'terrorism', which are obviously easier to oppose. The difference is the perpetrator as opposed to the crime or social harm. One thinks of the violent criminal, corrupt politician or official, or evil fraudster harming society as opposed to the otherwise law-abiding citizen or company wanting to shield their hard-earned money – unlawfully but 'understandably' – from the tax collector. Criminals, of course, injure individuals and society while 'earning' their money via murder, misery and mayhem. However, the damage done to society through revenue uncollected and unavailable to finance essential services such as health care, education, or maintaining an adequate criminal justice system, may be even greater, due to its volume, than the damage from 'traditional' crime.

However, including tax evasion as a predicate offence might create serious implementation problems for the AML regime. Criminals are few in number compared to tax evaders, the latter perceived as occupying a less threatening social niche. The potential number of

Suspicious Activity Reports (SARs) generated if tax evasion were a predicate crime would be immense, further burdening the existing oversupply of reporting. Sharing information between tax authorities that receive voluntary disclosures and criminal enforcement agencies gathering evidence to prosecute for a criminal offence is a sensitive matter. These are two different information flows, and although information from law enforcement to the tax authorities is not problematic, the reverse is, due to, for example, restrictions relating to self-incrimination in certain jurisdictions (Carrington & Shams, 2006). Another difficulty is the subjective way in which SARs are compiled. The reports are filed on unusual persons or unusual situations, not the people or corporations involved in 'tax planning' to minimise their taxes. And what effect would it have on the relation between law enforcement authorities and the financial institutions delegated the task of identifying suspicious behaviour and filing the SARs? Corporate and private banks are paid to advise on 'tax planning' to minimise tax liabilities. The conflict of interest is evident.

If tax evasion is to become a predicate offence some serious reform of the AML regime is obligatory. Just adding another stack of SARs to the already mountainous pile is not the solution, rule- or risk-based approach notwithstanding. If tax authorities were allowed automatic access to SARs, they could correlate them with other information in tax returns. Total transparency in the form of comprehensive access to information from banks and corporate service providers, combined with automatic information exchange would permit the tax authorities to judge if a company is abusing the tax system or not, rather than relying on SARs filed by bank clerks 'conscripted' to aid the criminal justice system. However, instituting a like reform raises concerns about privacy,

infringements of civil liberties, and a general sense of intrusiveness that need to be addressed.

International efforts to regulate the grey financial system

The current AML regime is remarkable for the range of institutions involved and the centrality of international agreements. The World Bank/IMF lists seven distinct international bodies including itself that either set rules or have formal monitoring responsibilities, mostly either for specific industries (such as insurance) or for parts of the process (like FIUs receiving reports from regulated institutions).¹³ The result is a plethora of regulations and, because money laundering is common to all highly profitable crimes, AML has come to be written into the ‘effectiveness’ of all regulatory efforts. If not in countering money laundering, the regime has been successful in transferring control policies, imposing them upon other actors. Every international body with finance and/or crime within its mandate has taken on AML because politically and bureaucratically, it cannot afford to neglect this source of funds, influence and prestige by failing to be a ‘player’ (Levi, 2005). Mutual evaluation has become the core tool of used by an international ‘soft law’ peer group methodology. The primary concern seems to be output rather than outcome. The goal of affecting the organisation and levels of serious crimes has been displaced by the more readily observable goal of enhancing and standardis-

ing rules and systems, while critical evaluation of what countries actually achieve with their costly suspicious transaction report data remains to be developed. “Global rule making on money laundering issues has become something of a growth industry,” according to an AML consultant. A large number of nongovernmental, multilateral, intergovernmental, and supranational organisations are involved. “Their analyses, reports, and recommendations reveal a disturbing tendency to quote each other’s work; since they enjoy substantially the same membership, this practice amounts to self-corroboration. Moreover, at times they offer overlapping sets of rules and best practices to deal with money laundering. It is ironic that the international community would fail to produce a single, unified set of rules to take on a criminal activity that thrives precisely on exploiting differences in laws and regulations” (Morris-Cotterill, 2001).

While the global AML regime developed, efforts to construct an equivalent regime to tackle capital flight, tax evasion and avoidance, and harmful tax competition became more prominent. Once again the G7 was driven by political concerns in setting new initiatives against tax havens and OFCs. At the Lyon summit in 1996 it concluded that “globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between states, carrying risks of distorting trade and investment, and could lead to

13. The bodies are the FATF, Egmont Group of FIUs, International Organization of Security Commissioners, United Nations Office of Drugs and Crime (UNODC), Basel Committee on Banking Supervision and the International Association of Insurance Supervisors. These are merely the top layer of standard-setting bodies, with a myriad of subsidiary public- and private-sector bodies beneath, including the FATF-style regional bodies (FSRBs), such as the Asia/Pacific Group, Caribbean Financial Action Task Force, ESAAMLG (Eastern and Southern Africa), EAG (Eurasia), GAFISUD (Latin America), MENAFATF (Middle East and North Africa), Moneyval (Europe) and the Offshore Group of Banking Supervisors is also part of this network. In the private sector there are national industrial and professional bodies (such as bankers associations, notaries and so on), plus the Wolfsberg Group of international banks (Levi & Reuter, 2006).

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erosion of national tax bases.” The G7 urged the OECD to “vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices” (G7, 1996). This position provided political backing for the OECD’s Harmful Tax Practices project, and a parallel effort launched by the European Union, both launched in 1998 (Picciotto, 2007).

Over the next two or three years key policy circles appeared to concur that tackling the use of the financial system for concealment of ‘dirty money’ required a concerted effort, including measures to prevent facilitating money laundering, tax avoidance and evasion, as well limiting the disruptive role of offshore-held capital. At the UN General Assembly Special Session on drugs in 1998 the UN published the report *Financial Havens, Banking Secrecy and Money Laundering*, identifying tax havens as an important conduit for money laundering (Blum et al, 1998). The same year the OECD tried to tackle ‘harmful tax competition’, in particular as practiced by a group of about three-dozen tax haven states. The OECD’s report *Harmful Tax Competition: An Emerging Global Issue* identified two obstacles to taxing geographically mobile activities: tax havens and harmful preferential tax regimes. The report proposed implementing activities

to eliminate both. The publication sent shock waves through the international tax avoidance industry and the community of small island tax havens (OECD, 1998; Christensen, 2007).

Scrutiny intensified when the Financial Stability Forum (FSF) identified the huge volume of private assets held offshore as a potential source of global financial instability. The usual suspects – money launderers and tax evaders – were referred to, but the use of tax havens and OFCs in circumventing onshore prudential regulatory requirements was also underscored. (See box *Secrecy jurisdictions*)

The reports stimulated debate regarding the adverse macroeconomic impacts that money laundering, tax evasion and avoidance, as well as harmful and tax competition create. They also emphasised how abusive tax practices distort global markets and undermine development. On the basis of these reports, the G7 finance ministers issued a ‘plan of action’ in 2000, entitled *Actions against Abuse of the Global Financial System* (G7, 2000). The report examined the connections between money laundering and corruption; tax havens and harmful tax practices; offshore financial centres and their threat to the stability of the international financial system by the elusion of international standards regarding financial supervision and cooperation; and the distortion

Secrecy jurisdictions

Global governance over money flows has been seriously compromised by the creation of tax havens and offshore financial centres (OFCs), better described as secrecy jurisdictions. They offer not only freedom from tax, but also a shield against any number of rules, laws and regulations of other jurisdictions. What these places have in common is legal and financial secrecy. These entail a kind of privatisation of

sovereignty, in which a legal refuge offering privileges for certain types of private parties and businesses is created, often designed by lawyers acting as intermediaries between governments and private interests. The beneficiaries are provided with a legal refuge or protection from the laws of other states, without needing to physically relocate as they can use the legal fictions of newly created corporations

or trusts. This type of shelter, essentially designed to avoid taxation, can be used to facilitate a wide variety of 'dirty money' flows when allied with offshore financial services (Picciotto, 2007).

Offshore is a confusing term, conjuring up palm-fringed tropical islands. However, some of the most attractive OFCs are in mountainous landlocked nations such as Switzerland, Andorra or Liechtenstein. The distinction between tax havens and OFCs is often confused. Tax havens are the countries that create laws designed to undermine other states. Offshore financial centres are made up of the lawyers, accountants and bankers, who sell the resulting products to foreign clients who want to evade laws where they live. Tax havens are geographically located as are their spheres of influence. OFC operators, many of them multinational companies or banks, and firms of accountants present in every major and most minor tax haven jurisdictions around the world can move their operations to wherever they want instantaneously. They have used this capacity as a bargaining chip to ensure that jurisdictions comply with their wish to secure the legislation they desire (TJN, 2008).

The FSF Working Group on Offshore Centres in April 2000 listed the users of OFCs as:

- international companies, to maximise profits in low tax regimes;
- international companies, to issue securitised products through special purpose vehicles;
- individuals and companies, to protect assets from potential claimants;
- investors (individuals, investment funds, trusts and so on), to minimise income and withholding taxes and to avoid disclosing investment positions;
- financial institutions with affiliates in OFCs, to minimise income and withholding tax and to avoid regulatory

requirements in the 'onshore' jurisdictions in which they operate;

- financial institutions assisting customers in minimising income and withholding tax;
- insurance companies, to accumulate reserves in low tax jurisdictions and while continuing to conduct business in responsive regulatory environments;
- criminals and others, to launder proceeds from crime through banking systems without appropriate checks on the sources and to use local secrecy legislation as a means of protection against enquiries from law enforcement and supervisory authorities (including foreign authorities), and/or to commit financial fraud.

(source: FSF, 2000a)

The 'offshore' and 'onshore' phenomena interact symbiotically. By providing facilities for avoiding or evading laws or regulations of other countries, the offshore undermines and puts pressure on them. The convenience of offshore facilities can be used to conceal outright illegal activities, and to expedite negotiating the often vague regulatory requirements, the very ambiguities of which reflect legal and moral uncertainties. The facilities offered offshore have often been developed with the tacit approval and encouragement and even active support from some authorities onshore. Contrary to many perceptions concerning OFCs, the biggest providers of the secrecy advantages are the financial centres such as New York or London or Amsterdam. Small island tax havens are satellites of the big OFCs, as over a half of all tax havens in the British overseas territories and crown dependencies function primarily as 'service providers' of the City of London (Picciotto, 2007; Christensen, 2007). In 2000 the FSF listed 42 OFCs (FSF, 2000b).

A fine line exists between tax evasion and legal tax planning strategies. The distinction is all important to defenders of tax havens: if a particular tax planning strategy is legal, or at least not illegal, it is sufficient. Soundness

of the national treasuries and fairness to fellow taxpayers do not, legally speaking, concern tax planning. Countries like the Netherlands, Denmark, Sweden and Ireland have all introduced special schemes to attract investment capital from international companies. Yet those countries are not generally considered to be tax havens. The Dutch, for instance, facilitate so-called 'conduit structures' which allow internationally operating companies to channel their financial flows through the Netherlands in order to reduce tax charges elsewhere (SOMO, 2008).

The Dutch offer companies who would not otherwise seek residence in the Netherlands the means to reduce their tax charges on interest, royalties, dividend and capital gains

income from foreign subsidiaries. Although Tax Justice Netherlands does not consider the Netherlands a tax haven as such, it is of the opinion that its extensive network of double taxation treaties and other tax regulation is regularly abused to avoid taxes in other countries. In May 2009, the United States issued a press release pointing at tax avoidance caused by fiscal constructions abroad and lumped the Netherlands in with a group of 'low-tax countries' some U.S. corporations use to avoid taxes in the United States. The Dutch Centre for Research on Multinational Corporations (SOMO) estimates that at least 20,000 'mailbox' companies use the Netherlands much like Jersey and probably with more money involved (SOMO, 2008; Tax Research, 2009a).¹⁴

14 . The White House press briefing announcing measures against tax avoidance and tax havens, published on 4 May 2009, originally contained the following sentence: 'Nearly one-third of all foreign profits reported by U.S. corporations in 2003 came from just three small, low-tax countries: Bermuda, the Netherlands, and Ireland.' The sentence was included as a bullet point in the introduction. The next day, after efforts by the Dutch Embassy in Washington, this sentence was removed and explained as a 'misunderstanding' (Tax Research, 2009b). The Dutch ministry of Finance underlines the active role of the Netherlands to promote transparency and information exchange, but does not seem to be willing to critically review the possibilities to abuse the Dutch tax treaties at the expense of other countries.

of economic behaviour and erosion of national tax bases. In conclusion, the G7 called upon international financial institutions to take action.

At the initial instigation of the U.S., but supported by the G7 after the peaceful resolution of some internal threats to 'blacklist' each other for non-compliance, the FATF overturned the commitment to mutual evaluation and engaged in a 'naming and shaming' campaign, identifying countries guilty of non-cooperation in the so-called Non-Cooperative Countries or Territories (NCCT) initiative.¹⁵ In February

2000, the FATF identified 15 'non-cooperative countries and territories' on a list of 29 suspect jurisdictions (FATF, 2000). The 'guilty' included the Cayman Islands, Bahamas, Liechtenstein, Panama, Israel and Russia, but not the British Virgin Islands, Gibraltar, Guernsey, the Isle of Man and Jersey. The FATF warned that if those countries or territories identified as non-cooperative "maintained their detrimental rules and practices, FATF members would then need to consider the adoption of countermeasures." Countermeasures ranged from issuing advisories to domestic financial institutions to the most serious

15 . Initially when the blacklist was being drawn up, the UK insisted that Switzerland be included because of its financial secrecy provisions. The Swiss delegation replied that if Switzerland was on the list, they would retaliate by making sure the UK was blacklisted as well. Subsequently both parties came to a quiet compromise whereby each agreed that the other would be left off the list. Later, Germany criticised the United States for lack of due diligence and 'know your customer' procedures regarding Delaware limited liability corporations, which could be established in 24 hours by fax. The German delegation's remarks were summarily rejected. (Sharman, 2004).

possible sanction: those members and non-members alike who failed to ‘sufficiently’ satisfy AML criteria would be listed and ‘punished’ by ‘enhanced due diligence’ (slowing down) or “conditioning, restricting, targeting, or even prohibiting financial transactions with non-cooperative jurisdictions” (FATF, 2000; Economist, 2007).

The NCCT initiative served as a potent coercive tool that shifted many of the most recalcitrant jurisdictions into legislative and institutional reform on money laundering – at least on paper. Following the 9/11 attacks, the G7 pressured the IMF and World Bank in 2002 to become involved in the AML regime in an effort to raise its profile. As a consequence the NCCT initiative withered away. The IMF insisted that the FATF blacklisting be discontinued because the practice was seen as inappropriate and likely to be discredited as arbitrary and discriminatory (Sharman, 2004; Drezner, 2005; Levi, 2005).¹⁶ IMF endorsement of the FATF recommendations was based on an agreement to wind down the NCCT list, instituting consensus, cooperation and a fair and transparent methodology in its place. The inclusion of AML/CFT monitoring as part of the Reports on the Observance of Standards and Codes (ROSC) process seems to have had mixed effects on the work that the FATF was already conducting. The IMF audits of offshore jurisdictions are very different in conduct and tone with a much more inclusive and consensual

approach. They lack the judgemental or assertive declarative aspect that is the key feature of blacklisting (Sharman, 2004). Auditing by the IMF may be considerably less effective than the blacklisting, which successfully took advantage of the sensitivity of OFCs to reputational damage.

The NCCT process has been criticised for being arbitrary and lacking a consistent methodology. Many have observed that the AML regime reinforced the political character of FATF and highlighted the influence of G7 countries.¹⁷ The willingness (or capacity) of the FATF to apply its consistent principles to the more powerful nations has been questioned. Critics argue the tighter control of ‘off-shores’ is aimed at generating a competitive advantage for FATF members (Levi, 2005).¹⁸ The United States and Canada, for instance, have consistently failed to meet some of the crucial FATF Forty Recommendations, yet there was never any likelihood that they would appear on the NCCT list (Sharman, 2004). In fact, Delaware’s standards are worse than those of some jurisdictions on the list. Including the IMF in the regime addressed some of the membership shortcomings of the FATF and renewed doubt regarding the ability of financial assessments to efficiently and legitimately deal with standards closely linked to criminal justice (Tsingou, 2005). With the removal of Burma in October 2006, there were no more countries on the NCCT list.

16. In a November 2002 agreement with the IMF, the FATF agreed to discontinue its NCCT list, although jurisdictions which at that point were still on the list remained until they had enacted specified reforms (Sharman, 2004; BBC, 2002). Monitoring of AML/CFT standards was added to the ROSCs, which are a key component of the IMF’s Financial Sector Assessment Program (FSAP), in November 2002.

17. Francisco Thoumi notes that from a Latin American perspective the AML regime is largely seen as a unilateralist approach to regulating financial markets, which didn’t take into account the concerns of some of the key countries in Latin America affected by money laundering when it was designed.

18. At the core of the regime, FATF promotes global standards but is essentially a political organisation in its membership and practices; while its scope is global, its website states that to qualify for membership a country has to be “strategically important” (Tsingou, 2005).

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The OECD blacklisting initiative against harmful tax practices withered away as well. Strong resistance came from the tax haven community, banks in OECD and non-OECD countries, and from low-tax-lobbying organisations. A major weakness was that the OECD proposals were restricted in geographical scope to tax evasion by corporate and individual residents of OECD countries. The OECD also restricted its list of tax havens to 38 jurisdictions, mostly small island tax havens, excluding major tax haven jurisdictions like Luxembourg, Switzerland, the United Kingdom and the United States. The targeted tax havens protested vigorously against this discrimination, and their frequent demands for “a more level playing field” stalled the process (Christensen, 2007; Rawlings, 2007).

Rather than instituting automatic exchange of information, the OECD proposals opted for information exchange on request through the bilateral Tax Information Exchange Agreements (TIEAs), which is far weaker, more expensive and cumbersome – consequently less likely to deter tax evasion. These agreements are extraordinarily difficult to negotiate. The onus remains on the requesting nation to prove that the information sought is ‘foreseeably relevant’ to suspected crime or tax evasion, which means applicant countries need to provide evidence to support their requests. This provision is to thwart any ‘fishing trips’ for information. Furthermore, havens and jurisdictions supporting secrecy are not required to provide information they do not normally collect. By 2005 the OECD’s process was effectively stalled. At the November 2005 meeting of the OECD Global Forum on Taxation the organisation abandoned the time periods it had imposed on tax havens to comply with transparency and information exchange requirements. This major retreat effectively transformed the

OECD proposals into relatively toothless voluntary code of conduct.

Since its inception, the OECD has had a lead role in dealing with international tax issues. However, its agenda has largely reflected the interests of member states. Rising concern about the role of tax havens, the majority of which are directly or indirectly connected to OECD member states, has demonstrated a need for a more broadly based multilateral forum, including developing countries. The OECD’s Global Forum on Taxation does not provide a genuinely multilateral framework for dialogue between equals. Participation is by invitation only, the agenda is offset by OECD countries, and decision-taking is generally reserved to them in closed meetings.

A report commissioned by the International Trade and Investment Organisation, a grouping of small countries with international finance centres, showed yet another weakness: OECD member countries do not operate to a higher standard than so-called offshore centres and in important cases they operate to a lower standard. Many US states, including Delaware and Nevada, require no beneficial ownership information from companies. The US, UK, Canada, France, Germany, Italy, Switzerland, Austria, Luxembourg and Costa Rica still permit bearer share companies, hence accepting reduced transparency. Major players in international finance like Hong Kong and Singapore restrict exchange of tax information to domestic interests, Switzerland limiting it to cases of tax fraud and the like (Stoll-Davey, 2007).

Many OECD countries indeed have skeletons in their own closets. Recent research by Sharman (2009; Sharman, upcoming) shows that the US, the UK and other OECD states collect significantly less information on the beneficial

owners of anonymous shell companies than do offshore financial centres. Identifying who is really behind corporate vehicles and their bank accounts is the key element in most important global governance initiatives to fight money laundering, tax evasion, grand corruption and corporate malfeasance, and the financing of terrorism. Requests were made to 45 different corporate service providers in 22 different countries to create anonymous corporate vehicles and to set up bank accounts linked to these shell companies. Seventeen of the 45 attempts to solicit anonymous corporate vehicles met with success, and all but four of the service providers were in OECD countries (seven in the UK, four in the US, one in Spain, and one in Canada). Only four service providers (in Hong Kong, Singapore, Belize and Uruguay) out of 28 in jurisdictions often identified as 'tax havens' were willing to meet the request. Corporate service providers in Bermuda, the Bahamas, British Virgin Islands, Cayman Islands, Liechtenstein, Seychelles and Panama were meticulous in their customer due diligence.

Obtaining bank accounts proved to be more difficult, as banks were rarely willing to open a corporate account without the 'know your customer' documentation. Although the level of international compliance was higher, the same patterns applied as that regarding the corporate service providers: on average, the US and UK have a worse record of compliance than offshore financial centres. In 2009, Sharman was able to create a Nevada company and subsequently open an account at one of America's most prominent banks producing only a scanned copy of a driver's licence. In contrast, when the author bought a Seychellois International Business Company with a Cypriot bank account he had to provide notarised passport copies, utility bills, bank references and complete a long questionnaire (Sharman, 2009).

If the blacklisting had been more effective than the subsequent IMF approach, it was, at best, flawed. Gregory Rawlings (2007) found that the blacklisting process might even have had a reverse effect. Although a number of states abolished their offshore facilities, reduced the number of offshore financial products, or experienced such a loss of business that the facilities' continued viability is doubtful, other key OFCs have seen business increase. Through complying with the OECD initiatives, OFC states (for example, the Cayman Islands, Bermuda, Jersey, Guernsey, and the Isle of Man, as well as unlisted centres of international private banking like Singapore) have re-established their reputation and political soundness in the eyes of investors, and are now considered jurisdictions with 'good governance', meeting the highest international standards. By fulfilling recommendations while tactfully treading over their intent, these OFCs have preserved their fiscal sovereignty, enjoying a restored reputation and enhanced viability. They continue to be ideal locales for structuring transnational business ventures for tax evasion and avoidance.

Credit crunch

Apparently the multilateral initiatives for responsive regulation have brought about the reverse of what was originally intended. By allowing OFCs to demonstrate their good governance they maintain their client base, hence sustaining an ongoing fiscal competition between states for tax revenues. Compliance with the OECD, EU and IMF, has enhanced offshore sovereignty and maintained its continued appeal to international finance. The failure to establish strong enforcement capacities, meant that the multilateral approach was vulnerable to bilateralism from the outset (Rawlings, 2007).



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An often repeated justification to support the AML regime is that it claims to counter the dark side of neo-liberal globalisation and protect the integrity of the financial system against the corruptive impact of crime money and laundering (Van Duyne, 2003b). However, the 2007-2008 credit crisis revealed that the global financial system wasn't jeopardised by a sinister league of criminals but by law-abiding cohorts of bankers and financial wizards. A remarkable shift in vocabulary has taken place. A term like 'shadow banking system' is not associated with the murky criminal underworld but with the world of legitimate banks and the financial services industry and their off-balance-sheet special purpose vehicles. These vehicles are not overpriced exotic cars bought with excessive bonuses, but financial products very few people understand, and appreciate even less so regarding their impact on the stability of the financial system.

"Since capital is costly, bank managers try to circumvent regulation by either hiding risk or by moving some leverage outside the bank," according to the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, better known as the Stiglitz Commission. The decrease in the leverage ratio of commercial banks was accompanied by an increase in the leverage ratios of non-bank financial institutions. This shift of leverage created a shadow banking system, that is, a parallel network for channelling investment and credit consisting of over-the-counter derivatives, off-balance-

sheet entities, and other non-bank financial institutions such as insurance companies, hedge funds, and private equity funds. "Thanks to credit derivatives, these new players can replicate the maturity transformation role of banks, while escaping normal bank regulation. At its peak, the shadow banking system in the United States held assets of more than \$16 trillion, about \$4 trillion more than regulated deposit-taking banks" (UNCTAD, 2009).

The emergence of the shadow banking system essentially went unnoticed, or unopposed, by the regulators responsible for the integrity of the financial system (Hannoun, 2008). This lack of probity is all the more blatant in light of the warnings in 2000 from the FSF that prudential regulatory requirements could be thwarted, and effective supervision frustrated by OFCs (FSF, 2000a). The collapse of that shadow banking system jump-started the current crisis, instigated by an overabundance of financial innovation and a lack of financial regulation within the core economies of the OECD (Dieter et. al., 2009).¹⁹

Attention returned to the tax havens and OFCs, which played a major role in the 'credit crunch' and the current financial crisis. They were not the only cause of the crisis, but they were a major contributing factor. According to Daniel Lebègue, former vice-chairman of BNP and present chairman of Transparency International France: "If the international community wants to regain control of the financial system, increase monitoring of players and promote international cooperation, then it must

19. In his book *The Return of Depression Economics and the Crisis of 2008*, Nobel laureate in economics Paul Krugman describes the run on the shadow banking system as the "core of what happened" to cause the crisis. "As the shadow banking system expanded to rival or even surpass conventional banking in importance, politicians and government officials should have realized that they were re-creating the kind of financial vulnerability that made the Great Depression possible – and they should have responded by extending regulations and the financial safety net to cover these new institutions. Influential figures should have proclaimed a simple rule: anything that does what a bank does, anything that has to be rescued in crises the way banks are, should be regulated like a bank." He referred to this lack of controls as "malign neglect" (Krugman, 2009: 163).

address this ‘black hole’ of finance that has built up underground, in the offshore financial centres. These places condone or facilitate money-laundering operations from criminal activities. But they also facilitate or contribute to the diversion of huge sums produced by other capital investments. They also deprive states of resources. Moreover, as the current crisis develops, these centres and the actors they host constitute a major systemic risk for all global finance” (TJN, 2008).

At the summit in London in April 2009 the G20, having replaced the G7/8, recognised the threat of unregulated and illicit money flows. “It is essential to protect public finances and international standards against the risks posed by non-cooperative jurisdictions. We call on all jurisdictions to adhere to the international standards in the prudential, tax, and AML/CFT areas. To this end, we call on the appropriate bodies to conduct and strengthen objective peer reviews, based on existing processes, including through the FSAP process” (G20, 2009b). The FATF was advised to revise and reinvigorate the review process for assessing compliance by jurisdictions with AML/CFT standards, using agreed evaluation reports where available. The G20 leaders pledged to take firm action against the so-called ‘non-cooperative jurisdictions,’ including tax havens. “We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over” (G20, 2009a).

In September in Pittsburgh, the G20 leaders re-committed themselves “to maintain the momentum in dealing with tax havens, money laundering, proceeds of corruption, terrorist financing, and prudential standards.” They promised to employ countermeasures against tax havens from March 2010 and called upon the FATF to issue a public list of high-risk

jurisdictions by February 2010. The Financial Stability Board (successor to the FSF, including G20 members not previously members of FSF) was asked to report on progress in addressing non-cooperative jurisdictions with regard to international cooperation and information exchange in November 2009 and to initiate a peer review process by February 2010 (G20, 2009c).

In the Progress report on the actions to promote financial regulatory reform, issued by the US chair of the Pittsburgh G20 summit, new initiatives to strengthen the AML regime were outlined. The FATF’s International Cooperation Review Group (ICRG) agreed on new procedures to identify high risk and uncooperative jurisdictions. An in-depth review is being undertaken, engaging with jurisdictions of interest, and the ICRG will report back to the FATF plenary with recommendations in February 2010. “The FATF will consider the progress of every publicly identified jurisdiction on an ongoing basis and will stand ready to use countermeasures where necessary.” The FATF is reviewing elements of the Recommendations, such as customer due diligence (‘know your customer’ rules), law enforcement, beneficial ownership of assets, international cooperation, and whether tax crimes should be considered as a predicate offence for money laundering (G20, 2009d).

A new drive to regulate and monitor unregulated and illicit money flows has been initiated. When the domestic tax payer had to cover the losses of large financial institutions tax evasion and tax avoidance activities of the financial industry and the rich became less acceptable than ever. The global financial crisis provided an opportunity for the first time in years to curb tax evasion worldwide. Under pressure from the EU, European tax havens such as Switzerland, Liechtenstein, Andorra,



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Austria and Luxembourg agreed to allow more cross-border cooperation. They were forced to conform to current international standards for tax information exchange in the OECD Model Tax Convention although this falls short in some respects of those in the OECD's Tax Information Exchange Agreements (TIEAs). Critics remain sceptical. The information is only provided 'on request'. Foreign tax authorities are required to supply prima facie evidence for their suspicions. Fears that foreign authorities would make 'blanket requests' for information did not materialise (Financial Times, 2009). In that the tax havens agreed to cooperate only on a case-by-case basis any vigorous onslaught was discouraged. Information sharing would not be automatic as is required by the European Savings Tax Directive (Spiegel, 2009a).

Offshore centres reluctant to co-operate with foreign tax authorities faced the threat of being blacklisted at the April 2009 G20 summit in London. Sanctions ranging from higher withholding taxes to restricting banking transactions could be applied. However, within five days after the close of the London summit, the OECD published the shortest blacklist of all time, with exactly zero entries. Miraculously, all tax havens disappeared overnight, and tax evasion had become a problem of the past. The 'non-list' was primarily the result of skilful diplomacy. To get off the OECD list, a jurisdiction needs twelve active tax-information-exchange treaties. Autonomous provinces like the Faroe Islands (population 48,000) suddenly found themselves in great demand to sign treaties with countries they had never had any commerce with. Even the most notorious OFCs managed to purge themselves of all suspicions of aiding and abetting tax evaders. All they had to do in order to be removed from the list was to provide the OECD with the solemn assurance

that they intended to abide by international agreements in the future. Whether this will actually happen remains to be seen (Spiegel, 2009b).

G20 countries lack moral legitimacy when demanding that smaller tax havens and OFCs comply. According to participants in the preparatory meetings leading up to the April London summit, the Chinese categorically refused to allow its two Special Administrative Regions, Hong Kong and Macau to be placed on the grey list, even though they are considered safe havens for tax evaders and merit being placed on the black list. The Chinese threatened to let the entire list project fail. Critics argue that the OECD and the G20 are the wrong organisations to handle the issue (Spiegel, 2009b).

Sharman (2009) suggests that the G20 countries, particularly the US and the UK, are much more guilty of financial opacity than are the exotic tax havens. "The G20 and OECD have fixated on the problem of the willingness to exchange financial information between countries. This ignores the prior issue that unless countries enforce the obligation to collect information on those entering the financial system, there will simply be no information to exchange. It is hardly credible to say that major OECD centres lack the means to enforce the 'know your customer' standards they have designed, committed to and imposed on others. Instead, it seems that these countries have simply chosen not to comply with important international benchmarks, or, in what amounts to the same thing, have not summoned the political will to face down domestic constituencies resisting tighter financial regulation. It is thus indicative that these governments of many onshore financial centres have failed to regulate corporate service providers."

Secrecy regarding the beneficial ownership of corporations is a much more serious obstacle to countering money laundering than bank customer secrecy, according to a report prepared for the UN, as far back as 1998 (Blum et al, 1998). In 2000 a study by Transcrime (2000: 15-16) also concluded that establishing the beneficial ownership of companies is the most essential factor in the transparency of a financial system. Failure to disclose beneficial ownership results in a “domino effect”: maximizing anonymity in financial transactions migrates to other sectors of the law, thwarting criminal investigation and prosecution. Removing bank customer secrecy doesn’t solve any problem if the companies operating the bank accounts remain anonymous. Contrary to the premise that the problem was offshore, the study found that on average EU members did worse than offshore centres regarding the transparency of company law, and thus needed to “clean up their act” before lecturing others.

Similarly, the FSF identified access to timely information regarding beneficial ownership of corporate vehicles as crucial. While there are international standards concerning the disclosure of information about corporate vehicles (the FATF Recommendations require financial institutions to know the identity of corporate customers, before opening accounts), there are no international standards or standard-setting body for corporate formation. “As a result, practice varies widely across jurisdictions, both onshore and offshore, on arrangements whereby authorities can obtain information about the beneficial ownership of corporate vehicles registered in their jurisdiction and the powers to share

that information with foreign authorities” (FSF, 2000: 18).

In 2009, the Stiglitz Commission, formed in 2008 to advise the United Nations on the consequences of the financial meltdown and its impact on development, did not see any improvements. “While particular attention has focused on offshore financial centres in developing countries, so far the principal sources of tax evasion, tax secrecy, money laundering, and regulatory arbitrage have been through on-shore tax havens in developed countries’ financial centres. Delaware and Nevada, for instance, are two U.S. states that make the establishment of anonymous accounts far easier than almost all international banking centres. Bank customer secrecy remains an issue in several developed country financial centres. London’s light touch regulatory regime has also been a source of much regulatory arbitrage. The biggest money laundering cases involved banks in London, New York, and Zurich. The European Commission has decided to refer four smaller member states to the European Court of Justice over non-implementation of the 2005 anti-money laundering directive, and two large member states have been given a final warning” (UN, 2009b: 82-84).²⁰

The way forward

The ‘new’ initiatives of the G20 to tackle non-cooperative jurisdictions are remarkably similar to previous attempts to stamp out money laundering and other illicit and unregulated

20 . In the US, Senator Carl Levin has sponsored a bill that would require all states to require the names of the beneficial owners of companies, and to release that information to law enforcement if subpoenaed. Whether that bill, S-569, will become law is still an open question. In 2007, before the economic meltdown, Levin with the then Senator Barack Obama introduced a similar bill, the Stop Tax Haven Abuse Act. It made no progress. Subsequently, President Obama chose the former senator from Delaware, Joe Biden, as his vice president. Delaware opposes the new bill (Sharman, 2009).

Financial Secrecy Index

The Tax Justice Network compiled a Financial Secrecy Index (FSI) ranking the jurisdictions most aggressive in providing secrecy in international finance, and which most actively shun co-operation with other jurisdictions. The FSI reveals that the majority of global players in the supply of financial secrecy are not the usual suspects, the tiny, isolated islands, but rich nations operating their own specialised jurisdictions of secrecy, often with links to smaller ‘satellite’ jurisdictions acting as conduits for illicit financial flows into the mainstream capital markets.

The FSI focused on 60 secrecy jurisdictions, employing two measurements, one qualitative and one quantitative. The qualitative measure takes into account a jurisdiction’s laws and regulations, international treaties, and so on, to assess how secretive it is. The assessment is given in the form of an opacity score. The higher the score, the more opaque the jurisdiction. The quantitative measurement is a weighting of the jurisdiction’s size and overall importance to the global financial markets (TJN, 2009). In the Table is the Top 15 of the FSI.

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Secrecy Jurisdiction	Opacity Score	Global Scale Weight	Opacity Component Value	FSI Value	FSI Rank
USA (Delaware)	92	0.17767	84.6	1503.80	1
Luxembourg	87	0.14890	75.7	1127.02	2
Switzerland	100	0.05134	100.0	513.40	3
Cayman Islands	92	0.04767	84.6	403.48	4
United Kingdom (City of London)	42	0.19716	17.6	347.79	5
Ireland	62	0.03739	38.4	143.73	6
Bermuda	92	0.01445	84.6	122.30	7
Singapore	79	0.01752	62.4	109.34	8
Belgium	73	0.01475	53.3	78.60	9
Hong Kong	62	0.01986	38.4	76.34	10
Jersey	87	0.01007	75.7	76.22	11
Austria	91	0.00511	82.8	42.32	12
Guernsey	79	0.00580	62.4	36.20	13
Bahrain	92	0.00278	84.6	23.53	14
Netherlands	58	0.00689	33.6	23.18	15

Source: Financial Secrecy Index at <http://www.financialsecrecyindex.com/>

money flows. Whether or not the G20 will succeed this time remains to be seen. Previous experience provides little cause for hope. Financial regulation regimes need to advance from ensuring compliance toward ensuring implementation and testing effectiveness (Sharman, upcoming). Eliminating the veil of secrecy and increasing transparency is crucial to any progress. At the TNI seminar Money Laundering, Tax Evasion and Financial Regulation in June 2007 the common denominator of all illicit and harmful unregulated money flows as well as regulation avoidance in the shadow economy, was identified as the attempt to obscure the origin of the money and the beneficial owner, undertaking an 'identity change'. Usually this ID change is made through tax havens and OFCs. Consequently, on the level of regulation any regime pretending to locate untraceable illicit or harmful financial flows should attempt to tackle this process of ID change. Financial transparency is therefore required for competent law enforcement and tax authorities. Needless to say, attention to establish safeguards for privacy and civil liberties is imperative to address legitimate concerns about infringements.

The central importance of tax for all states suggests that the United Nations, the 'G192', would be the best organisation for convening an international tax body. Indeed, the UN International Conference Financing for Development identified the need to address capital flight and associated tax evasion to mobilise resources for development to meet the Millennium Development Goals (UN, 2009a). Since its formation in 2004 the UN Committee of Experts on International Cooperation in Tax Matters (known as the UN Tax Committee) remains dominated by OECD member states. It has not shown to be very effective or proactive, and in need of resources to be so. In contrast to the OECD Department of Fiscal

Affairs, which is globally renowned for its technical expertise, the UN Tax Committee has minimal staff. The Tax Justice Network (TJN) proposes upgrading the UN Committee of Tax Experts to become a legitimate specialist Commission, inside the UN Economic and Social Council, complemented by a strengthening of the UN Convention Against Corruption. The convention offers possible avenues for tackling the enablers of corruption, hence combating capital flight and tax evasion, despite not explicitly identifying the issues (Christensen, 2007).

The G20, the OECD and the FATF may have been more effective than the UN in constructing an AML regime and devising an international tax regime, but in the long run they lacked the functional mechanisms and legitimacy to make it work. Although the 'soft law' mutual evaluation approach created a set of recommendations accepted by most countries, it nevertheless appears to have reached the end of its implementation. The G20 seems to be set on another round of blacklisting, despite the questionable practices of some its members. When the major powers in these 'clubs', as Drezner (2005) labelled them, cannot be held to account, the system's effectiveness, as well as its legitimacy, is diminished. The Stiglitz Commission's report clearly addresses this issue: "The determinants of standards and whether particular countries are in violation of those standards must be conducted through a multilateral process in which developing and developed countries have adequate representation. The current dominance of an organization of the advanced industrial countries [NB: the OECD] in this area should be viewed as unacceptable" (UN, 2009b: 82-84).

Substantial reform is necessary. The Stiglitz Commission notes bilateral tax agreements



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should end: “The matter would be best handled through multilateral agreements on issues of tax secrecy, which have reciprocity and are enforceable by international courts. The major financial centres should sign up to these agreements first and then urge others to follow, with the threat that those who do not chose to do so will not be allowed to have links with those financial centres that have accepted the conditions of the agreement. Under these agreements, ‘rogue centres’ should be ring-fenced from the rest of the international financial system, but this would be done in an objective manner that could include rich as well as poor countries.” It is necessary “to strive for a universal no-tolerance policy towards financial centres that provide banking secrecy and facilitate tax evasion” (UN, 2009b: 82-84).

To do so, the Stiglitz Commission proposes “a new Global Financial Authority to co-ordinate financial regulation in general and to establish and/or coordinate global rules in certain areas, such as regarding money laundering and tax secrecy” (UN, 2009b: 94-96). One of the first tasks of such an institution might be to prepare a UN convention on financial integrity and stability. Such a convention should overcome the shortcomings of the ‘soft law’ approach to address all the issues of illicit and unregulated money flows, including tax avoidance and avoidance of prudential regulatory requirements to hide substantial risks from regulators. The elimination of

secrecy jurisdictions is equally a top priority. An earlier report observed how much recent liberalisation of financial services has been advanced through multilateral and bilateral trade agreements. It proposed that as regulatory frameworks of the financial system are changed and the issue of tax havens and OFCs is being addressed, the WTO/GATS trade rules regarding the financial services trade must be revisited (UN, 2009a).

To avoid powerful countries taking unilateral measures, a multilateral agreement or convention is necessary to protect every country’s tax base and pursue money launderers and tax evaders. The US forcing the Swiss UBS bank and the government of Switzerland to give up the names of account holders and adjust the country’s bank customer secrecy laws is a clear example of the unilateral tendency.²¹ Less powerful countries do not have the same leverage on secrecy jurisdictions. The US effectively serves the role of Switzerland for Mexico, which suffers from rampant tax evasion. Much of the estimated US\$ 42 billion a year of illicit funds flowing out of Mexico each year ends up in US banks, according to Global Financial Integrity (GFIP, 2008).²² This sum does not include drug cartel money, although the system in place is believed to facilitate those funds as well. In this context, the US\$ 1.5 billion of US aid to fight the drug-related violence in Mexico (the Merida Initiative) is small change.

21. In March 2009, the Swiss Federal Government announced that it was to adopt the standards of the OECD and in future would also offer administrative assistance regarding tax evasion in new negotiations with major financial centres (Article 26 of the OECD Model Tax Convention). This does not, however, imply the automatic exchange of information, as there are strict conditions on administrative assistance, like well-founded suspicion of a tax offence (Swiss Bankers Association website, access date, December 5, 2009; <http://www.swissbanking.org/en/home/themen-geheimnis.htm>).

22. “It’s not that the U.S. has no policies in place to stem the flow of illicit monies into the U.S. banking system. American banks are in fact required to file suspicious activity reports (SARs) for cash deposits over \$10,000 or when they detect deposit patterns in lower amounts, known as ‘structuring.’ The problem is that the U.S. government is overwhelmed by more than a million of these reports a year. Computers can detect some irregularities, but these need to be combed through carefully by 85 SAR review teams – combining FBI, IRS, DEA and U.S. Attorneys – across the country. That’s why, says international white collar crime lawyer Bruce Zagaris, “U.S. officials have practically begged banks to call them when they have something really good” (Time, 2009).

Many of the obstacles cited above will have to be dealt with in designing a transparent and effective global framework at the UN level. However, much of the preparatory work has been laid down in the recommendations and proposals of the FATF, OECD and the Financial Stability Board that most countries have endorsed or accepted. The devil is in the detail: moving from recommendations to obligations; prioritising the main issues (such as beneficial ownership, bank customer secrecy and transparent information exchange); and ensuring the necessary coercive instruments to prevent jurisdictions from opting out. Issues like tax avoidance and harmful tax competition between nations might be addressed by a country-by-country accounting of sales, profits, and taxes paid by multinational corporations as well as automatic cross-border exchange of tax information on personal and business accounts. Another measure could be to introduce a sufficiently high mandatory minimum tax rate at the global level.

A UN convention is neither the panacea nor guarantee for successfully creating an efficient regime to counter money laundering and tax dodging. However, previous efforts have reached their sale-by dates. A convention would codify the soft law recommendations and oblige signatories to include them in national legislation, obliging observance. The great powers who until now have enjoyed a certain immunity because they control the system would have to follow the same rules as the smaller nations. Of course negotiating the treaty is a cumbersome process, full of obstacles and potential deadlocks. UN involvement puts issues on the agenda. The UN climate change negotiations are such a case, as is the UN Millennium Goals process, exemplified by the Doha Declaration on Financing for Development that proposed solidarity levies to fund development. And the UN process is

inclusive and would engage developing nations, at present left out in the 'club' oriented process.

Unlike the issue of global warming, there is no hard evidence that money laundering, tax evasion and its attendant social evils has created enormous public concern. Serious UN commitment to the issue would draw media attention and subsequent public awareness, creating an opportunity for civil society to hold governments to their commitments and come up with new suggestions. A global agreement to regulate tax havens and OFCs to guarantee national and international tax bases as well as seize criminal money would help to ensure the necessary funding for global ambitions, as well as helping to confront the cost and the underlying causes of the financial crisis.



Glossary of main terms and abbreviations

- **AML** - Anti Money Laundering
- **BCBS** - Basel Committee on Banking Supervision
- **Bearer share** - A bearer share differs from a normal share because no record is kept of who owns it. Whoever physically has the bearer share is for legal purposes its owner. Bearer shares are used to preserve anonymity on the part of owners. Because of their potential use for money laundering and in tax evasion they are severely frowned upon but some states still allow their use regardless.
- **Beneficial owner** - Anyone who has the benefits of ownership. The term refers to the true owner of an entity, asset, or transaction as opposed to the legal or nominee owners of property and with trustees, all of whom might be recorded as having legal title to property without possessing the right to enjoy the benefits of using it. The beneficial owner is the one that receives proceeds or other advantages as a result of the ownership. It is common practice in offshore financial secrecy jurisdictions to interpose entities, individuals, or both as stated owners. The beneficial or true owner is contractually acknowledged in side agreements, statements or by other devices.
- **Capital flight** - The process whereby wealth holders deposit their funds and other assets offshore rather than in the banks of their country of residence. The result is that assets and income are not declared in the country in which a person resides.
- **CFC** - Controlled foreign corporation: a tax definition to describe a situation in which a company which charges tax on the profits of corporations has a subsidiary registered in a tax haven or other territory where little or no tax is charged on the profit the subsidiary makes. The subsidiary is then called a CFC and its profits can in some cases be subject to tax in the country of residence of the parent company.
- **CFT** - Combating the Financing of Terrorism.
- **DTA** - Double tax agreement or treaty: an agreement between two sovereign states or territories to ensure, as far as possible, that income arising in one and received in the other is taxed only once. Includes rules to define residence and source, and limits on withholding taxes. Also usually includes provisions for cooperation to prevent avoidance, especially bilateral information exchange. Considerably more comprehensive than Tax Information Exchange Agreements and usually not made available to tax havens / secrecy jurisdictions for that reason.
- **Due Diligence** - A legal term meaning to do your homework/research. Due diligence projects are typically a kind of audit. Customer due diligence (CDD) or 'know your customer' (KYC) measures are identifying and verifying the customer ; identifying and verifying the beneficial owner; obtaining information on the purpose and intended nature of the business relationship; scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the institution's knowledge of the customer, their business and risk profile, including the source of funds.
- **EU Savings Tax Directive** - The EU Savings Tax Directive was adopted to ensure the proper operation of the internal market and tackle the problem of tax evasion. It was approved in 2003 and came into effect on July 1, 2005. It is an agreement between the Member States of the European Union (EU) that requires Member States to exchange information with each other about EU residents who earn interest on savings and investments in one EU Member State but live in another. Although the legal scope of the Directive does not extend outside the EU, certain jurisdictions – such as Switzerland, Liechtenstein, Andorra, Monaco, and San Marino, the UK's Crown dependencies and Overseas Territories and their Dutch equivalents – have agreed to put in place legislation that supports the aims of the Directive. All Member States are ultimately expected to automatically exchange information on interest payments by paying agents established in their territories to individuals resident in other Member States. The major weaknesses in the Directive are that it only applies to interest income and only to income paid to individuals and not to companies, trusts, foundations and other arrangements.
- **FATF** - Financial Action Task Force. The FATF is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. The FATF is a policy-making body created in 1989 that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas. The FATF has published 40 + 9 Recommendations in order to meet this objective (FATF website; <http://www.fatf-gafi.org/>)
- **Freezing of assets** - The process by which a person suspected of money laundering may have their assets seized temporarily by the state(s) investigating their affairs to ensure that if the case against them

is proven those funds can be either claimed by that state or be returned to those to whom the rightfully belong. Seized assets are appropriated by regulatory authorities from those found guilty of or suspected of money laundering offences.

- **FSAP** - Financial Sector Assessment Program. A joint IMF and World Bank effort introduced in May 1999, which aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries. Its work programs seek to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the financial sector's developmental and technical assistance needs; and to help prioritize policy responses. The results are published in Reports on Observance of Standards and Codes (ROSCs).
- **FSB** - Financial Stability Board, successor to the FSF, including G20 members not previously members of FSF. Although the 2007-2008 financial crisis provided clear indication that the FSF had neither achieved its goals nor given warning of an impending crisis, the G20 London Summit in April 2009 re-established the FSF as the FSB, with a broadened mandate to promote financial stability.
- **FSF** - Financial Stability Forum. The FSF was established in April 1999 after the 1997-1998 Asian financial crisis and was constituted at the initiative of G7 Finance Ministers and Central Bank Governors as a 'club of clubs' representing G7 interests. Each G7 member is assigned three members – a finance ministry official, a central bank official, and a financial regulatory authority. Three other countries – Hong Kong, Australia, and the Netherlands – have a total of five members. The remaining sixteen members consist of representatives from the IMF and the World Bank, the BIS and its emanations, and pre-existing regulatory bodies. Six of those sixteen representatives come from club-based organisations of which the G7 were the principal members (Drezner, 2005). The FSF was established in order to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country, thus destabilizing the world economy.
- **FSRB** - FATF-Style Regional Body, such as the Asia/Pacific Group on Money Laundering (APG), the Caribbean Financial Action Task Force (CFATF), the Eastern and South African Anti Money Laundering Group (ESAAMLG), the Eurasian Group (EAG), the Financial Action Task Force of South America Against Money Laundering (GAFISUD), the Groupe

Inter-Gouvernemental d'Action Contre le Blanchiment de l'Argent en Afrique (GIABA), the Middle East & North Africa Financial Action Task Force (MENAFATF), and the Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL)

- **G7/8** - Group of governments of the richest major industrial democracies in the world: France, Germany, Italy, Japan, the United Kingdom, Canada, and the United States, formed in the mid-1970s. Russia formally joined the G7 in 1997. Annual meetings deal with the major economic and political issues facing the international community, circumventing the United Nations. The G7/8 has developed a network of supporting ministerial meetings, which allow ministers to meet regularly throughout the year in order to continue the work set out at each summit; these include the meetings of the finance ministers, foreign ministers and environment ministers, among others. G7/8 ministers and officials also meet on an ad hoc basis to deal with pressing issues, such as terrorism, energy, and development; sometimes task forces or working groups are created to focus intensively on issues of concern, such as a drug-related money laundering (FATF), nuclear safety, and transnational organized crime. Succeeded by the G20.
- **G20** - The G20 is made up of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, and the United States of America. The European Union, represented by the rotating Council presidency and the European Central Bank, is the twentieth member of the G20. To ensure global economic forums and institutions work together, the heads of the IMF and the World Bank, plus the chairs of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank also participate in G20 meetings on an ex-officio basis. The G20 claims that the member states represent around 90 percent of global gross national product, 80 percent of world trade as well as two-thirds of the world's population. With the G20 growing in stature since the 2008 Washington summit, its leaders announced in September 2009 that the group would replace the G8 as the main global economic council.
- **Illicit financial flow** - Illicit money is money that is illegally earned, transferred or utilized. Breaking laws anywhere along the way earns such funds the label. Frequently described as 'dirty money'. These

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cross-border transfers come in three forms: (1) criminal activities including drug trafficking, human trafficking, illegal arms, contraband and more; (2) the proceeds of bribery and theft by government officials; and (3) commercial trade mis-pricing (transfer pricing) and tax evasion.

- **KYC** - 'Know your customer' or 'know your client' rule, urging banks to get to know the true identity of their clients so that money launderers can be detected. KYC is the due diligence and bank regulation that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business with them (see: due diligence).
- **Limited liability** - The right granted in law to the members of a company to be protected from claims made by that company's third party creditors in the event of its insolvency. Whilst of benefit when used properly it is also an opportunity for fraudulent abuse, requiring its proper regulation which can rarely happen in secrecy jurisdictions where too little information is available to regulators for this purpose
- **Money laundering** - The processing of criminal proceeds to disguise their illegal origin to give it the appearance of originating from a legitimate source, enabling the criminal to enjoy profits without jeopardising their source. Money laundering is usually described as having three sequential elements – placement, layering, and integration. Placement is the introduction of the funds into the financial system, whether through cash deposits or more complex methods. Layering is a set of activities intended to distance the funds from their point of criminal origin. Integration involves converting illegal proceeds into apparently legitimate business earnings through normal financial or commercial operations.
- **NCCT** - Non-Cooperative Countries or Territories: financial centres that do not adopt and implement measures for the prevention, detection and punishment of money laundering according to internationally recognised FATF standards (FATF website). In February 2000, the FATF identified 15 'non-cooperative countries and territories' on a list of 29 suspect jurisdictions (FATF, 2000). Since 2007 there were no more countries on the NCCT list.
- **OECD** - Organisation for Economic Co-operation and Development: comprises the major industrial countries committed to democracy and the market economy from around the world. The OECD was the successor to the Organisation for European Economic Co-operation (OEEC), set up in 1948 to

help administer the Marshall Plan to reconstruct Western Europe during the cold war. The OECD has a particular role with regard to tax related issues where it has established most of the rules with regard to information exchange now in use, the most commonly used models for double tax agreements and Tax Information Exchange Agreements and has played a significant role in the attack on tax havens / secrecy jurisdictions. It has, however, been criticised for being a 'rich country club' and for being too lenient on its own members.

- **OFC** - Offshore Financial Centre: there is no agreed definition of offshore. The term has often been used to describe any jurisdiction (regardless of whether they are islands) which provides tax and regulatory privileges or advantages, generally to companies, trusts and bank account holders on condition that they do not conduct active business affairs within that jurisdiction. Although most tax havens are Offshore Finance Centres (OFCs) the terms are not synonymous. Tax havens are defined by their offering low or minimal rates of tax to non-residents but may or may not host a range of financial services providers. An OFC actually hosts a functional financial services centre, including branches or subsidiaries of major international banks. States that host tax havens and OFCs generally dislike both terms, preferring to use the term International Finance Centres.
- **Risk-based approach** - A risk-based approach allows the regulated institutions to determine the relevant risks and to tailor their controls on the basis of their risk appraisal. Institutions are then inspected for the reasonableness of and justification for the risk appraisal and the design of the controls. This is often contrasted with a so-called rule-based approach where the regulator determines the rules that the regulated must apply. In a rule-based system institutions are inspected to determine whether they comply with the prescribed rules. Risk is not unimportant in the latter context because a reasonable regulator will determine the relevant rules based on its determination of risk. The main difference between the two approaches is the allocation of responsibility for determining the risk and the appropriate risk management actions: the regulator (rule-based) or the regulated (risk-based). In practice the approaches may be even be combined with some elements being regulated in a rule-based and others in a risk-based manner. A risk-based approach allows financial institutions to find solutions more closely attuned to their needs.
- **ROSC** - Report on the Observance of Standards

and Codes, coordinated by the IMF and World Bank. ROSCs summarize the extent to which countries observe certain internationally recognized financial standards and codes. These comprise accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation; AML/CFT was added in November 2002. Reports summarizing countries' observance of these standards are prepared and published at the request of the member country. ROSCs are expected to identify institutional weaknesses, as well as their significance, and progress achieved in implementing standards, as well as to include prioritised recommendations. The World Bank and IMF have underscored that care should be exercised to ensure that ROSCs do not provide ratings or make use of pass-fail judgments. (Reports on the Observance of Standards and Codes (ROSCs), IMF website; <https://www.imf.org/external/np/rosc/rosc.asp>, accessed October 15, 2009)

- **Rule-based approach** - See risk-based approach.
- **Secrecy jurisdiction** - Places such as tax havens and OFCs that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so. What these places have in common is legal and financial secrecy. These entail a kind of privatisation of sovereignty, in which a legal refuge offering privileges for certain types of private parties and businesses is created, often designed by lawyers acting as intermediaries between governments and private interests. The beneficiaries are provided with a legal refuge or protection from the laws of other states, without needing to physically relocate as they can use the legal fictions of newly created corporations or trusts. This type of shelter, essentially designed to avoid taxation, can be used to facilitate a wide variety of 'dirty money' flows when allied with offshore financial services.
- **Shadow banking system** - The shadow banking system is a parallel network for channelling investment and credit consisting of over-the-coun-

ter derivatives, off-balance-sheet entities, and other non-bank financial institutions such as insurance companies, hedge funds, and private equity funds. The system replicates the maturity transformation role of banks, while escaping normal bank regulation. At its peak, the shadow banking system in the United States held assets of more than \$16 trillion, about \$4 trillion more than regulated deposit-taking banks (UNCTAD, 2009).

- **Shell companies** - A limited liability entity usually formed in a tax haven / secrecy jurisdiction for the purposes of hiding illicit financial flows, tax evasion or regulatory abuse. The entity is highly unlikely to have a real trade, its sole purpose being to hide transactions from view. No one knows how many such corporations there are, but they are commonplace.
- **Tax avoidance** - The term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud). It refers to structuring one's affairs so as to reduce one's tax liability within the limits of the law. A given form of tax avoidance is legal unless and until otherwise determined by a court. A notable example of tax avoidance is a multinational enterprise choosing to locate intellectual property in a subsidiary based in low tax jurisdiction. Such activity is usually legal, yet some may regard it as unethical given that it can substantially reduce tax contributions and, therefore, deplete public finances.
- **Tax competition** - This term refers to the pressure on governments to reduce taxes usually to attract investment, either by way of reduction in declared tax rates, or through the granting of special allowances and reliefs such as tax holidays or the use of export processing zones. Some argue that the main role of tax havens / secrecy jurisdictions is in promoting tax competition which forces down the rates of tax in states. Others argue that this is the job of political parties elected by free and fair election and thus receiving democratic mandates.
- **Tax evasion** - General term for efforts by individuals, companies, trusts and other entities to evade taxes by illegal means. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, often through the use of tax havens or secrecy jurisdictions.
- **Tax haven** - There is no agreed upon definition of tax haven. To most people, the term 'tax haven' is an expression synonymous with tax circumvention

or evasion. The central feature of a tax haven is that its laws and other measures can be used to evade or avoid the tax laws or regulations of other jurisdictions. Minimisation of tax liability is an important element. This generally depends on (1) use of paper or 'shell' companies, trusts and other legal entities, and (2) routing and managing financial flows. Hence, tax and financial management are closely linked. The OECD defined a tax haven as a jurisdiction which has: (a) no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by nonresidents to escape tax in their country of residence; (b) laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction; (c) lack of transparency, and (d) the absence of a requirement that the activity be substantial, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven (transactions may be booked there without the requirement of adding value so that there is little real activity, i.e. these jurisdictions are essentially 'booking centres')" (OECD 1998, 22-23).

- **Tax Justice Network** - TJN promotes transparency in international finance and opposes secrecy. They support a level playing field on tax and oppose loopholes and distortions in tax and regulation, and the abuses that flow from them. TJN promotes tax compliance and opposes tax evasion, tax avoidance, and all the mechanisms that enable owners and controllers of wealth to escape their responsibilities to the societies on which they and their wealth depend. Tax havens, or secrecy jurisdictions as TJN prefers to call them, lie at the centre of their concerns (TJN website; <http://www.taxjustice.net/>).
- **TIEA** - Tax Information Exchange Agreement: bilateral agreement under which territories agree to co-operate in tax matters through exchange of information. TIEAs represent the standard of effective exchange of information for the purposes of the OECD's initiative on harmful tax practices. The model agreement, which was released in April 2002, is not a binding instrument but contains two models for bilateral agreements. In practice the model was little used until the G20 applied considerable pressure to tax havens / secrecy jurisdictions to sign such agreements. The evidence is that the few that are operational are little-used because of the considerable obstacles to making requests that are inherent within them. Until secrecy jurisdictions make data

on beneficial ownership publicly available and the use of offshore trusts is better regulated, it is hard to see what impact Tax Information Exchange Agreements will have on transparency.

- **Transfer Pricing** - Pricing agreements established by mutual agreement rather than free market forces through over- and under-invoicing to shift money at will between parent companies, subsidiaries, and affiliates in different countries. In practice, these are often associated with intra-company transactions of transnational corporations to minimize taxes and maximize profits. The technique is also used to launder money. The difficulty for many corporations at a time when up to 60% of world trade is within rather than between corporations is that there is no market price for many of the goods or services that they trade across national boundaries because they are never sold to third parties in the state in which they are transferred across national boundaries within the corporation. This gives rise to complex models in which attempts are made to allocate value to various stages within the supply chain within a company, a process which is open to potential abuse. For this reason it is argued that such firms should be taxed on a unitary basis.
- **Trust** - A trust is formed whenever a person (the settlor) gives legal ownership of an asset (the trust property) to another person (the trustee) on condition that they apply the income and gains arising from that asset for the benefit of one or other people (the beneficiaries). Trustees are frequently professional people or firms charging fees. The identity of beneficiaries can remain a secret because those to whom payment of income or capital from a trust might be made is supposedly left to the sole discretion of the trustees.
- **Withholding tax** - Tax deducted from a payment made to a person resident outside the jurisdiction in which the payment originates. Generally applied to investment income, such as interest, dividends, royalties and licence fees. The use of withholding taxes has reduced considerably in the last two decades as they are thought to impede the free movement and flow of capital.

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In this issue of Crime & Globalisation, Tom Blickman tracks the history of the international anti-money laundering (AML) regime. Since its origin in 1989 there is a growing awareness that the AML regime is not working as well as intended. After two decades of failed efforts, experts still ponder how to implement one that does work.

During that time other illicit or unregulated money flows have appeared on the international agenda as well. Today, tax evasion and avoidance, flight capital, transfer pricing and mispricing, and the proceeds of grand corruption are seen as perhaps more detrimental obstacles to good governance and the stability and integrity of the financial system.

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Tax havens and offshore financial centres (OFCs) were identified as facilitating these unregulated and illicit money flows. The 2007-2008 credit crisis made only too clear the major systemic risk for all global finance posed by the secrecy provided by tax havens and OFCs. They were used to circumvent prudential regulatory requirements for banks and other financial institutions and hide substantial risks from onshore regulators.

In 2009 the G20 has again pledged to bring illicit and harmful unregulated money flows under control. This briefing looks at previous attempts to do so and the difficulties encountered along the way. Can the G20 succeed or is it merely following the same path that led to inadequate measures? What are the lessons to be learned and are bolder initiatives required?

In brief, the paper concludes that current initiatives have reached their sale-by date and that a bolder initiative is required at the United Nations level, moving from recommendations to obligations, and fully engaging developing nations, at present left out in the current 'club'-oriented process.

Founded in 1974, TNI is an international network of activists and researchers committed to critically analysing current and future global problems. Its goal is to provide intellectual support to grassroots movements concerned about creating a more democratic, equitable and sustainable world.

The Crime and Globalisation Project examines the synergy between neo-liberal globalisation and crime. The project aims to stimulate critical thinking about mainstream discourses, which turn a blind eye to the criminogenic effects of globalisation. Crime is deteriorating human security situations and is a serious challenge to achieve the United Nations Millennium Development Goals.

The programme does field research, fosters political debate, provides information to officials and journalists, coordinates expert seminars, and produces analytical articles and documents.

On the one hand, the project is concerned with the number of people being forced to 'migrate into illegality' due to impoverishment and marginalisation. The development of 'shadow' or 'underground' economies is a major challenge to good governance. It is in the grey area of unregulated informal markets, that illegal and legal economic actors meet.

On the other hand, the project is concerned with the body of multilateral agreements put in place to counter the complex issues of security, transnational organized crime, money laundering, and political terrorism. Countermeasures are often based on limited national security concepts and are being adopted on the basis of vague definitions, scant information and tenuous links, and have serious consequences for civil liberties, human rights and national sovereignty.

Such an approach takes no cognisance of the criminogenic aspects of the globalisation process, nor does it help meet the much broader human security needs of developing countries, particularly in relation to the increasing urban crime problems of the booming shanty towns of the South.