Plundering a Continent

Raymond W. Baker, Director, Global Financial Integrity

Raymond Baker is the Director of Global Financial Integrity and a Senior Fellow at the Center for International Policy in Washington, D.C., researching and writing on the linkages between corruption, money laundering, and poverty. He is the author of Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System. *In 2011 he was named to the High Level Panel on Illicit Financial Flows from Africa, chaired by former President of South Africa, Thabo Mbeki.*

In 1961 I arrived in Lagos, Nigeria, to take over the management of a company. One of the early conversations I had was with an "old coaster," a British gentleman who was managing director of a UK-based trading company that had been active along the west coast of Africa since the late 1800s. I asked him, "How do you do business in Africa?" He looked me skeptically up one side and down the other and wasn't very forthcoming. I got the distinct impression that he did not like Americans showing up in his former British colony so soon after independence. But I pressed on as is my American manner and asked further, "Well, okay, tell me, how do you price your imported cars and textiles and building materials to sell in the Nigerian market?" He answered, "Price? Price is not a problem. I'm not trying to make a profit."

Imagine my surprise. I had just finished Harvard Business School learning all about how to make a profit and here in Africa one of the first persons I encounter tells me he's not trying to make a profit. What could be going on here?

It took me a while to realize that what he was talking about was transfer pricing. Everything he imported was priced at such a high level that, indeed, the Nigerian subsidiary was not supposed to make a profit. It was only supposed to pay the bills for its imports, with all potential profits shifted back to the UK within the invoices of what was being purchased for resale locally. It took me some time longer to realize that most foreign companies were doing similarly and a bit longer still to figure out that many Nigerians involved in foreign trade were doing the same thing—overpricing imports and underpricing exports in order to shift money out of the continent and into foreign bank accounts. Thus began my education in unrecorded, hidden, usually illegal financial flows and the harm they do to developing countries.

The 1960s marked the takeoff point in developing the structure that facilitates such cross-border illicit financial flows. There are two reasons that account for this. First, the 1960s was the decade of independence. Between the late 1950s and the end of the 1960s, 48 countries gained their independence from colonial powers.[1] Some of the political and economic elites in these countries wanted to take their money out by any means possible, and western financial institutions and even governments serviced this desire creatively and effectively.

The 1960s also marked the decade when multinational corporations accelerated their expansion across the world. There were already a handful of international oil and trading companies with operations in perhaps a dozen countries, but the thrust to expand globally took off simultaneously with the decade of independence and has continued since. Many multinational corporations utilized a practice continuing today—aggressive transfer pricing and money laundering schemes to shift profits from countries where they are in business into locations where they are often not in business.

1 http://www.un.org/en/members/growth.shtml

How is this possible? How do you lose money or operate at little or no profit in countries where you are heavily invested and make money in countries and enclaves where you are not invested? Quite simply, you use the global shadow financial system to shift your revenues and profits across borders at will.

This system comprises a number of elements. Tax havens, rising from four or five in the 1950s, now number upwards of 60 situated all around the globe. Most of these tax havens operate as secrecy jurisdictions, meaning that you can establish entities behind nominees and trustees such that no one can find out who are the real owners and managers of these entities. The most popular form—disguised corporations—now number in the millions around the world, more in the United States than in any other country. Anonymous trust accounts are part of this structure. Fake foundations are available, enabling you to donate money to your own foundation and then designate yourself the beneficiary of the distributions. Trade mispricing is the most commonly used device in the global shadow financial system, accounting for more than half of illicit cross-border financial flows. And then there are many specialized forms of money laundering available, so that capital movements can be facilitated through interest payments, derivatives, swap contracts, entirely fake transactions, barter, and more. This global shadow financial system was built by those who live in the countries into which the money arrives, not by those who live in the countries out of which the money comes.

At Global Financial Integrity, we estimate that the shift of laundered money out of Africa over the last 30 years is very roughly on the order to US$1 trillion (Kar and Cartwright-Smith 2010). It could be half that and it could easily be twice that, depending on what cannot be seen in our analyses. Whatever the proper figure, we are dealing with an order of magnitude resulting in a devastating impact on the poorest continent and its one billion-plus people.

For many well meaning observers, including the authors of the Washington Consensus promoting unfettered international trade, the only concern here is the loss of tax revenues. Important as this is, the larger impact is the loss of capital to the economies of the continent. Retaining resources in countries has a multiplier effect on domestic activity. Losing resources drains bank accounts, curtails investment, worsens poverty and inequality, and contributes to political instability.

For a half century the western media has focused attention on corruption in Africa. Much of this attention is well deserved. I lived 15 years in Nigeria and retained business interests there until three years ago, so I am not unfamiliar with the reality. But in our analysis of global cross-border illicit financial flows, we think that the corrupt component, stemming from bribery and theft by government officials, is only about three percent of the total. The criminal component arising from drugs, human trafficking, counterfeiting, illegal arms trading, and more is about 30 to 35 percent of the global total. Trade mispricing, in which multinational corporations are heavily involved, is about 60 to 65 percent of the global total. We have not made a separate analysis of these percentages for Africa. The corrupt component may well be higher, and then again the trade mispricing component may also be considerably higher. But the ranking of the three is no doubt correct.

What is missed by most development experts and economic and political analysts is the systemic nature of this problem. Drug trading is approached as a problem to be fought largely through eradication and interdiction. Human trafficking is basically conceived of as a problem of immigration and border control. Corruption is fought from the bottom up more often than from the top down. Money laundering is a matter of know your customer and suspicious activities reports. What we do not want to admit to ourselves is that all three forms of cross-border illicit financial flows utilize the same shadow financial system to shift their revenues and profits. The key fallacy in global anti-money laundering efforts is the idea that commercial interests can hold on to their use of the shadow financial system to move commercially tax-evading money and at the same time make others give up their use of the shadow financial system to move corrupt and criminal money. This is not possible. It is the facilitating system itself that must be changed.

How? Two guidelines are important. Recognize, first of all, that the goal is to curtail illicit financial flows rather the impossible one of stopping them. And second, encompass both rich and poor countries in accomplishing the necessary reforms.

Broadly speaking, the answer is to replace the shadows with transparency. This means a number of steps.

First, banks and other financial intermediaries should be required to know the natural persons owning and managing all financial accounts. This proposal elicited a response from a Wall Street banker who asked, “Do you have any idea how much it would cost us to know the beneficial owners of all our accounts?” The answer is it costs nothing. You put the shoe on the other foot. You the banker sends a letter to each of your non-personalized account holders requesting within six months the name(s) of the natural person(s) owning the account. You advise of the penalties of making a false declaration to a bank. And you advise that if you subsequently find that the information given is incorrect you will have no choice but to block the account pending disposition according to law. Immediately you the banker will get correct information on probably upwards of 99 percent of your accounts. Hopefully the holders that do not want to respond are the accounts that you would prefer not to have anyway. To put it simply, there is no argument in favor of not knowing with whom you are doing business. This is an issue of huge significance in the fight against corruption, crime, terrorism, and tax evasion, and it is the element of the shadow financial system that is the easiest to curtail.

Second, adopt consistent anti-money laundering (AML) policies across the globe. AML has been important on the world scene for two decades. And for two decades money laundering has been growing. How can this be? Very simply, our efforts are more geared to looking for the money after it has passed from one party to another instead of curtailing the flow before it begins. The shadow financial system defeats AML efforts. The Arab Spring is informative. The Mubaraks, the Ben Alis, and the Kaddafis were found to have large deposits abroad, as yet untallied. But with revelations pouring out of these countries, banks were quick to freeze these accounts, pending further determination of their disposition. Of course, the question is, “Why did you take the money in the first place?” And the reason is because vast gaps are left in global AML efforts, with a decided bias toward easily accepting the money and asking questions only later, if at all. The United States and Europe are replete with laundered money scandals and will continue to be so until AML regulations are tightened and sanctions against sheltering ill-gotten gains are stronger.

Third, automatic exchange of tax information needs to be implemented globally. The argument that African nations and other developing countries cannot deal with the volume of data that would be produced through automatic exchange does not stand up to scrutiny. Any nation can deal with the 10 names or 100 names on their tax rolls with the largest incomes. Automatic exchange has been a reality in the European Union for years. It has existed between the United States and Canada for decades, yet remains to be implemented between the United States and Mexico. Prime Minister Manmoham Singh of India called for automatic exchange at the Cannes G-20 summit in 2011. India is certainly an example of an emerging market country with billions spirited abroad, billions on which tax information should be provided.

In relation to this point, note that all the available measures of global inequality are decidedly underestimates, because they do not include earnings on capital deposited by citizens outside their countries. Those incomes from interest, dividends, and rents pile up abroad and largely slip through the global accounting net, meaning that the rich in many developing countries are far richer than they appear to be. The global gap is wider than income statistics show and getting wider every year. Poverty appears to be declining, but inequality is rising and that poses the greater problem in the long run to reconciling democracy and capitalism. Automatic exchange of tax information is a key toward fighting money laundering and its impact on income inequality.

Fourth, trade mispricing, moving more illicit money across borders than all other methods combined, has to be curtailed. And this is the toughest to accomplish. Fortunately, there is a growing set of data on world market pricing that can be accessed online. Customs officers could compare prices on an invoice to world market data to quickly and fairly check for discrepancies. Customs declaration forms that had a statistically significant deviation from market prices would then be pulled out for further review. Use can be made also of pricing declarations backed up by the signatures of importers and exporters. Both can be asked to sign a statement saying that “The transaction herein is priced at world market norms with no element of mispricing for the purpose of manipulating VAT taxes, customs duties, or income taxes, and the transaction conforms to all exchange control regulations, banking statutes, anti-money laundering laws, and terrorist financing prohibitions in the countries of origin and destination.” Certainly, some exporters and importers will readily violate such a clause. But there are not many multinational corporations that will run such transactions through their tax planning departments for the prohibited tax manipulations and then ask their people to sign a statement saying they did no such thing. Remember, what we are trying to accomplish here is to curtail—not eliminate but curtail—illicit cross-border financial flows. This issue of trade mispricing needs to be addressed now and cannot wait for a perfect world decades down the road.

Finally, country-by-country reporting is an important step leading toward greater integrity in the global financial system. Discussed in another paper in this bulletin, efforts are underway to require extractive industries to report on their payments to governments, vitally important to Africa. But this merely begins what needs to be accomplished, which is full financial reporting in each country, so that corporations cannot continue this process of losing money where they are in business and making money where they are not in business.

Africa has taken a major step on the road toward curtailing cross-border illicit flows. The United Nations Economic Commission for Africa has named a High Level Panel to research how this phenomenon affects the peoples of the continent and what can be done to surmount the problem. Led by former President of South Africa Thabo Mbeki, the panel constitutes the first effort by a continent-wide organization to come to grips with the reality of massive flows shifting money from poor to rich countries.

Above all else, this is a problem requiring concerted effort by both sides of the equation—those in the countries out of which the money comes and those in the countries into which the money arrives. The solutions are not technically difficult. The issue is a matter of political will.

References

Kar, Deve, and Devon Cartwright-Smith. 2010. *Illicit Financial Flows from Africa: Hidden Resource for Development*. Washington, DC: Global Financial Integrity.