# GLOBAL ILLICIT FINANCIAL FLOWS

# AND

# THE PHILOSOPHICAL UNDERMINING OF CAPITALISM

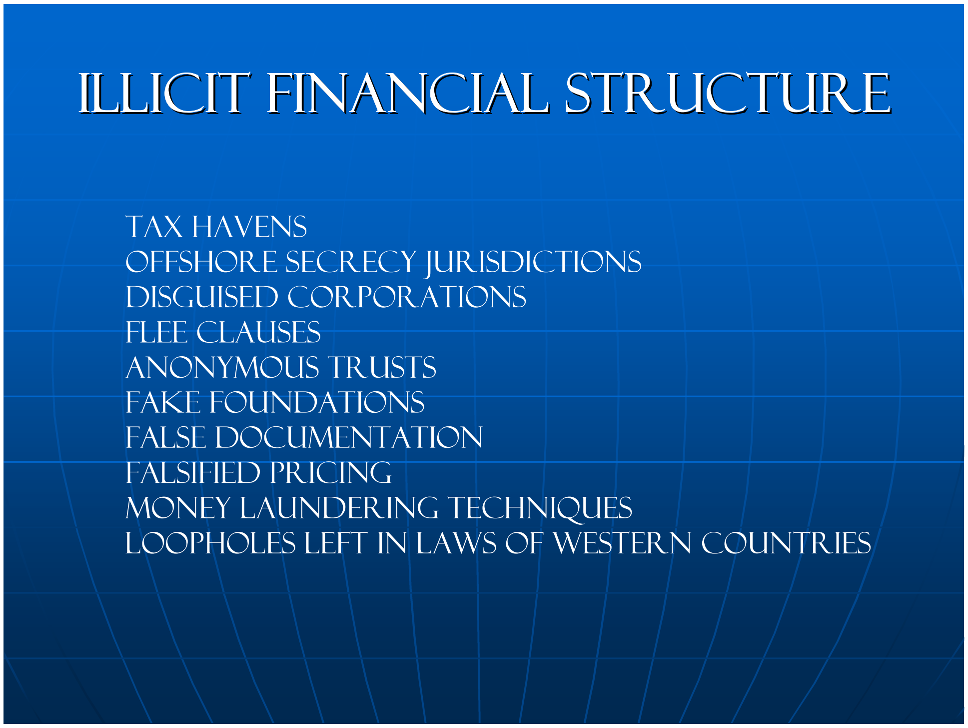
By Raymond W. Baker

Over the past half century, we in the West have created an enormous, integrated global financial structure to facilitate the movement of illicit money across borders. Use of this structure is taught in business schools. Reasons to avoid this structure are not adequately conveyed in ethics courses.

Illicit money is money that is illegally earned, transferred, or utilized. If it breaks laws in its origin, movement, or use it merits the label.

Illicit money crossing borders comes in three forms: 1) the proceeds of bribery and theft by government officials, 2) the proceeds of criminal activities such as drug trafficking and racketeering and including terrorist financing, and 3) the proceeds of commercial tax evasion. All three forms of illicit money use the same structures in shifting across borders.

A few elements of the illicit financial structure were available before the 1960s, but the development of the structure accelerated in that decade 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 countries, 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 multinational 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 an entity can be established—a corporation or partnership or trust fund—and then sales can be made to the entity, and that entity can sell to other entities, and prices can be structured in such a way that all or most of the profits are earned in the tax haven entity, and it does not have to pay taxes or pays only minimal taxes on those profits. There are now 91 tax havens around the world.

Offshore secrecy jurisdictions – Functioning as an integral service within tax havens, these trading entities can be set up behind nominees and trustees such that no one knows who are the real owners and managers of the business.

Disguised corporations – These and other secret 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 seek to find out who are the real owners or managers of the business.

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

Fake foundations – An ostensibly charitable foundation can be established, and donors can designate themselves as beneficiaries of the charity of the foundation.

False documentation – A common feature in many types 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 had been created in the West for the purpose of moving flight capital and tax-evading money.

Many nations leave major holes in their anti-money laundering laws. The United States, for example, bars 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, an entire integrated global financial structure has been built, the basic purpose of which is to shift illicit money across borders.

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 *Capitalism's Achilles Heel*,[1] 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.

What about the impact on global 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 is estimated to cross borders annually, it is further estimated 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 use secretive techniques 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.

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, only for individual depositors, the amount of money domiciled in tax havens, ultimately sent on to the West, is $11.5 trillion. Think of this in terms of 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 is an oil-rich country of 140 million people with 70 percent of its population—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. In other words, illicit money flowing out of poor countries contributes to killing people in poor countries. In Venezuela, the fight between Hugo Chavez 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 ills. 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.

Many business school students, particularly at the graduate level, learn about use of tax havens, shell corporations, and transfer pricing techniques. What they often do not learn is that use of these devices frequently breaks laws in one country or another. The deliberate evasion of value-added taxes, customs duties, and company income taxes through abusive transfer pricing breaks laws in many developed and developing countries. Channeling transactions through non-functioning entities located in tax havens, while claiming that such entities have other legitimate purposes, breaks or skirts laws in more countries.

A recent ruling by the U.S. Supreme Court makes these issues far more urgent for students planning careers in American multinational corporations. Evasion of customs duties was the question in *U.S. vs. Pasquantino*,[2] a case concerning smuggled liquor moving from the United States into Canada. The Supreme Court upheld a lower court ruling that involvement in a scheme to defraud was a violation of U.S. law. The ruling was not contingent upon who was defrauded or of what they were defrauded. A commentary on this and similar cases states that "The misuse of U.S. mails and wires in furtherance of an illegal operation transforms schemes to defraud foreign governments of customs duties into crimes against the United States."[3]

On occasions I speak to a class of law school students who have read *U.S. vs. Pasquantino* in advance. Three or four MBA students are brought into the class to consider a transfer pricing decision in connection with a product to be sold by an American parent company to its foreign subsidiary. The students are asked to maximize profits for the corporation. Invariably they settle on a price that is below the cost of manufacture in the United States and that minimizes VAT taxes and customs duties in the foreign country. The law students are then asked to give a one sentence letter to the MBA students informing them that A) the chance that they have committed a felony offense is zero, or B) there is a chance that their participation in this scheme constitutes a felony offense. Recently, three-fourths of the law school students chose B). How many business and law schools convey to their students the risks attendant to some of the most frequent decisions made in multinational corporations?

Use of the illicit financial structure has become normalized in global business. Estimates are that half of global trade and capital transactions pass through a tax haven or secrecy jurisdiction somewhere between initiation and completion. A high percentage of such transactions violates laws in countries where they are originated, through which they pass, or into which they arrive. Furthermore, a very high percentage of such transactions with developing and transitional economies are intended to extract money from such countries without having to go through the process of accumulating profits locally and declaring dividends payable to parent companies in developed countries. Such actions deprive developing and transitional economies of profits, capital, and tax revenues. These consequences bring hardship and injury into the lives of billions of people around the globe, contributing directly to poverty and inequality.

How did capitalism get to this point?:

- A multifaceted global financial structure designed to handle illicit money.
- An estimated half of international financial flows using this structure.
- Considerable harm done by illicit financial flows to western political and security interests.

- Even greater harm done by illicit financial flows to the nearly three billion people of the world living on $1 to $2 a day.

Netting out its positive and negative features, capitalism is certainly of positive value to global economic progress. But this is not a justification for its poor practices and resulting consequences. Rather, it is grounds for change in the intellectual underpinnings that lend support to the worst aspects of the economic system.

Capitalism is being damaged by the deeply entrenched priority of maximizing—maximizing profits, maximizing returns to shareholders, maximizing the income of the few at the expense of the many, maximizing in far too many situations where even legality becomes subordinate.

We did not learn the priority of maximizing from Adam Smith. His *Theory of Moral Sentiments*, focusing on the “impartial spectator” and a sense of “fellow feeling” makes clear the kinds of people he believed could most effectively function in community. Indeed, Smith opted for the interests of the poor over the rich at every juncture in both *Moral Sentiments* and *Wealth of Nations*.

We did not learn the priority of maximizing from Herbert Spencer. Spencer’s Social Darwinism was focused on sheer survival, not maximizing. The carryover of his notions into modern capitalism is limited at best. Business schools relentlessly teach maximizing, far more often than they teach survival.

We learned maximizing primarily from Jeremy Bentham, the chief proponent of utilitarianism. Bentham’s notion of “the greatest good for the greatest number” arose at the same time as capitalism, in the late 1700s. With its core maximizing intent, the philosophy goes on to posit that:

- Ends can justify means.
- Selective sacrifice of the interest of some to the greater interest of others is acceptable.
- Individual rights are secondary to the goal of maximizing.
- Consequences are the primary basis for judging actions.

Capitalism and utilitarianism soon became linked in an attempt to address problems in English society in the early 1800s, including the Industrial Revolution, serious poverty, the need for judicial reform, and growing calls for greater political participation. Utilitarianism embraced capitalism as a system dedicated to maximizing advantages. Capitalism embraced utilitarianism as a creed that allowed selective sacrifice and approved ends justifying means. The two systems aligned through the next two centuries, presenting future philosophers and capitalists with problems requiring careful reexamination.[4]

Today, utilitarianism—the philosophy of maximizing—lies at the core of the capitalist system and at the core of business school teachings. There is no need to utter the word "utilitarianism" or to identify the concept with Jeremy Bentham and its other proponents. But there is an expectation that among students, faculties, and practitioners, the idea of maximizing will be firmly embedded, its acceptance virtually required for admission into the capitalist club. As Rakesh Khurana at Harvard Business School puts it, students have

> adopted a perverse model of a career that sometimes goes under the umbrella of 'learning, earning, and giving.' That is, I'll get my utilitarian education, I'll earn as much money as possible and as quickly as possible, and *then* I'll give back to society. That's a very unhealthy model.[5]

Two forces attempt to moderate the overriding emphasis on maximizing—the teaching of ethics and the corporate social responsibility (CSR) movement. Teachers of business ethics often find themselves at odds with prevailing doctrines in their schools. Situational ethics within the priority of maximizing is very difficult to convey effectively to many students. CSR is often limited to labor, environmental, and stakeholder concerns. Its concepts are almost never applied to questions surrounding the use of the global illicit financial structure—tax havens, secrecy jurisdictions, dummy corporations, abusive transfer pricing, and financial laundering techniques.

There is a third force that can be brought to bear—the teaching of philosophy. Students would benefit greatly from learning that the priority of maximizing, which lies at the heart of business and legal education, is a choice we have made, not a necessity or inevitability. It is not even what Adam Smith had in mind for the free-market system. It is what others grafted onto his remarkable economic thesis, supplanting his own philosophical offerings. Furthermore, there are alternatives to the priority of maximizing. Students would be well served by teachings that enable them to emerge from their educations with a grasp, however brief, of alternatives offered by Immanuel Kant, John Rawls, even Robert Nozick, and others. Thus, the suggestion here is that consideration be given to segueing from the teaching of ethics into the teaching of philosophy—the philosophical underpinnings of the capitalist system and how such underpinnings may evolve in future years.

Permit me to end with a personal note. At Harvard Business School, I took a required course entitled "Business Responsibilities in the American Society." I do not recall a single case or situation taken up in that course. After finishing my MBA, I went across the river to Harvard University and took a course entitled "Twentieth Century Philosophical Movements," taught by Rafael Demos. I recall much of what I learned from this experience, particularly about the philosophy of existentialism. This course prepared my mind for what I then encountered in my 35-year business career all over the developing world and further prepared my mind for understanding something of the philosophical writings on social justice emanating from Rawls and others in later years. For me, it was the philosophy course rather than the ethics course that proved to be formative across my career.

I recently had an interaction with Lord Daniel Brennan, former Chairman of the Bar in England and Wales.[6] Lord Brennan lamented that the essential thrust of business and legal education today is “functional, not formative.” In the future, professional education will hopefully become much more balanced across concerns that are both functional and formative. With strong skills and inquisitive intellects, students will be better prepared to handle the quite different economic and social challenges facing them in the 21st century.

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[1] Raymond W. Baker, Capitalism’s Achilles Heel: Dirty Money and How to Renew the Free-Market System. John Wiley & Sons, Inc. 2005.
[2] *United States v Pasquantino*, 336 F.3d 321. (Argued November 9, 2004–Decided April 26, 2005).
[3] Bradley R. Wilson, “Subtle Indiscretions? International Smuggling, Federal Criminal Law, and the Revenue Rule.” *Cornell Law Review* 89, no. 1 (November 2003): p.253, 260.
[4] A further discussion of this can be found in Part III of Capitalism’s Achilles Heel, p.279-331.
[5] Thompson, Roger, "How Business Schools Lost Their Way." Harvard Business School Alumni Bulletin, Dec 2007: p.35.
[6] Lord Brennan is also a member of the Global Financial Integrity Advisory Board.

**ABSTRACT**

Over the past half century, an integrated global financial structure to facilitate the movement of illicit money has been created. This structure comprises tax havens, secrecy jurisdictions, disguised corporations, anonymous trust accounts, fake foundations, falsified pricing, and money-laundering techniques. This structure moves corrupt, criminal, and commercially tax evading money easily across borders. Global illicit financial flows are estimated at $1 to $1.6 trillion a

year, with half—$500 to $800 billion a year—coming out of developing countries into western economies. These illicit flows undermine foreign aid, contribute to poverty and inequality in poorer countries, undermine the fight against global crime, and negatively impact the security interests of richer nations. Yet this structure and these illicit financial flows find justifications in the maximizing underpinnings of the capitalist system, contrary to the vision of Adam Smith but consistent with the vision of Jeremy Bentham. The teaching of situational ethics does not appear to satisfactorily address this issue. Teachers of ethics in business, law and economics schools may wish to consider segueing entirely into the teaching of philosophy and how the philosophical foundations of capitalism may evolve in the future.