The Ugliest Chapter in Global Economic Affairs Since Slavery

Speech by Raymond W. Baker, Global Financial Integrity Program, www.gfip.org
"Illicit Financial Flows: The Missing Link in Development"
Thursday, June 28, 2007

I want to talk about two things this morning. One, the international structure that supports the flow of illicit money across borders, and two the harmful impact these illicit flows have on economic growth and poverty alleviation in poorer countries.

To begin, let's get a simple picture of global poverty and inequality fixed in our minds.

What we have here are two bar charts depicting the two usual ways of measuring global income. One is based on purchasing power parity and the other on currency exchange rates. In each bar chart each color represents 20 percent of the world's population. The size of the color indicates the portion of global income flowing to that 20 percent grouping. Look at how much of global income flows to the top 20 percent, or quintile, and how little of global income is available to the bottom 80 percent. Seventy to 90 percent of global income belongs to the top 20 percent, leaving only ten to 30 percent of global income for the bottom 80 percent of the world.

What I want you to understand about illicit financial flows is that the basic motivation driving this phenomenon is the shift of money from the bottom to the top, from poor to rich. In particular, out of the hands of the 80 percent into the hands of the 20 percent, out of the countries where 80 percent of the world's population lives into countries where 20 percent of the world's population lives.

Now let's focus on the structure that supports illicit financial flows. Illicit or corrupt money is money that is illegally earned, illegally transferred, or illegally utilized. If it breaks laws in its origin, movement, or use it merits the label.

There are three forms of illicit and corrupt money that cross borders—1) the proceeds of bribery and theft by government officials, 2) the proceeds of criminal activities such as drug trading, racketeering, counterfeiting, contraband, and including terrorist funds, and 3) the proceeds of tax-evading and laundered commercial transactions.

Since the 1960s we have built and expanded a global structure to facilitate the movement of illicit money. A few elements of this structure were available before then, but the development of the structure accelerated in the 1960s for two reasons. First, it was the period of decolonization. From the late 1950s to the end of the 1960s, 48 countries gained their independence from European powers. Many political leaders and wealthy businesspeople wanted to take money out of these newly independent counties, a desire which was well serviced by western financial institutions. Second, corporations began to spread their flags across the planet. Certainly there were international companies before the 1960s, but typically an international oil or trading company had overseas branches in only 12 or 15 countries. The great thrust to expand all over the globe took off in the

1960s and has continued up to the present. Most of these corporations utilize tax evading techniques to relocate profits across borders at will. For these two reasons—decolonization and the spread of multinational corporations—the 1960s marked the point at which the expansion of the illicit financial structure took off in earnest.

There are a number of interrelated parts of the illicit financial structure.

Tax havens – These are places where you can set up an entity—a corporation or partnership or trust fund—and then you can sell to that entity and that entity can sell to other entities, and you can structure the pricing in such a way that all or most of the profits are earned in the tax haven entity, and it doesn't have to pay taxes or pays only minimal taxes on those profits. There are now 72 tax havens around the world.

Offshore secrecy jurisdictions – These are places, usually located within tax havens, where you can set up these entities behind nominees and trustees such that no one knows who are the real owners and managers of the business.

Disguised corporations – These disguised entities now number in the millions across the globe.

Flee clauses – Many of these disguised corporations are equipped with flee clauses. Thus, the nominee directors and fake owners can have the entity flee from one secrecy jurisdiction to another should anyone come knocking on the door trying to find out who are the real owners or managers of the business.

Anonymous trust accounts – You can also set up trust accounts behind nominees and trustees, disguising both the donor and the beneficiary of the trust.

Fake foundations – You can set up a charitable foundation, donate money to this charitable entity, and designate yourself the beneficiary of the charity of the foundation.

False documentation – Used in all sorts of trade and capital transactions.

Falsified pricing – This is by far the most commonly used element in the illicit financial structure—falsifying prices on imports and exports in order to shift money across borders.

Money-laundering techniques – Many specialized devices have been created to facilitate the disguised shift of illicit funds across borders.

Holes left in western laws – Gaps in legislation facilitate the movement of money through the illicit financial structure and ultimately into western economies.

All three forms of illicit money—the bribery component, the criminal component, and the commercial component—use this structure. It was developed in the West originally to facilitate the movement of flight capital and tax-evading proceeds out of one place and into another place. In the mid and late 1960s and 1970s, drug dealers stepped into these channels to shift their proceeds across borders into the legitimate financial system. In the 1980s and 1990s, seeing how easy it was for drug dealers to move their profits, other kinds of racketeers stepped into these same channels to move their illicit proceeds across borders. In the 1990s and in the current decade, again observing how easy it was for the drug dealers and racketeers, terrorists stepped into these same channels to shift their proceeds around the world.

Drug kingpins, criminal syndicate heads, and terrorist masterminds did not invent any new ways of moving their illicit proceeds. They merely utilized the mechanisms that we had created for the purpose of moving flight capital and tax-evading money.

Perhaps you are thinking that anti-money laundering laws are designed to address this. Well, yes and no. Many nations have major holes in their anti-money laundering laws. Take the United States for example. We bar only the incoming proceeds of drugs, bribery, and terrorism. It remains legal to bring into the United States the proceeds of other forms of foreign crimes, including racketeering, handling stolen property, credit fraud, counterfeiting, contraband, slave trading, alien smuggling, trafficking in women, environmental crimes, and of course, all forms of tax-evading money. Without trying to cover each country in Europe, suffice it to say that no western nation does a good job of enforcing its anti-money laundering regime.

For the first time in the 200-year run of the free-market system, we have built and expanded an entire integrated global financial structure the basic purpose of which is to shift money from poor to rich.

I estimate that something on the order of $1 trillion to $1.6 trillion of illicit money moves across borders annually. These estimates are conservative and are developed with some care in my book, Capitalism's Achilles Heel, utilizing both top down and bottom up approaches. Other analysts think these estimates are considerably short of the real global totals.

This $1 trillion or more per year of illicit money that moves across borders and the structure that facilitates its movement is the biggest loophole in the global economic system.

Now let me turn again to poverty and inequality. This $1 trillion or more a year of illicit money that flows across borders and the structure that facilitates its movement is not only the biggest loophole in the global economic system. It is also the most damaging economic condition hurting the poor in developing and transitional economies. It drains hard-currency reserves, heightens inflation, reduces tax collection, worsens income gaps, cancels investment, hurts competition, and undermines trade. It leads to shortened lives for millions of people and deprived existences for billions more. Within the economic realm, as distinguishable from political affairs or environmental constraints, nothing approaches the harmful effects caused by massive outflows of illegal money from poor nations into rich nations.

Of the $1 to $1.6 trillion of illicit money that I estimate crosses borders annually, I further estimate that half—$500 to $800 billion a year—comes out of developing and transitional economies. These are countries with the weakest legal and administrative structures, the largest drug and criminal gangs, and, far too often, political and economic elites who want to shift their money abroad.

The cross-border component of bribery and theft by government officials is the smallest, only about three percent of the global total. The criminal component constitutes about 30 to 35 percent of the total. And the commercially tax-evading component, driven primarily by falsified pricing in imports and exports, is by far the largest, at some 60 to 65 percent of the global total. I am the first to state that these are orders of magnitude, but they nevertheless serve to illustrate the scope of the problem.

Now, cross-border illicit financial flows force us to address some prevailing myths and erroneous assumptions we often make in economics.

First, many people think that outflows of illicit money are just a temporary phenomenon, and when economic and political conditions become normalized this illicit money will return to countries of origin. Not correct. By far the greater part of illicit money streaming out of developing and transitional economies— some 80 to 90 percent of it—is a permanent outward transfer. The little bit that does come back almost always returns as foreign direct investment—FDI—having gone abroad and acquired a foreign nationality as a company or partnership or investment fund. Then, of course, after investment locally, it is intended to go abroad again in the form of interest and principle on loans or dividends on share capital.

Second, some people argue that we can't distinguish between legal and illegal capital flight. On the contrary, there is a very clear difference. Legal transfers stay on the books of the company or individual making the transfer. Illegal transfers are designed to disappear from any record in the country from which the money comes. For example, many bank accounts opened by foreigners in Europe and the contain the instruction, "Hold all mail."

Third, the little account known as "errors and omissions." Many people think this balancing account in national statistics shows flight capital going out of a country. In fact it shows very little of it. It does not record any of the trade mispricing, which is the biggest component. When a transaction is mispriced for the purpose of shifting money across borders, this mixes capital with trade, and the capital component does not appear separately on the commercial invoice. This explains how literally trillions of dollars have escaped across borders with hardly anyone taking notice.

Fourth, illicit financial flows make the most basic data we collect on developing and transitional economies inaccurate. Trade mispricing misstates the value of imports and exports. Capital transfers are unrecorded. And as a result, GDP is misstated. The cumulative effect of these errors is enormous. Furthermore, illicit financial flows make all our data on global inequality wrong. We are substantially under-recording the income of the rich. No one can accurately assert that the global income gap is narrowing. It may be, but we will not know this until we do a much better job of estimating the hidden income of the rich, particularly that tucked away in tax havens globally and in private banks in Europe and North America.

Now, let's go further and consider the impact of this estimated $500 to $800 billion of illegal money coming annually out of poor countries.

1) It eviscerates foreign aid. Through most of the 1990s and into the current decade, aid has been running about $50 to $80 billion a year from all sources. Consider the comparison: $50 to $80 billion of aid in; $500 to $800 billion of illicit money out. In other words, for every $1 that we have been generously handing out across the top of the table, we in the West have been taking back some $10 of illicit money under the table. There is no way to make this formula work for anyone, poor or rich.

2) Consider the effect on specific countries. The Tax Justice Network estimates that the amount of money domiciled in tax havens, ultimately sent on to the West, is $11.5 trillion. Think of this in terms of individual countries. Russia has probably experienced the greatest theft of resources that has ever occurred in a short period of time—an estimated $200 to $500 billion since the beginning of the 1990s. This was accomplished by underpricing exports of oil, gas, gold, diamonds, aluminum, tin, zinc, pulp, timber, and other commodities. China is pushing these numbers and may have exceeded this level already. Again, the technique is underpricing of exports out of China, with the balance of the price accumulating in foreign subsidiaries and lodged in foreign bank accounts. Nigeria has probably experienced the greatest illegal outflow as a percentage of GDP. Here we have an oil-rich country of 140 million people with 70 percent of its population— that's 100 million people—living on $1 to $2 a day. Congo has had the longest rip-off of any country, going on for two centuries now. The best available estimate of incremental deaths in Congo, above normal mortality rates, since 2000 is 4.5 million. Illicit money flowing out of poor countries kills people. In Venezuela, the fight between HugoChavez and his state-owned oil company, PDVSA, is over the question of who will control oil revenues. For more than 20 years, the overseers of Venezuela's oil reserves have shifted proceeds offshore, using transfer pricing techniques, in order to get revenues out of the hands of politicians and bureaucrats in Caracas.

3) Consider the impact on other global "bads." Illicit money makes the drug problem insolvable, in the United States and in Europe and in producing countries as well. Illicit money has been the principle driving force in the explosion of global crime over the last 25 years, making cross-border racketeering one of the fastest growing businesses in the world. Illicit money underlies the rise of Al Qaeda, with some $300 million estimated to have passed through the illicit financial structure into bin Laden's hands in the decade prior to 9/11. Illicit money is the way that Saddam Hussein rearmed after the first Persian Gulf War, buying munitions that are killing Iraqis, Americans, British, and others in that country today. The illicit financial structure enabled A.Q. Khan, the Pakistani nuclear scientist, to buy and sell nuclear materials across many countries. And this phenomenon

contributes to a number of failed states. My wife's NGO, The Fund for Peace, annually produces the "Failed State Index," published in Foreign Policy magazine. Two years ago the most failed state on the index was Côte d'Ivoire — Ivory Coast. Several years ago I was in the Bank of France, the equivalent of our Federal Reserve Board, talking with the director of West African affairs. He told me that at the time of his death in 1993, the long-term leader of Côte d'Ivoire, Houphouët-Boigny, had assets outside of Côte d'Ivoire valued at $7 billion. I blanched and asked, "Do you mean francs or dollars?" He repeated, "dollars." This is a small country primarily producing cocoa for export to Europe and the United States to make chocolate, and its long-term leader had accumulated $7 billion in foreign assets. Of course, the country soon descended into utter chaos.

Think what would happen if $500 billion a year, or a reasonable part of it, stayed in the developing and transitional economies rather than coming illegally out. It would alter our shared world for the better, rich and poor alike.

Ten years ago I stepped out of international business and into the think-tank community with a primary goal of getting reality on the table. I had seen more corruption, more money laundering, more financial crime than any one person should see in a lifetime, and I resolved to say what I wanted to say about this overarching reality. Why wasn't reality already on the table? What is it about this subject matter that is so mysterious or so frightening that we hesitate to go there? Basically is it that we can't see it or don't want to see it?

Paul Krugman, the American economist, says that he has come to understand ". . . the remarkable extent to which the methodology of economics creates blind spots. We just don't see what we can't model."

Jack Blum, the well-known money-laundering legal expert and a member of our program's advisory board, says that these are numbers that ". . . no one wants to know."

Which is it? We can't see it, or we don't want to see it, or a combination of the two, or some other explanation? Whatever the explanation, this is a shortcoming in our analysis of and pursuit of economic development that must be corrected.

This is the reality that we seek to get on the table. Illicit outflows from developing and transitional economies vastly exceed overseas development assistance going into developing and transitional economies. In my estimates, which I and others think are conservative, by a factor of ten to one. More analysis, better analysis in the future may make this a narrower picture or make it a wider picture. But no analysis will make this a pretty picture.

What we need to do is analyze the whole of the financial equation for development—total capital in, total capital out, what's left over, both the money we can see and estimates of the money that is veiled and hidden.

Within the whole of the financial equation we should include foreign direct investment going into developing and transitional economies. And when we look at FDI going in, we also have to look at visible dividends and loan repayments coming out and invisible transfer pricing taking money out. We also have to look at remittances going into developing and transitional economies, largely by family members living abroad. We also have to look at charitable and foundation money going into poorer countries.

The biggest item we have to consider is this illicit money streaming out of developing and transitional economies. The harm done by illicit financial outflows exceeds the good done by overseas development assistance.

Economic deprivation brutalizes billions of people. This makes it necessary for us to be brutally honest with ourselves. This reality, broadly depicted here, has been going on for decades and cumulatively has moved trillions of dollars out of poor countries into rich countries. This reality, broadly depicted here, propelled by the illicit financial structure that we created in good part of accomplish exactly this end, this reality is, in my reading of history and in my judgment, this reality is the ugliest chapter in global economic affairs since slavery. The poor deserve better from us.

Now let me close with three points.

1) We don’t ask you to accept these numbers. We ask you to do just the opposite – to produce your own numbers. We ask the World Bank and other international financial institutions and the community of development scholars to do your own analyses. If you do it honestly and thoroughly, you are very likely to come up with numbers that are greater than these.

2) Be prepared to produce a range of numbers. Highs and lows. Best estimates and deviations from such estimates. We will not reach certainty about these illicit and hidden flows, just as we do not have certainty about how many poor people there are in the world. But we can reach clarity as to the order of magnitude of the problem and consensus on the importance of the issue.

3) Numbers produced by the World Bank and the development community—your numbers— will bolster the political will to address the issue—curtailing illicit outflows from poorer countries. How such flows can be reduced is another subject. Two quick comments. The goal is to curtail, not stop, but substantially curtail illicit outflows. And curtailing these outflows is a matter of political will; it is not rocket science. We are not asking the international financial institutions or the community of development scholars to solve the problem. We are asking you to put numbers on the problem. What is required is a broad consensus as to the magnitude of the problem and the damage that is wrought by these realities.

Numbers will drive the policy. Believable numbers will drive this issue onto the political-economy agenda.

It is time, ladies and gentlemen, for the first time, to put the whole of the financial equation for development squarely on the table. This may well be the most important contribution we can currently make toward achieving poverty alleviation, growth, security, and perhaps even contributing to peace for the vast majority of people in our shared world.

Raymond W. Baker, author of "Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-market System," (John Wiley and Sons, Inc., 2005) is a guest scholar at the Brookings Institution and senior fellow at the Center for International Policy in Washington, D.C. Jennifer Nordin was director of economic studies at the Center for International Policy.