

COUNCIL *on*  
FOREIGN  
RELATIONS

*International Institutions and  
Global Governance Program*

October 2018

# Global Governance to Combat Illicit Financial Flows

Measurement, Evaluation, Innovation

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# Countering Illicit Financial Flows: Expanding Agenda, Fragmented Governance

*Miles Kahler*

International efforts to curb illicit financial flows (IFFs) resemble post–Cold War collaboration in other issue areas that have risen on the global agenda: climate change, global health, internet governance, and cybersecurity. Nongovernmental actors, including private corporations and nongovernmental organizations (NGOs), have often driven agenda-setting in those domains. The focus has shifted over time, as new issues have been added and as older issues have assumed renewed importance. That reshaped agenda has in turn affected the institutional ecosystem of global action, which is captured only in part by formal and informal intergovernmental institutions. These new issue areas are characterized not by a single dominant institution or core set of institutions but by multiple clusters of institutions that have each claimed a segment of the agenda and the instruments of cooperation. The result is a fragmented landscape with disjointed actors and organizations that often compete, collaborate, and act in parallel in pursuing their collective ends.

The term of art for such an institutional landscape, one with several institutional or legal foundations, is “regime complex.”<sup>1</sup> The regime complex for combating IFFs differs in its complexity from other, similar issue areas. Defining IFFs produces disagreement among researchers, activists, and policymakers. “Illicit” captures a normative judgment perhaps broader than “illegal.” For law enforcement, IFFs are framed by predicate crimes, activities that are illegal in one jurisdiction or another and often of greater interest to authorities than IFFs. For those interested in broader global outcomes, such as the effects of IFFs on economic development, “illicit” could include cross-border financial flows associated with activities that they believe should be forbidden, such as tax avoidance by multinational corporations (MNCs). Those activities may not be illegal, however.<sup>2</sup> These categories shift over time: bribery of foreign officials by corporations based in Organization for Economic Cooperation and Development (OECD) countries was made illegal in the United States well before it was criminalized in other industrialized countries. Variations in national treatment of both IFFs of certain kinds and the underlying predicate crimes have made harmonization of national policies and their implementation in many IFF domains difficult.

IFFs are also one of the most important features of globalization’s dark side. Unlike other illicit or dangerous cross-border flows, however, IFFs bear almost no markers in and of themselves: *pecunia non olet*. Tainted food, endangered species, and dangerous individuals all present fewer problems of identification. For IFFs, it is suspicious activity rather than a characteristic of the funds themselves that generates the attention of those attempting to curb the flows.

These definitional and identification problems make measuring the effectiveness of counter-IFF policies more difficult than assessing the effectiveness of policies in other issue areas. As many skeptics and critics have pointed out, without a clear grasp of the scale of underlying flows, the scale of

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Kyle Evanoff and James Chizungu provided research and editorial assistance for this paper.

effects, though perhaps not the direction, of policies to counter those flows cannot reliably be determined.<sup>3</sup> If the costs of enforcement and compliance or unintended negative effects are included in estimates, the balance sheet becomes even more uncertain.

International collaboration to curb IFFs and domestic measures to support that collaboration are directed to a wide array of predicate crimes that produce IFFs (drug trafficking, terrorism, or tax evasion) or to negative externalities (global “bads,” such as corruption) that both support IFFs and are sustained and promoted by them. This diversity of IFF sources and effects, and the public policy goals that follow, mobilize an unusually large number of actors: law enforcement agencies, financial supervisors and ministries, private financial institutions, and NGOs. These actors are interested more in certain IFFs and predicate crimes than in others. The links between specific crimes or categories of crime and larger global outcomes of interest, whether economic development or international security, are often second or third order. As a result, political attention to these issues—and willingness to bear the costs of implementation—fluctuates over time and across jurisdictions. As Peter Reuter and Edwin M. Truman observed in their classic 2004 account, the anti-money laundering (AML) regime (a subset of the complex countering IFFs) “reflects shifting priorities, compromises, and trade-offs.”<sup>4</sup> This variation over time is particularly important in combating IFFs, because enforcement depends largely on national governments and both their incentives and their capacity to enact anti-IFF policies. Financial markets and naming-and-shaming campaigns can strengthen those national efforts; they can also direct attention and effort against particular IFFs. However, they cannot substitute entirely for government action.

What follows is a summary and introduction to organized international efforts to combat IFFs. In order to limit the policy universe, the narrower definition of IFFs used by the World Bank—“money illegally earned, transferred, or used that crosses borders”—will be used to define the wider international regime complex to combat IFFs.<sup>5</sup> Mapping the institutions and actors involved in this issue area over time will capture the evolution of the global IFF agenda and the politics surrounding its development and implementation.

#### *ANTI-MONEY LAUNDERING GOES GLOBAL: FINANCIAL ACTION TASK FORCE*

Initial international coordination of efforts against money laundering was marked by a persistent feature of future advances in the regime: domestic politics in the United States. In this case, a concern over organized crime and drug trafficking led the U.S. government to pressure the country’s major economic partners to step up their own surveillance and enforcement. In 1986, Congress required the chair of the Federal Reserve Board to consult with Group of Ten counterparts about their banks’ efforts to control money laundering, and the Basel Committee on Banking Supervision (BCBS), the core coordinating mechanism for bank supervisors, issued a statement of principles regarding customer due diligence and cooperation with law enforcement. U.S.-initiated steps of this kind met initial resistance from these institutions, which did not view law enforcement as part of their mandate or role, a pattern that would be repeated with other financial institutions.<sup>6</sup>

These measures were complemented by the formation of a new institution in 1989: the Financial Action Task Force (FATF). Its early activities focused on coordination of national action against money laundering that flowed from drug trafficking; tax evasion was not part of its original agenda. From its core of OECD members, FATF has expanded to include thirty-five member states (includ-

ing most major financial centers) as well as the European Commission and the Gulf Cooperation Council. National delegations to FATF are typically composed of multiple agencies; one of the consequences of its formation, at least in the United States, has been more intragovernmental cooperation.<sup>7</sup> FATF has become the central standard-setting agency in the domain of anti-money laundering and combating the financing of terrorism (AML/CFT). Its Forty Recommendations, first issued in 1990 and most recently updated in February 2018, have become the principal international standard for defining money laundering and setting national policies to combat it. FATF's work is complemented by a constellation of FATF-style regional bodies (FSRBs) that promote its standards among nonmember countries.<sup>8</sup> FATF has limited enforcement powers: its principal lever is monitoring countries for compliance with its standards and assigning those countries to lists according to their levels of deficiency and their cooperation with FATF to remedy those shortcomings.<sup>9</sup> As documented by Julia Morse, international financial markets also serve to reinforce FATF recommendations, which are backed by FATF's credibility and technical expertise. Countries listed as noncompliant by FATF pay a risk premium on their sovereign debt.<sup>10</sup>

FATF's standard-setting is supplemented by the Egmont Group, a network of financial intelligence units (FIUs), self-described as the "operational arm of the international AML/CFT apparatus," designed to facilitate information- and intelligence-sharing.<sup>11</sup> During the 1990s, as AML became more institutionalized, successive UN conventions (the 1988 Convention Against the Illicit Traffic in Narcotic Drugs and Psychotropic Substances and the 2000 Convention Against Transnational Organized Crime) bolstered the legal basis for international cooperation against money laundering and its predicate crimes. The United Nations also established its Office on Drugs and Crime (UNODC), which included a unit responsible for AML activities, in 1997.

### *9/11 AND COMBATING THE FINANCING OF TERRORISM*

Combating the financing of terrorism became an international concern by the 1990s: the UN General Assembly adopted the International Convention for the Suppression of the Financing of Terrorism in 1999.<sup>12</sup> The September 2001 terrorist attacks in New York and Washington and subsequent major attacks in Madrid and London elevated the financing of terrorist networks to the top of the IFF agenda. AML became securitized: from an official network based in law enforcement and finance, anti-money laundering expanded to incorporate intelligence and national security agencies. The core institutions in AML/CFT remained the same, although the scope of the network and its collaborating agencies grew. FATF adopted Eight Special Recommendations on Terrorist Financing in October 2001.<sup>13</sup> Despite the broad international consensus against transnational terrorist networks, specifically al-Qaeda, some national governments initially showed "considerable indifference and resistance" to speedy implementation of these counterterrorist measures.<sup>14</sup>

Additional groups of financial supervisors, for securities markets and insurance, were added to the AML measures of the BCBS at this time.<sup>15</sup> The International Monetary Fund (IMF) and the World Bank also collaborated with FATF, the IMF beginning with a pilot project on AML/CFT that was made permanent in 2004. The IMF has incorporated FATF AML/CFT standards into its surveillance activities and its Financial Sector Assessment Programs (FSAPs), as well as IMF-supported country programs "when financial integrity issues are critical to financing assurances or to achieve program objectives."<sup>16</sup> In addition, the IMF in 2009 joined a growing list of international and domestic agencies in financing capacity development through a donor-supported trust fund. The IMF grew more

comfortable with its role in AML/CFT, although it maintained a distance from any connection to law enforcement. In order to deal with members' concerns over mission creep, the organization also re-defined its primary concern as the integrity of the financial sector or macroeconomic and financial stability, goals that were well within its traditional mandate. In so defining its involvement with AML/CFT, the IMF added yet another goal—also difficult to evaluate—to the AML/CFT agenda.

Another category of IFFs assumed prominence as a result of efforts by the United States and allied governments to stop the proliferation of nuclear weapons. Financial globalization appeared to enhance the effectiveness of financial sanctions, particularly when exercised by the United States, a major financial market and issuer of the currency used most widely for cross-border transactions. The ability to enact financial sanctions against governments, financial institutions, and individuals by targeting “specific money laundering and terrorist financing risks” was expanded under Section 311 of the USA Patriot Act. Its power was demonstrated against financial institutions associated with sanctioned governments, such as Banco Delta Asia, a major financial conduit for the North Korean government.<sup>17</sup> Following U.S. withdrawal from the Joint Comprehensive Plan of Action (JCPOA) on Iran's nuclear program, additional financial sanctions have been unilaterally imposed on Iran and countries and corporations that trade with and invest in Iran. The 2017 Global Magnitsky Human Rights Accountability Act has also led to financial sanctions being imposed on individuals guilty of corruption and human rights abuses. In the recent Iranian and Global Magnitsky Act sanctions, however, the U.S. government unilaterally defines IFFs that result from sanctions violations and imposes penalties on violators.

#### *RISE OF THE ANTICORRUPTION AGENDA: CIVIL SOCIETY, GOOD GOVERNANCE, AND KLEPTOCRATS*

The rise of corruption as an independent issue on the development agenda and its linkage to IFFs have a complicated intellectual and political history. One early step in this arena was taken in 1977 by the United States with the anti-bribery Foreign Corrupt Practices Act. For the next decade, despite pressure from the United States to forge an international agreement that would curb bribery of public officials by private corporations, the rest of the industrialized world was not responsive.

The 1997 OECD Anti-Bribery Convention marked a shift that would elevate corruption as a global issue and mobilize governments to act against it. The rise of the corruption agenda was in part intellectual: a recognition by the end of the 1980s that the prescriptions of structural adjustment programs, advocated by the IMF, the World Bank, and many bilateral donors, had not produced sustained economic development, particularly in the poorest developing countries. The attention of development economists turned to good governance—the role of institutions in economic development—defined to include public sector management and rule of law as well as broader principles of institutional accountability and transparency. Many experts at the World Bank, which played a central role in setting the development agenda, viewed politics—and even more so corruption—as radioactive, banned by the bank's charter. That taboo was broken in the late 1990s, under the presidency of James Wolfensohn, with the launch of bank programs to combat what Wolfensohn labeled the “cancer of corruption.”

However, the development community and the World Bank would not have pivoted their focus toward corruption when they did without the emergence of civil society actors who pressed this agenda. Their efforts during the 1990s were enabled by digital information and communications

technologies, which made international investigation and coordination through activist campaigns less costly. Global Witness, founded in 1993, initiated a strategy of investigation, exposure, and public campaigns to challenge corruption and its links to conflict. A group of discontented World Bank employees founded Transparency International (TI) in the same year; with its surveys and annual country rankings, TI soon became a leading advocate in the global movement against corruption.<sup>18</sup> Transparency International's strategy—and that of other NGOs working against corruption—was similar to that of organizations in sectors such as global health and climate change mitigation: pressing the new agenda; forging coalitions with international organizations, national governments, and international corporations; and aiming for international commitments from all the actors implicated in corruption. As in the past, national governments (e.g., Norway and the United Kingdom) sometimes took a lead, but they rarely set the new agenda.

After the adoption of the OECD Anti-Bribery Convention and the elevation of corruption as a central issue in development at the World Bank and other agencies, the 2003 UN Convention Against Corruption (UNCAC) committed its signatories to countering public sector corruption. UNCAC linked to the existing AML/CFT regime by requiring states parties to criminalize money laundering and to implement a domestic AML regime. Chapter V of UNCAC solidified the norm of asset recovery—return of corrupt proceeds to the “victim” countries—as a “fundamental principle” of the convention. It also served as an anchor for the UNCAC Coalition, a global network of more than 350 NGOs across more than 100 countries committed to mobilization in support of the convention's implementation. Both the OECD convention and UNCAC have been criticized, however, for weak or nonexistent monitoring mechanisms.<sup>19</sup>

Despite the global acceptance of UNCAC—it has 186 states parties as of 2018—much of the anticorruption agenda focused implicitly or explicitly on the institutional weaknesses of developing countries. During the 2000s, however, the anticorruption agenda, through its connection to IFFs, was expanded to include industrialized countries, home to the largest global financial markets. The increased commitments to development assistance made by the industrialized countries directed public attention to the outflow of illicit funds from developing countries and attendant damaging effects on resource mobilization in affected countries. The influential work of Raymond Baker and Global Financial Integrity, the organization that he founded, made clear the link between grand corruption or kleptocracy—large-scale theft of public resources by high-ranking officials—and the financial infrastructure that made it possible for corrupt officials to safely hide stolen assets.<sup>20</sup> That enabling infrastructure encompasses transnational networks that include many professional intermediaries—banks, corporate services providers, lawyers, real estate brokers, and accountants—in the OECD countries, even though those countries are ranked as less corrupt than their developing country counterparts.<sup>21</sup> Countering the theft of national assets became a global issue rather than one limited to the developing world. More developing country governments took the lead in setting the IFF agenda, rather than conceding that role to the OECD capitals. The 2015 Report of the High Level Panel on Illicit Financial Flows from Africa (Mbeki Report), commissioned by the Joint African Union and UN Economic Commission for Africa Conference of African Ministers of Finance, Planning, and Economic Development, confirmed the new consensus.<sup>22</sup> The World Bank became directly involved with the recovery of stolen assets through its Stolen Asset Recovery Initiative (StAR), a 2007 joint initiative with the UNODC.

Corruption, IFFs, and the industrialized countries are also connected through the natural resource sectors of the developing countries. Much of the grand corruption originated in those sectors during the commodity boom of the first decade of this century. NGOs and development economists viewed



the opaque practices of major MNCs, whether or not guilty of bribery, as facilitating such corruption and the IFFs that it produced. Then UK Prime Minister Tony Blair launched the Extractive Industries Transparency Initiative (EITI) in 2002. Supported by government, its multistakeholder structure (with participation from countries, companies, and civil society) typified the new model of governance, once again directed toward standard-setting. EITI aims for accountability and transparency, with publicly available information improving national debates about the use of natural resource revenues. EITI, similar to other organizations working to shape the anti-IFF agenda, responded to and incorporated NGO campaigns on the issue of natural resource sector governance.<sup>23</sup>

Countering IFFs was confirmed as part of the global development agenda by its inclusion in the UN Sustainable Development Goals.<sup>24</sup> In addition to the specific targets set in the SDGs, many developing countries came to view curbing IFFs as essential to the domestic resource mobilization and growth that would underpin sustainable development. At the same time, the costs imposed on development by the existing AML/CFT regime were also becoming apparent. The AML/CFT regime has had the unintended consequence of de-risking on the part of private financial institutions, which were delegated a central role in preventing IFFs. Rather than assessing risks of clients individually, banks are “ceasing to engage in types of activities that are seen to be higher risk in a wholesale fashion.” This has meant reduced access to financial services for customers that banks deem too risky. The costs of such exclusion will likely be the heaviest for recipients of remittances, small businesses, and people working in high-risk settings, such as postconflict countries.<sup>25</sup> De-risking may also undermine efforts to counter IFFs, since IFFs often thrive in areas that suffer from financial exclusion.<sup>26</sup>

#### *ILLICIT FINANCIAL FLOWS COME HOME (AGAIN): INEQUALITY AND TAX EVASION*

The slow economic recovery in the United States and Europe from the global financial crisis of 2008–2009 revived debates in industrialized countries over levels of economic inequality. This debate has become linked to IFFs and their facilitation of tax evasion, particularly after the Swiss Leaks in 2015 implicated HSBC in facilitating a far-reaching tax evasion scheme and the release of the Panama Papers in 2016 and the Paradise Papers in 2017 revealed a web of political and economic elites participating in tax avoidance and evasion. Using data from these sources, recent research finds that individuals in the top 0.01 percent of the wealth distribution use offshore tax havens to evade about 30 percent of taxes levied on them.<sup>27</sup> The effects of tax evasion and “gray area” tax avoidance by individuals and companies have long been accepted as a burden imposed on developing countries by IFFs. Those burdens now appear to contribute to tax inequality in the OECD economies as well: “Absent information exchange between countries, personal capital income taxes cannot be properly enforced, giving rise to substantial revenue losses and constraining the design of tax systems.”<sup>28</sup>

Since the financial crisis, the Group of Twenty (G20) and the OECD have been major forums for international cooperation on both tax evasion and corporate tax avoidance. At their 2009 summit, G20 countries urged tax havens to sign information-exchange treaties under threat of economic sanctions. Evidence suggests that this initiative resulted in asset shifting among jurisdictions rather than tax evasion being reduced.<sup>29</sup> The OECD’s efforts to counter tax evasion have been anchored in the intergovernmental Convention on Mutual Administrative Assistance in Tax Matters and the initiatives of its 153-member Global Forum on Transparency and Exchange of Information for Tax Purposes. The OECD has utilized a model of standard-setting and peer review similar to the formula

used by FATF. Its peer-reviewed Exchange of Information on Request was followed by a more demanding Automatic Exchange of Information (AEOI) standard, which eliminates the need for tax authorities to provide a justification for each information request by mandating an annual exchange of pre-agreed financial account information. Information exchange is based on a Common Reporting Standard (CRS) agreed to in the 2014 CRS Multilateral Competent Authority Agreement (MCAA). Ninety-four jurisdictions have committed to implementing the CRS by 2018; their implementation will be monitored and reviewed by the Global Forum. Although AEOI was prompted in part by the 2010 U.S. Foreign Account Tax Compliance Act, the United States is not a signatory to the CRS MCAA.

Unlike tax evasion, the issue of tax avoidance through profit shifting and other means has divided the anti-IFF coalition. Some experts argue that this gray-area behavior should be treated as illicit, while others hold that flows associated with a predicate crime (among them, tax evasion) should define IFFs and serve as the principal focus of anti-IFF action. Tax avoidance by MNCs has been a particularly salient issue for developing country governments, which rely heavily on corporate income tax for revenue. The principal global framework for collaboration has been the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), aimed at implementation of the OECD/G20 BEPS Package of fifteen actions that equip countries to deal with BEPS. Once again, the OECD follows a peer review process to assess implementation of these standards. Additionally, a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) entered into force on July 1, 2018. The MLI closes gaps in existing tax rules and reduces opportunities for MNC treaty-shopping and tax avoidance by transposing results from the OECD/G20 BEPS Project into bilateral tax treaties.

#### *COMBATING ILLICIT FINANCIAL FLOWS: EXPANDING AGENDA, UNCERTAIN EFFECTS*

An expanding array of agencies and institutions—global, regional, national, and subnational—has been chasing dirty money for decades. The AML/CFT regime complex, like other entrants on the post-Cold War global agenda, has evolved from an intergovernmental arrangement with relatively limited goals (countering transnational crime and especially drug trafficking) to a universe of international conventions and agreements, new and old international organizations and networks, and coalitions of private and public actors. In this respect, the evolution of governance in this space has resembled that in other contemporary issue areas such as climate change or global health. The anti-IFF agenda, however, has grown more rapidly than agendas in other domains, serving as a means for curbing other illicit activities, such as corruption and tax evasion. A reduction in those activities has, in turn, been linked to even broader goals—the integrity of the financial system, reduction of inequality, and economic development. Even as this growing complex of rules becomes more international and collaborative, policymakers have considerable discretion in the energy and resources that they devote to combating IFFs. Here, as elsewhere, the commitment of the U.S. government—both leader and laggard in the past—is currently in question.

This expanded agenda, and the often tenuous links between combating IFFs and larger global goals, has made measurement of the effectiveness of international action—problematic for all global governance and international institutions—even more difficult for the actions taken to counter IFFs. Critics and skeptics contend that AML/CFT has been subjected to “a minimal effort at evaluation, at

least in the sense in which evaluation is generally understood by public policy and social science researchers, namely how well an intervention does in achieving its goals.”<sup>30</sup> For climate change or global health, the scale of the problem being attacked can be measured with relative precision; that has not been the case for IFFs. Definitional and measurement issues are raised with each expansion of the IFF agenda: what was once acceptable (e.g., bribery of public officials by MNCs) has become unacceptable and illegal.<sup>31</sup> Evaluation becomes even more important when the costs of current regimes are taken into account, particularly costs imposed on financial sectors and those who use or attempt to use financial institutions.

If the effectiveness of existing institutions and procedures is uncertain, their efficiency can also be questioned. Efficiency arguments have been advanced by the financial sector, most recently in a 2017 report by the Clearing House, an association and payments company owned by the largest commercial banks. The report echoes earlier arguments that prevention and enforcement should move away from procedural checklists to more active government collaboration with the private sector in detecting and prosecuting crimes.<sup>32</sup> The broad and more distant goals of anti-IFF measures (the global public bads of Reuter and Truman) only compound the difficulty of assessing efficiency. For example, the importance of anti-IFF efforts to a broader strategy against corruption and kleptocracy can be questioned. Some researchers have argued that systemic corruption will only be overcome through a political big bang rather than incremental policy changes.<sup>33</sup> Curbing IFFs primarily affects that portion of corruption relying on cross-border transfer of its proceeds. Even within that segment of grand corruption, recent cases demonstrate the limitations to anti-kleptocratic measures. Effective steps against those who had pillaged the government-owned 1MDB in Malaysia required an unexpected electoral victory by the opposition. Although the new coalition has made clear its intention to pursue the case with international assistance, whether the investigation will be limited to political opponents or expand to those deeply rooted in the political system and economy, including coalition members themselves, is uncertain. The massive corruption under former President Jacob Zuma in South Africa so eroded corruption-monitoring institutions that restoring them will be difficult; moreover, Zuma and his accomplices worked with respected international collaborators, including the consulting firm McKinsey & Company and the auditor KPMG South Africa. The costs of pursuing, seizing, and redistributing kleptocratic wealth are substantial: more than two years after the exposure of a massive theft from the Nigerian state oil company, recovery of the proceeds has been painfully slow. Enforcing anticorruption laws requires both resources and commitment, and those are often lacking in asset recovery cases that will benefit other jurisdictions.

### *ILLICIT FINANCIAL FLOWS AND GOVERNANCE STRATEGIES*

Future effectiveness of the AML/CFT regime will depend in part on the selection of alternative strategies of global governance. The core of FATF and other AML/CFT conventions has been a regime of harmonization, diffusing a template for AML/CFT laws and practices to as many national governments as possible. Critics argue that these efforts impose a costly burden on developing countries while offering them minimal benefits.<sup>34</sup> Global governance produces a specific distribution of costs and benefits: AML/CFT was largely driven by an agenda crafted to meet the political demands of the industrialized world and often the United States. Although the anticorruption agenda also began with a similar asymmetry, the shift toward combating kleptocracy and tax evasion has produced a more balanced bottom line. Asymmetries remain, however, and given the transnational nature of

IFFs—with beneficiaries in both the industrialized and developing countries—these distributional issues will remain. They can be eased by continuing commitments to building capacity as well as sharing information and best practices across jurisdictions.

The ever-expanding agenda assigned to the AML/CFT regime risks institutional overload and greater obstacles to coordination. Technological innovations, such as cryptocurrencies, will not only expand the AML/CFT agenda, they will also highlight the shortcomings of purely intergovernmental responses. The much wider coalition that has been mobilized on these issues since the 1990s, however, also presents opportunities. From its origins as an intergovernmental issue promoted by the industrialized countries, combating IFFs has become a global cause. One sign of this new status: the African Union committed to eliminating “all forms of illicit flows” as part of its Agenda 2063 commitment to strengthen domestic resource mobilization.<sup>35</sup>

Although certain segments of global efforts to counter IFFs will remain largely in the hands of government agencies and private financial institutions, NGOs have played a central role in moving the international agenda and playing a role in naming and shaming those who benefit from IFFs. For example, NGOs and European governments have recently made progress toward ending the loophole of anonymous shell companies by expanding requirements for beneficial ownership transparency.<sup>36</sup> Although the anti-IFF coalition is occasionally unwieldy and fractious, international strategy should aim at turning this diversity to global advantage, using different actors and instruments for different targets.

As with the provision of other global public goods—and attacks on global public bads—recent advice from the 2018 OECD report *Illicit Financial Flows: The Economy of Illicit Trade in West Africa* can be applied more broadly: the “most informed and effective response” will “leverage the potential of multiple actors,” including public officials, the private sector, and nonstate actors.<sup>37</sup> In that respect, global efforts to combat IFFs could come to resemble even more closely the “all hands on deck” approach that has been adopted in climate change mitigation and other arenas. As in those other issue areas, however, the effectiveness of this model of global governance, which focuses less on governments and depends on a larger and more diverse set of actors, remains unproven.

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9. In 2018, nine countries were assessed as having "strategic deficiencies," but each had provided a "written high-level political commitment to address the identified deficiencies." Four of these countries were in civil conflict or were postconflict. Two other jurisdictions—Iran and North Korea—were labeled as greater risks, requiring "enhanced due diligence" or countermeasures.
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11. Financial intelligence units (FIUs) are "agencies that receive reports of suspicious transactions from financial institutions and other persons and entities, analyze them, and disseminate the resulting intelligence to local law-enforcement agencies and foreign FIUs to combat money laundering." See International Monetary Fund and World Bank, *Financial Intelligence Units: An Overview* (Washington, DC: International Monetary Fund, 2004), 4, <http://imf.org/external/pubs/ft/FIU/fiu.pdf>.
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## Defining and Measuring Illicit Financial Flows

*Maya Forstater*

Combating illicit financial flows (IFFs) is clearly important for international development and security, but the concept of IFFs remains contested and debates are often confused. Questions of definitions and measurement are contentious.

Large and confidently stated estimates of the scale of IFFs have played a critical role in attracting attention and encouraging political momentum. In 1998, the managing director of the International Monetary Fund (IMF) stated the expert consensus that laundered monies accounted for 2–5 percent of global gross domestic product (GDP), around \$1.5 trillion at the time. No methodology, however, has been found for this estimate.<sup>1</sup> Global Financial Integrity (GFI), a nongovernmental organization (NGO) that publishes annual estimates for individual developing countries, has claimed that around \$1 trillion “drains” from developing countries annually.<sup>2</sup> The High Level Panel on Illicit Financial Flows from Africa, set up by the African Union and the UN Economic Commission for Africa (UNECA), found that trade misinvoicing, concentrated on a few commodities, is the dominant form of IFFs and is responsible for \$50 billion of illicit flows from Africa.<sup>3</sup>

Numbers such as these are widely repeated, giving the impression that amounts and trends in IFFs can be tracked and that reliable country-level data is available. However, many estimates are no more than speculative guesses or suffer from significant methodological issues. While estimates have been important in raising attention and highlighting the potential magnitude of the issue, they have also heightened both expectations and confusion regarding the nature of IFFs, which could undermine ongoing efforts to address them.<sup>4</sup> Debates on IFFs should not remain mired in arguments over definitions and measurement but should instead focus on the information that measurement provides and on how best to prioritize interventions and support. Debate, research, and action on IFFs need to go beyond the broad-brush narrative and international legal and transparency measures toward clearer understanding of the political and economic factors driving IFFs and the particular channels used.

### *DEFINING ILLICIT FINANCIAL FLOWS*

There is no one agreed-upon definition of IFFs, but the concept generally relates to flows of money (or sometimes other assets used as stores of value) associated with crime and corruption.<sup>5</sup> As Miles Kahler describes, the IFF agenda has developed through several iterations.<sup>6</sup> Different professional and organizational groups tend to have somewhat different working conceptions.

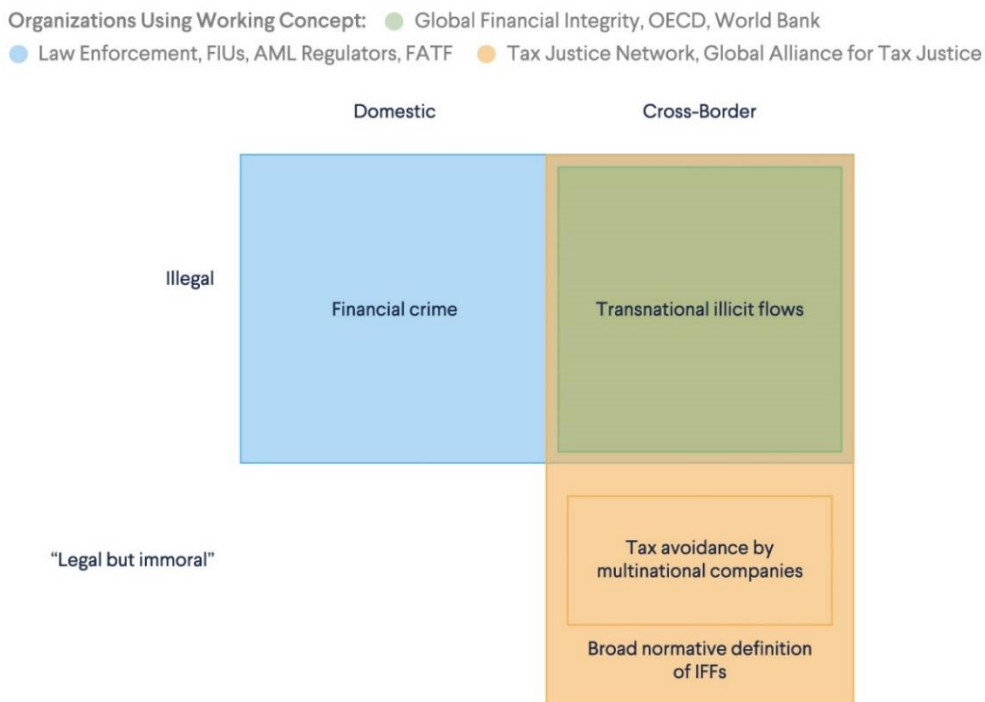
- International development organizations focus on transnational illicit flows and, in their context, tend to use the concept of IFFs to describe financial assets that cross borders, with a particular focus on money leaving developing countries. This is closely linked to concerns about capi-

tal flight.<sup>7</sup> Raymond Baker, founder and president of GFI, an organization that has played a critical role in promoting the term, uses the definition: “funds crossing borders [that] are illegally earned, transferred, and/or utilized.”<sup>8</sup>

- Law enforcement agencies and regulators are concerned with financial crime. Operational agencies such as the police, financial intelligence units, and regulators with anti–money laundering (AML) responsibilities tend to think of illicit finance in terms of financial crimes that relate to their jurisdiction, whether or not there is an international dimension. For example, the Financial Crimes Enforcement Network (FinCEN), an agency in the U.S. Department of Treasury, has a mission to “safeguard the financial system from illicit use, combat money laundering, and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities.”<sup>9</sup>
- The tax justice movement advocates a broader normative definition.<sup>10</sup> Civil society organizations in the tax justice movement tend to argue that *illicit* relates to the dictionary definition of immoral or contrary to social norms rather than being limited to unlawful behaviors. They argue in particular that tax avoidance by multinational corporations (also called base erosion and profit shifting [BEPS]) should be included under the definition of IFFs. For example, the Tax Justice Network argues: “IFF is by its nature hidden, whether it is illegal or simply unacceptable to the public—this makes clear that the source of funds may be perfectly legal, while the avoidance of tax, for example, may be technically legal but illicit according to societal norms.”<sup>11</sup>

While in practice there can be uncertainty about the borderline between legal and illegal behaviors, these different domains of concerns are illustrated in simplified form in figure 1.

**Figure 1. Approaches to Defining Illicit Financial Flows**



Source: Author.



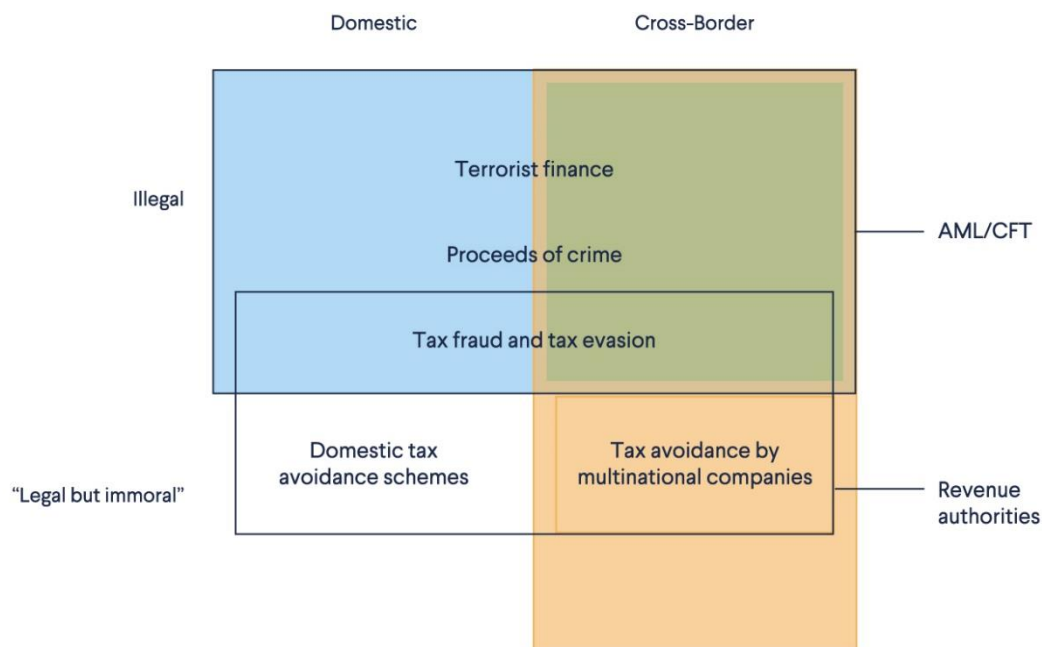
The first two definitional approaches are conceptually consistent (transnational IFFs are a subset of illicit finance). They are closely related to the concept of money laundering, which refers to activities intended to conceal or disguise the origins of the proceeds of crime related to predicate offenses, including fraud, corruption, drug trafficking, and tax evasion. Anti-money laundering and countering the financing of terrorism (AML/CFT) refers to the set of actions governments take to prevent, detect, disrupt, investigate, and prosecute money laundering and terrorist financing. Examples of financial crime and money laundering include the following:

- financial fraud, such as the Bernie Madoff investment scandal. Another example is the Kabul Bank scandal, in which over \$900 million—more than 5 percent of Afghanistan’s GDP and 50 percent of the government’s budget—was diverted through interest-free loans to bank insiders and politically connected parties.
- corporate fraud, such as the Enron and Parmalat cases, in which corporate insiders concealed fraud through lack of transparency and use of offshore tax havens, aided by inefficient controls by auditors, administrators, and stock exchange authorities.
- corruption involving governments and businesses, such as Siemens’ payment of €1.3 billion to officials around the world to win contracts, and the web of corruption surrounding companies such as Petrobras and Odebrecht.
- money laundering of criminal proceeds—such as the \$881 million in criminal proceeds from Mexican and Colombian cartels transferred by HSBC—including by transporting billions of dollars of cash in armored vehicles, clearing suspicious traveler’s checks worth billions, and allowing Mexican drug lords to buy planes with money laundered through Cayman Islands accounts.
- handling and laundering stolen assets for kleptocratic leaders, such as when British banks were implicated in facilitating transfers of millions of dollars of state assets by James Ibori, former governor of Delta State in Nigeria. The U.S.-based Riggs Bank (and its UK branch), which set up corporate vehicles for the Chilean dictator Augusto Pinochet to both hide his assets and shield them from asset freezing and confiscation or civil recovery orders, provides another example. In still another case, UK lawyers set up corporate vehicles for President Frederick Chiluba of Zambia to distribute and disguise money embezzled from the Zambian government, money that had purportedly been assigned for the country’s security services.
- money laundering, such as by the Russian mafia buying football clubs to use as front companies for money laundering through over- or undervaluation of players on the transfer market and through television rights deals.
- tax evasion, such as in Greece, where it was considered to be one of the causes of the financial crisis. Unreported income of sole proprietors—such as doctors, accountants, and lawyers—was estimated at €28 billion in 2009. In some cases, tax evasion involves international financial institutions; for example, as was revealed in 2009, UBS bankers helped U.S. and other account-holders evade taxation, including, in one case, by squeezing diamonds into tubes of toothpaste to help a client transfer assets without detection.

- tax fraud—such as missing trader fraud (in which a seller collects value-added tax [VAT] from a purchaser but does not pass the tax to the government) or carousel fraud (in which a seller claims from the government VAT that was probably not even paid in the first place)—which is estimated to cost the European Union around €60 billion per year. Another case is of the British hedge fund manager Sanjay Shah, who is alleged to have undertaken tax frauds worth €1.65 billion in the United States, Belgium, Denmark, Germany, Norway, and the United Kingdom.<sup>12</sup>

The third definitional approach includes a set of practices that are conceptually different from those outlined above: tax planning and so-called aggressive tax avoidance, which take advantage of the letter of the law and arbitrage between different jurisdictions but do not break laws. Examples include the tax-motivated international structures of companies such as Apple, Facebook, Google, and many others. The domains of concern of different regulators and law enforcement agencies overlap with different definitions of IFFs (figure 2).

Figure 2. Domains of Concern of Competent Authorities



Source: Author.

A wide variety of predicate crimes underlie IFFs, but what businesspeople paying bribes, kleptocrats involved in grand corruption, organized crime syndicates managing transnational operations, and tax evaders have in common is that they exploit those vulnerabilities in financial systems that allow for anonymity and secrecy in financial transactions. Ill-gotten gains are moved by three main means: physical movement of cash, through the global financial system, and movement of goods through the international trading system. Perpetrators shop around for jurisdictions in which investigation is difficult or those that provide greater stability and safety, as well as opportunities for consumption. Ownership structures can be designed to obscure who controls assets: a bank account in one country could be owned by a corporation in another jurisdiction; that corporation could in turn be owned by a trust in a third jurisdiction.<sup>13</sup>

Critical interventions explicitly aimed at combating IFFs include AML laws and programs, stolen asset recovery procedures, automatic exchange of financial information between and among countries, and registration of information on the beneficial owners of companies and trusts. While AML rules have been widely adopted, evidence of their success in combating criminal enterprises and corruption is scarce, and concerns about unintended reductions of access to financial services remain.<sup>14</sup>

The Organization for Economic Cooperation and Development (OECD) and Group of Twenty (G20) are addressing international corporate tax avoidance through a suite of fifteen actions, which includes tightening tax treaties, exchanging information, and removing harmful tax incentives. Beyond this, debate about future reforms to the international corporate tax system continues.

Whether tax avoidance should be included under the definition of IFFs, however, remains disputed. Nonetheless, there is good reason to maintain that IFFs should not encompass tax avoidance, as the latter does not involve breaking the law and is not characterized by secrecy, inappropriate anonymity, or misreporting. It is therefore not consistent with other areas of IFFs, and its inclusion under the concept risks confusion and undermining the rule of law.<sup>15</sup>

### *EFFORTS AT GLOBAL ESTIMATES*

AML regulation is expensive to effect, with costs borne by both the public and private sectors, including users of financial services. In theory, assessing and quantifying IFFs (and the risk of IFFs) could support prioritization and more effective action through an enhanced understanding of

- the scale of the issue;
- the level of risk for different countries—as sources, conduits, and sinks for IFFs;
- the relative importance of different sources and channels (e.g., drug trafficking versus corruption, and wire transfers versus smuggling of high-value commodities);
- the nature of the threat (predicate offenses) and vulnerability (typologies of money laundering) in practice;
- the degree of harm caused by different types of IFFs (and associated predicate crimes);
- the effectiveness of AML/CFT actions at national and international levels; and
- change over time, both in the volume of money seeking illicit channels and the progress of AML/CFT efforts.

In practice, however, only a little headway has been made in quantitative assessment. A 2011 UN Office on Drugs and Crime study to estimate the volume of IFFs resulting from drug trafficking and other transnational organized criminal activity found that “there is currently no single method that would give clear, unambiguous, and indisputable results.”<sup>16</sup>

### **Constructed Money Laundering Estimates**

The Walker model was the first large-scale attempt at estimating money laundering worldwide. The methodology falls into a class of estimates termed constructed money laundering estimates. These start with observed crime statistics and then estimate how much profit is associated with the crime,

what proportion of the profits are laundered, and where they are laundered. At each step, available data is supplemented by educated guesswork, such as the assumption that money generated in the least corrupt countries (based on Transparency International's Corruption Perceptions Index) is largely sent abroad, whereas criminal money generated in the most corrupt countries is never sent abroad. The estimate of where in the world laundered money is sent is based on factors such as gross national product per capita, level of banking secrecy, government efforts against money laundering, and level of corruption.<sup>17</sup> Some of the assumptions seem arbitrary, including the overall assumption that countries attract criminal money for the same reasons.

### Balance-of-Payments Mismatches

A common approach to estimating capital flight is the so-called sources-and-uses method. The method makes inferences about capital flight based on balance-of-payments statistics: if recorded capital inflows (net increases in foreign debt and in foreign direct investment [FDI]) exceed the recorded uses of capital inflows (the deficit on the current account and increases in the country's foreign reserves), it is assumed that this must be due to transfers of capital to foreign countries by private individuals. This residual amount is used as a measure of capital flight. However, this accounting identity would include both IFFs and legitimate capital transfers, such as acquisition of foreign securities for portfolio diversification. Therefore, it is not suitable as a measure of IFFs.<sup>18</sup>

Another method involving balance-of-payment mismatches, the hot-money-narrow method, focuses only on the net errors and omissions (NEO) entry in the statistics. This is based on the rationale that NEOs are more likely to reflect hidden flows. However, errors and omissions can also reflect compilation errors, incomplete measurement, or inadequate currency conversions.<sup>19</sup> This methodology cannot identify how much of the NEO entry is made up of this kind of noise in the data and how much reflects illicit capital flight.

### Mirror Trade Analyses

Mirror trade analysis seeks to identify IFFs that take place through the channel of trade misinvoicing (under- or overreporting the value of imports or exports to generate unreported side payments). Motives can be trade-based money laundering (using misinvoicing as a means to transfer money), evading tariffs and taxes, or evading currency controls. Mirror trade analyses are the basis for the widely cited trade misinvoicing studies, such as those carried out regularly by GFI. Other examples include the findings of UNECA's High Level Panel on Illicit Financial Flows from Africa and research by James Boyce and Leonce Ndikumana.<sup>20</sup>

When goods are traded internationally, they generate at least two sets of records: one at the export end and another at the import end. This methodology assumes that the declared price and quantity of an export should match the declared price and quantity of the shipment when it reaches its destination (allowing for shipping and insurance costs). Most commonly, studies allow a 10 percent margin for insurance and freight, but some seek to take a more sophisticated approach, applying different margins for different types of goods and different pairs of countries at different times.

Gaps and mismatches in trade statistics can occur for innocent reasons, such as errors in recording prices or amounts, goods transiting via bonded warehouses, price volatility, differences among countries in categorizing products, and variable shipping and insurance costs.<sup>21</sup> Volker Nitsch highlights how small changes to underlying assumptions can have large implications for the resulting esti-

mates.<sup>22</sup> The calculations also tend to deliver a different pattern of findings for landlocked countries and for countries with seaports, which are more likely to reflect different patterns of trade reporting and transport costs than inherently different patterns of underlying criminal economies. Mirror data analysis can be used as a starting point for investigating customs fraud but cannot be directly interpreted as evidence of such fraud.<sup>23</sup>

Mirror trade analyses have led to substantial overestimates and mischaracterizations of IFFs in several high-profile cases. Most notable, in 2016, the UN Conference on Trade and Development (UNCTAD) claimed that 67 percent of gold exports from South Africa were misinvoiced, indicative of IFFs of nearly \$80 billion between 2000 and 2014.<sup>24</sup> It was later revealed that much of the discrepancy was driven by differences in the way that South Africa and its trading partners record gold exports and imports.<sup>25</sup> This is explained by South Africa's Statistics Agency in its explanations and notes to its published trade data.<sup>26</sup>

### Trade Price Deviation

Another approach looks at deviations in the recorded price of imports and exports from some reasonable range of prices. Simon Pak and John Zdanowicz examine U.S. exports and imports and concludes that trade prices that are in the top or bottom quartile of the range indicate illicit behavior (under- or overpricing).<sup>27</sup> However, these deviations can also reflect ordinary deviations in price (and underlying quality differences within some commodity categories) as well as errors in the data.<sup>28</sup>

### Deviations From Traditional Gravity Models of Financial Flows

Another method uses a model that predicts cross-border flows based on the economic characteristics of countries, then attempts to estimate the additional amount that is attracted into jurisdictions solely on the basis of the ability to hide these assets (i.e., financial secrecy). Josef Brada, Zdenek Drabek, and Marcos Perez use a gravity model that predicts FDI from transition economies to the rest of the world and find that those they term money laundering jurisdictions are associated with higher-than-predicted levels of FDI, with the suggestion that around 10 percent of the FDI from the east European countries studied is money being laundered. (Money laundering jurisdictions are identified as those that the U.S. State Department's International Narcotics Control Strategy Report identifies as being of "primary concern"; these include Austria, Hong Kong, Luxembourg, Switzerland, and the United Kingdom.) However, this methodology cannot distinguish whether jurisdictions are financial centers and conduits for legitimate investment or money laundering centers.<sup>29</sup>

### Extrapolation From International Offshore Wealth

Other estimates seek to identify the stock of financial assets held offshore and estimate the proportion housed there to evade taxes. The Tax Justice Network, for example, estimates that between \$21 trillion and \$32 trillion of private wealth is registered in offshore international financial centers.<sup>30</sup> Gabriel Zucman uses data on aggregate worldwide reported assets and liabilities and cross-border deposits provided by the Bank of International Settlements to estimate that approximately 8 percent of household financial wealth is held overseas. However, much offshore money represents sovereign wealth funds, pension funds, and other institutional investment, as well as individual investment that is tax compliant. Zucman assumes that 75–80 percent of offshore assets and income are unreported

by owners.<sup>31</sup> However, this assumption seems hard to support given that many of the offshore jurisdictions Zucman assesses are largely compliant with Financial Action Task Force (FATF) standards and are part of the Common Reporting Standard of exchange of financial information.

### Methodological Issues

Criminal finances are difficult to find and estimate because, by their nature, they are hidden. Little reliable data is available, and each estimation method involves a large degree of speculation. No method can provide solid indicators of the scale of different channels and sources, or of trends over time or among countries, and all depend strongly on the input assumptions used.

Adding to the data and methodological issues are the problems of contemplating stocks and flows in intentionally opaque networks. Money laundering involves many stages—placement (e.g., depositing illicit cash at a bank), layering (moving money to hide its illicit origin), and integration (investing laundered money)—so the same money can go through many different transactions, each of which is an instance of money laundering. While financial regulators and law enforcement agents are interested in each of these instances, adding them together to generate an overall dollar sum produces a meaningless figure.

While aggregate estimates have been powerful as advocacy tools, for policy and research purposes it is more appropriate to disaggregate the concepts and estimates to understand which of the flows policy tools can target. As Peter Reuter argues,

the relationship between the underlying concept of IFFs and the estimates is obscure. Nothing is known about the relative importance of component sources or of the channels that are used to move the funds overseas, which will surely vary over time and across countries. Discussions of the likely effect of different control measures is just an exchange of impressions rather than the result of any systematic analysis.<sup>32</sup>

### LOCAL ANALYSIS

Getting beyond the broad-brush global estimates to understand the channels and drivers of IFFs depends on local and thematic analysis.

### National Risk Assessments

Countries are increasingly undertaking national risk assessments (NRAs) as part of FATF's risk-based approach to AML/CFT measures. FATF calls for countries to identify and assess national money laundering/terrorist financing risks, keep risk assessments up to date, and provide information on the results to all relevant competent authorities and self-regulatory bodies, financial institutions, and other businesses with AML responsibilities. This risk assessment, according to FATF, should be used as the basis for allocating resources and implementing measures to prevent or mitigate risk of IFFs.<sup>33</sup>

NRAs are often elaborate exercises conducted over many months. They draw on detailed analysis of crime and tax enforcement statistics, extrapolation from suspicious activity reports and audit findings, and expert opinion surveys and dialogues. They can involve classified and restricted information, but many countries produce a public version of the report. Depending on the particular threats and vulnerabilities faced, some NRAs are concerned mainly with domestic IFFs, and others

are more international-facing. For example, Italy's NRA is focused on domestic organized crime, whereas Switzerland's addresses the role of the country's banking system in holding foreign assets, including the fruits of corruption and fraud from other countries.<sup>34</sup> FATF advises a three-step process:

1. identification of potential risks or risk factors drawn from known or suspected threats or vulnerabilities
2. analysis of the nature, sources, likelihood, and consequences of the identified risks or risk factors
3. evaluation to determine priorities for addressing them and to contribute to the development of a strategy for mitigation

Notably, NRAs do not tend to make the confident assertions about volumes of IFFs, as top-down international studies commonly do. For example, Bhutan's NRA estimated that annual proceeds of crime amount to between \$10 million and \$100 million.<sup>35</sup> FATF warns against an overreliance on seemingly robust statistics:

While quantitative assessments (i.e., based mostly on statistics) may seem much more reliable and able to be replicated over time, the lack of available quantitative data in the ML/TF field makes it difficult to rely exclusively on such information. Moreover, information on all relevant factors may not be expressed or explained in numerical or quantitative form, and there is a danger that risk assessments relying heavily on available quantitative information may be biased towards risks that are easier to measure and discount those for which quantitative information is not readily available.<sup>36</sup>

FATF advises countries to draw on intelligence information, expert judgments, private sector input, case studies, thematic assessments, and typology studies.

The IMF includes AML/CFT assessments as part of Article IV consultations with countries. Outputs include estimates of the domestic proceeds of crime by category based on an expert survey. However, there is often a wide range. In some cases, the estimates are broken down into cash, financial and physical assets, and assets attributable to domestic and transnational organized criminal groups and other criminals.

The 2013 FATF methodology for risk assessments refers to the critical concepts of threat and vulnerability. Threats are the external forces, such as drug trafficking, that could lead to demand for money laundering. Vulnerability refers to those characteristics of a sector or country that make it attractive: weaknesses in prevention, detection, or enforcement. The idea of threat and vulnerability highlights the need for both a numerator and a denominator in considering risks of illicit flows. For example, the threat that a sector regulator is concerned with is the degree of contamination of a particular sector, such as banking, real estate, or fine art—in other words, the chance that a dollar entering the sector is associated with a predicate crime. However, the threat with which an investigative agency is concerned is how much money generated by a particular area of predicate crime can be found in a sector. At the same time, the regulator and the agency are also concerned with vulnerability, the chance that a dollar of dirty money goes undetected.

Joras Ferwerda and Peter Reuter argue that while these labels have intuitive appeal as means of structuring the NRA exercise, they could use greater conceptual clarity. NRAs tend to use qualitative scoring schemes to assess these risks and depend on a consensus among the experts consulted to reach their conclusions. However, these scoring procedures are specific and arbitrary, and the consensus approach does not pay attention to uncertainty of expert views, or the reasons experts from

different areas might disagree. Ferwerda and Reuter note that the FATF methodology treats threat and vulnerability as independent variables, whereas in practice criminals, kleptocrats, and tax evaders (the threats) will shop around for jurisdictions where they are less likely to be caught (the vulnerability).<sup>37</sup> While clearer concepts of threat and vulnerability are helpful, in practice no credible estimates exist of the proceeds of crime by predicate offense or of the amount of money laundered by sector.

Beyond the methodological challenges, issues of politics exist. Countries seek to demonstrate that their AML/CFT systems are working while also meeting the expectations of the financial sector and other actors with vested interests. At the extreme end, in countries where kleptocrats and organized crime syndicates have sufficient control over the state to embezzle, disguise, and move money with impunity, no administrative risk assessment methodology will be able to target those that effectively control the judiciary, law enforcement, bureaucracy, and media.

### Donor Studies

Detailed domestic studies have been undertaken by international institutions and commissioned by donors. A World Bank study in Malawi and Namibia, for example, used an approach that involved identification of the main sources of ill-gotten money, based on interviews and a review of available literature and government reports; guesstimates of the magnitudes of flows in each area; narrative description of how the money is spent or recycled within the economy, and the economic effects; and analysis of AML policies.<sup>38</sup>

Collaboration with experts in Malawi and Namibia who deal with the issues on a daily basis was crucial to the study. Their findings highlighted that illicit transactions mainly did not involve high-end money laundering that used international financial structures. Instead, they involved cash-based payments. Illicit earnings were primarily used for family support and purchase of real estate, cars, and luxury goods, with only the smallest portion of the crime proceeds going to capital flight.

Other donor-led studies include a qualitative study of IFFs in West Africa conducted recently by the OECD that examines the nature of specific criminal and illicit economies, and a Royal United Services Institute study of specific IFFs in Asia that looked at the financial flows associated with cross-border trade in jade, heroin, and counterfeit goods. Both studies emphasize that, beyond the big numbers, IFFs are complex political and economic phenomena, and it is unclear how to intervene effectively without exacerbating economic problems or simply diverting the illicit activity elsewhere.<sup>39</sup> Several local studies, such as in Zambia and Tanzania, have attempted to confirm the global estimates, but their findings remain unpublished.<sup>40</sup>

### Tracking Anti-Money Laundering Systems

Countries are increasingly releasing figures on their AML systems, such as the number of suspicious activity reports (SARs) submitted to the financial intelligence agency; the number of SARs that are screened and transmitted to competent authorities; the number of investigations, indictments, legal proceedings, and resulting convictions; and the scale of funds frozen, confiscated, or returned. AML systems produce large quantities of such data, although collating and comparing the data across countries is challenging.

Often, the number of SARs is offered as a proxy for the rigor of a sector's AML efforts, but it could also be an indicator of the severity of the sector's money laundering problem. In practice, no method exists for distinguishing the two. Similarly, increases in the number of police investigations



and enforcement actions can support a mistaken conclusion that a policy change has caused an increase in money laundering—even when money laundering has decreased—if the policy change in question leads to a higher proportion of financial crimes being discovered.

As Michael Findley highlights, randomized audit studies (known as mystery shopper tests) offer a powerful and underused means to test aspects of the effectiveness of AML and beneficial ownership registration regimes.

### *MULTINATIONAL TAX AVOIDANCE: ILLICIT FLOW OR ODD ONE OUT?*

Debate about whether the definition of IFFs should be widened beyond financial flows associated with criminal activities to include financial flows associated with multinational tax avoidance or profit shifting continues.

One critical historical pathway for the argument for including multinational tax avoidance has been confusion of the large estimates of trade misinvoicing with the practice of corporate transfer pricing. Trade misinvoicing is a form of customs and/or tax fraud in which exporters or importers deliberately misreport the value, quantity, or nature of goods or services. Estimates of trade misinvoicing are closely linked to the term *illicit financial flows*, as both were popularized by GFI. GFI describes trade misinvoicing as fraudulently manipulating the price, quantity, or quality of a good or service on an invoice submitted to customs and lists four primary reasons “why criminals misinvoice trade”: money laundering, tax evasion, fraudulently claiming tax incentives, and dodging capital controls.<sup>41</sup> All of this would be captured under a definition of illicit flows related to illegality. These behaviors are not the same thing as the tax-planning structures referred to as base erosion and profit shifting: BEPS does not depend on hiding or misreporting transactions to the tax authorities but on using tax rules advantageously. Trade misinvoicing is often misinterpreted as representing commercial tax avoidance (related to transfer mispricing).

Perhaps another reason it is attractive to include tax avoidance under IFFs is that BEPS is easier to measure—or at least it is easier to generate annual figures from readily available statistics. This reflects the fact that multinational corporations tend to be legally compliant registered companies that file tax returns and, in many countries, publish accounts. This information is accessible from databases such as Orbis and can also be estimated from macroeconomic statistics. In some countries, microdata is available to researchers through tax authority data labs, which provide access to anonymized tax return data. The data can be used to investigate how sensitive corporate profitability is to tax rates and whether the pattern of revenues, profits, assets, and taxes reveals higher profitability in low tax jurisdictions and vice versa.<sup>42</sup> The G20/OECD-led BEPS Action Plan has established a system of country-by-country reporting for large companies whereby they have to submit data about their sales, profits, assets, and taxes paid on a jurisdiction-by-jurisdiction basis. While this information is confidential to tax authorities, the OECD will compile it and release statistical aggregates starting in 2019.<sup>43</sup>

The differences in the challenge of estimating tax avoidance versus IFFs is also reflected in official country assessments. For example, in the United Kingdom, the revenue authority produces an annual tax gap estimate, which includes figures for tax evasion and avoidance based on a combination of bottom-up and top-down analyses. Although the authority recognizes that uncertainty and potential error can come from many sources, it is able to generate annual estimates differentiated by type of

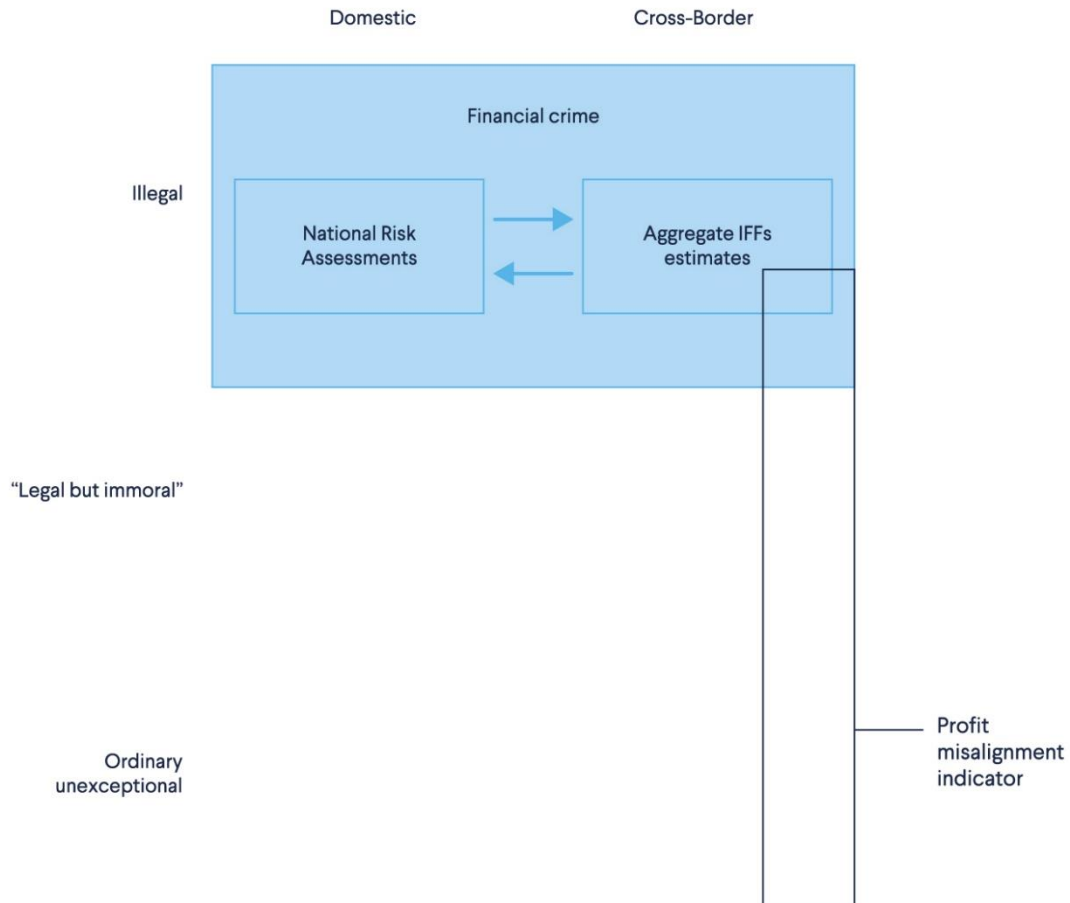
taxpayer and type of behavior. However, the UK National Crime Agency is only able to say that the amount of money laundered in the country in 2016 “could be between £36 billion and £90 billion”; the amount now is likely to be higher.<sup>44</sup>

As Kahler notes in this collection’s introduction, the boundaries of legal behavior are not immutable, and actions that were once seen as acceptable (such as bribery of public officials by multinational corporations) have become unacceptable and illegal. Similarly, legalization of previously illicit drugs can lead to illegal enterprises becoming (or being replaced by) legal ones. Where a state is captured by criminal, corrupt, or despotic rulers, arguably its rules are themselves illegitimate. Nevertheless, replacing the legal boundary on IFFs with a vaguer one referring to social norms or morality makes the whole concept amorphous. In practice, this broader conceptualization is only applied in the argument about including tax avoidance under IFFs.

An initial proposal on Measurement of Illicit Financial Flows, commissioned by UNCTAD, argues for a sub-indicator based on “misaligned profits” of multinational corporate taxation with the site of economic activity, using the soon-to-be-available country-by-country reporting data produced as a result of the BEPS reforms.<sup>45</sup> The sub-indicator would capture economic activity as the simple average of single indicators of production (the share of full-time equivalent employees in a jurisdiction) and consumption (final sales within each jurisdiction), and would define misalignment as the total excess profits declared in jurisdictions with a greater share of profits than would be aligned with their share of economic activity.

As the UNCTAD proposal notes, this sub-indicator would cast a wide net, including lawful and unlawful avoidance, along with criminal evasion, as well as companies simply following tax rules that do not explicitly seek alignment with this formula (see figure 3 for an illustration of how the profit misalignment indicator and other IFF measurements map to IFF definitions). This measure, as defined, would be easy and inexpensive to determine, without the need to collect additional data. But it would be assessing something that is not close to what countries are seeking to assess in terms of national risk assessments for IFFs.

Figure 3. Mapping Different Approaches to Measurements Against Definitions and Concepts



Source: Author.

## CONCLUSION AND RECOMMENDATIONS

While popular estimates of IFFs have been influential in drawing attention to the issue, the idea that IFFs can be assessed at a distance through simple calculations using official statistics from global databases is overoptimistic. Calculations tend to rely more strongly on assumptions than on empirical analysis, and the resulting estimates are not much more than simply indicative of the orders of magnitude. They shed light on neither specific policy measures nor progress over time.

Yet the expectation that IFFs can be measured in this way and that the large estimate amounts can be interpreted simply and directly as lost funds for international development has become strongly established. Large and ostensibly accurate estimates have whetted public, policymaker, and press appetites for more of the same, and have run ahead of discussions about whether the numbers themselves are meaningful. This trend risks diverting the focus on IFFs away from crime and corruption toward the fashionable—and more politically appetizing—target of multinational tax avoidance.

The existing system of AML standards has been patchily implemented and largely ineffective in tackling transnational organized crime and grand corruption among political leaders.<sup>46</sup> Uncertainty

of measurement and difficulty in assessing IFFs should not stop governments from taking action to address this gap, but the fact that countries are taking action should not be reason to ignore the problems of definition and measurement.

### Definition

*Develop a common definition of illicit financial flows—one that can be recognized by experts and actors in AML, anticorruption, and revenue compliance, and one that would support coherent action.*<sup>47</sup> The concept of IFFs has become tied up with the confusion between trade misinvoicing and transfer pricing. However, that these two different phenomena are often confused and conflated is not a good reason to adopt a measure for IFFs that includes legal tax planning, a practice far removed from the core concept. Nor is the convenient availability of annual data to construct an internationally comparable set of numbers on misalignment. Conflating legal and illegal behavior risks offers a way to drive attention away from criminal and corrupt finances toward more politically attractive targets. The narrower view of IFFs relates closely to AML. However, it goes beyond the specific set of practices, compliance standards, and financial regulations developed under the international AML/CFT system. The idea of illicit financial flows is important because it highlights the international aspect of financial crime; crime and corruption are not just the problem of the country where they happen but also of the countries that allow their financial systems, goods trade, or real estate markets to be used as getaway vehicles for ill-gotten money. The concept also focuses attention on the need for an effective international response that goes beyond AML compliance.

### Aggregate Estimates

*Recognize the limitations of aggregate measurements of IFFs, and put more focus on disaggregate analysis.* AML/CFT regulators need to know about threats and vulnerability at activity and sector levels to focus on preventive action, while law enforcement authorities and investigators need to know about where to focus their attention to monitor, prevent, attack, and seize flows of criminal finances. Refinements to existing methods could reduce error. For example, recent revisions to GFI's methodology have led to reductions in its global estimates of IFFs, with large reductions in countries such as India and Zambia.<sup>48</sup> However, without reliable, representative data on actual illicit activity, it is impossible to gauge how close these estimates are to reality, nor how much noise remains in the data. Randomized audits and mystery shopper studies can help reveal the amount of illicit finance or non-compliant actors in a given sample. More detailed research on customs records could help authorities identify genuine misinvoicing.<sup>49</sup>

*Publish the data and code for IFF estimates.* Large-scale estimates involving the manipulation of detailed bilateral trade data are costly to calculate and replicate, and the full details of calculations are rarely published; therefore, estimates often enter the public discourse before they have been verified. Recently, for example, the UNECA increased its estimate of IFFs from Africa from \$50 billion to \$72 billion, but it has not published the underlying calculations.<sup>50</sup> Opening up the data and code to public scrutiny would make it easier for researchers to spot problems and suggest improvements. Donors funding analytical work in this area could encourage this practice.

*Address the possible limitation to measuring IFFs as a Sustainable Development Goal indicator.* IFFs are included in the UN Sustainable Development Goals under target 16.4, and the UN Statistical Commission has agreed that IFFs would be measured using the indicator “total value of inward and outward illicit financial flows.” If this indicator cannot be possibly—or meaningfully—measured, the governments, international organizations, and expert committees involved should recognize the limitation and not substitute in dollar estimates of multinational profit shifting.

### **National Risk Assessments and Other Local Analysis**

*Evolve and improve national risk assessments.* Approaches to national risk assessments are new and evolving, and quantitative approaches are still a long way from producing comparable policy-relevant data. In the first rounds, authorities have focused on building qualitative understanding of risks and identifying sectors that need stronger action, and have highlighted limits of knowledge and data. Future rounds of risk assessment should strengthen both the conceptual basis for risk analysis and the quantitative and qualitative analyses. Better dialogue and closer cooperation between the public and private sectors to inform national risk assessments will be crucial to this.<sup>51</sup> Countries should report on their methods so that they can learn from one another’s experience and approach.

*Address overseas crime and corruption risks.* Developed countries and international financial centers should assess their role as conduits and facilitators of IFFs, and their role in supporting stolen asset recovery. Domestic IFF control efforts in developing countries will likely have limited influence.<sup>52</sup> Therefore, the role of countries that tend to attract or act as conduits for international assets, both legitimate and illegitimate, such as the United States, Dubai, Singapore, Switzerland, and the United Kingdom (and its overseas territories and crown dependencies) is critical. They should address overseas crime and corruption risk in their NRAs.

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## Evaluation Strategies for Global and National Measures Against Illicit Financial Flows

*Michael G. Findley*

Increased attention to problems of corruption, organized crime, and terrorism has led to greater international focus on illicit financial flows (IFFs), including in the form of generating strategies for combating such flows. At least four UN conventions—the Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, the International Convention for the Suppression of the Financing of Terrorism, the Convention Against Transnational Organized Crime, and the Convention Against Corruption—have been adopted, as have many regional agreements, all of which seek to stem IFFs. UN Sustainable Development Goal target 16.4, moreover, calls for addressing IFFs as a critical priority for the developing world.<sup>1</sup>

While global and national measures to combat IFFs are diverse and advanced by many organizations, they were most prominently developed through the Forty Recommendations of the Financial Action Task Force (FATF).<sup>2</sup> Governments have delegated standard-setting authority to FATF, and nearly all countries in the world have agreed, in principle, to abide by FATF standards, either because the countries are FATF members or belong to one of FATF's nine regional satellite organizations.<sup>3</sup> National adoption and enforcement, though, vary widely. Among others, the World Bank and the International Monetary Fund consider FATF to be the authoritative organization for setting and enforcing anti-money laundering (AML) standards.<sup>4</sup> The range of global standards is impressively broad; a few critical measures, including the establishment of beneficial ownership and the implementation of AML recommendations, are highlighted below.

Evaluation strategies for these global and national measures against IFFs have been severely neglected, in contrast to issues of IFF measurement. Much has been written on whether IFFs are increasing or decreasing year to year, with at least implicit attribution to existing global and national measures. Extant attributions of success should be interpreted with caution because existing research approaches are not well suited to establish confidently that current policies are responsible for any shifts and that alternative explanations are not responsible. This argument can be contextualized through a brief discussion of different evaluation methods, including of what evaluation experts count as credible evidence.

National statutory compliance with international standards does not correlate much with actual compliance; knowledge of international standards does not motivate compliance with the mandate to establish beneficial ownership; the threat of national enforcement does appear to motivate compliance; the risk-based approach in know-your-customer (KYC) process appears to motivate greater compliance with international standards; and although tax havens have a bad reputation, they appear to be among the most compliant jurisdictions in the world.<sup>5</sup>

Evaluating IFFs defined in the macroeconomic sense of aggregating unlawful cross-border movements of money (assuming the severe measurement issues can be remedied) is unlikely to yield valuable conclusions to inform specific policy recommendations. Instead, scholars and policymakers should prioritize more rigorous evaluations of specific programs applied to narrower illicit flows. Rather than focus so much attention on aggregate flows, evaluators should examine the efficacy of global governance strategies considering meso- or micro-level dimensions of the IFFs.

## *MEASUREMENT AND EVALUATION OF ILLICIT FINANCIAL FLOWS*

IFFs take on many forms. Much of the literature emphasizes fraudulent misinvoicing of trade to the developing world.<sup>6</sup> Substantial effort has been devoted to understanding how money associated with such trade, or more broadly for transferring bulk cash or otherwise, is concealed or laundered. Untraceable shell corporations with bank accounts (so that the accounts are de facto anonymous) provide likely the most common mechanism for doing so, whether in the specific domains of money laundering, transnational corruption, tax evasion, or other related crimes.<sup>7</sup> The FATF recommendations are designed, in particular, to prevent such money laundering.

The scrutiny paid to fraudulent misinvoicing of trade is likely due to the attention that Global Financial Integrity (GFI) and other advocacy nongovernmental organizations have brought to this form of IFFs. While trade misinvoicing is potentially extremely consequential, with global estimates consistently on the order of trillions of dollars annually, estimating the scale of these activities is a precarious enterprise and existing estimates could be highly inaccurate.<sup>8</sup> Maya Forstater has produced several excellent treatments of the measurement problems, including in this collection.<sup>9</sup> Michael Levi, Peter Reuter, and Terence Halliday contend that no one takes the GFI estimates seriously in the sense of using the estimates for evaluating policy effectiveness and instead argue that the estimates are mere advocacy claims.<sup>10</sup> Without solving, or at least mitigating, the nontrivial measurement challenges, evaluation at this macroeconomic level is near impossible.<sup>11</sup>

Outside the measurement problems currently under debate, evaluation of global governance strategies to stem IFFs has been almost nonexistent. Levi and coauthors compellingly argue that evaluation in the AML and IFF space is miserable at best. They provide a scathing critique of the state of evaluation, perhaps best captured in their claim that “despite the publication of national Mutual Evaluation Reports (MERs) and, more recently, National Risk Assessments, the fact is that there has been minimal effort at AML evaluation, at least in the sense in which evaluation is generally understood by public policy and social science researchers, namely how well an intervention does in achieving its goals.”<sup>12</sup> They further note: “The ideal evaluation would take some measure of the target activity, such as the total amount of money laundered, and estimate how much that has been reduced by the imposition of AML controls.” They demonstrate just how little data has actually been used to evaluate AML efforts. A broader review of the scholarly literature provides no greater cause for optimism. Outside a handful of isolated studies, little rigorous research provides any basis for evaluation.<sup>13</sup> And yet, as J. C. Sharman has noted, the global AML regime has developed and spread quickly even without any evidence of suitability or success.<sup>14</sup>

## EVALUATION STRATEGIES

The literature on evaluation methods primarily distinguishes between performance and impact evaluations; performance focuses on how a program has been implemented and impact evaluation focuses on the effects of the program. Of course, the two are not always easily separable. The FATF Mutual Evaluation Reports examine both whether global standards are being implemented nationally (performance component) and whether those national laws are effective in practice (impact component).

Impact evaluations measure the change in some outcome (e.g., IFFs) that is attributable to a specific, defined intervention (e.g., KYC rules). Because the task is to make proper attribution, one must be able to demonstrate that the intervention is responsible for the change in outcome, which requires ruling out alternative explanations that could confound the inferences made. The best practice for ruling out alternative explanations is to construct rigorously a counterfactual that allows one to control for competing factors. Randomized designs are broadly accepted as the most rigorous approach for constructing counterfactuals.

Randomized evaluations should be used much more often to combat IFFs. To the extent that randomized evaluations are infeasible, other methods that approximate the randomized ideal—quasi-experimental approaches—should be considered. A separate consideration is whether an intervention is sufficiently uniform across disparate cases so as to make appropriate comparisons, a task that is complicated when national or regional differences lead to qualitatively different interventions.

The task of evaluating the effects of global governance strategies on IFFs is further complicated if one looks beyond the flows themselves to various second-order outcomes.<sup>15</sup> Stemming IFFs is important in its own right, but frequently the goal is to reduce IFFs in order to address the predicate crimes linked to the flows (e.g., drug trafficking, corruption, terrorism). Alternatively, addressing IFFs is often directed toward broader macroeconomic outcomes such as development. If the goal is to evaluate these second-order outcomes, the task is substantially more difficult. Again, evaluating the effects on the first-order outcome of volume of IFFs is itself difficult. Indeed, as Levi and coauthors note, “if the right measure of AML success is a reduction in the volume of money laundering, there is little prospect of developing meaningful indicators at the national or global level.”<sup>16</sup>

Because randomization of a specific intervention (again, think about a global standard such as KYC) is not always or often possible, various other impact evaluation approaches seek to approximate a randomized design, though always with some compromises. Generally, quasi-experimental approaches begin from the premise that there exists a broken experiment to be fixed. In most cases, this means that the subjects under consideration could not be randomized to experimental conditions and so research design and econometric fixes need to be introduced to approximate randomization or produce comparisons of subjects that are as good as randomized. Of course, one can never reverse-engineer actual randomization, so the various quasi-experimental methods typically introduce some basic compromises. Even so, experimental and quasi-experimental designs hold substantially more promise than more basic case study comparisons or overall descriptive trends. The appendix provides a synopsis of the major impact evaluation approaches, including experimental, quasi-experimental, and observational approaches.

*FORMAL AND INFORMAL COMPLIANCE WITH  
FINANCIAL ACTION TASK FORCE RECOMMENDATIONS*

Concerned about the validity of current approaches to evaluating the FATF recommendations, Daniel Nielson, J. C. Sharman, and I carried out a global randomized experiment and associated audit study in the area of beneficial ownership and AML to measure whether FATF standards are effective. This is one of the few studies that attempt rigorous evaluation of global governance strategies to stem IFFs.<sup>17</sup>

Before carrying out the full randomized audit study, we established a baseline of formal compliance. Formal compliance refers to whether national governments enact laws that match international standards. Along with Shima Baradaran, we first culled statutory compliance levels from FATF's Mutual Evaluation Reports and set that as a baseline.<sup>18</sup> Because the enactment of a national law does not guarantee that corporate service providers (CSPs) in practice follow KYC rules to establish beneficial ownership, formal compliance measures cannot guarantee actual compliance.

A randomized experimental audit study on CSPs was carried out to measure informal compliance with FATF recommendations 10, 22, and 24 specifically.<sup>19</sup> Informal compliance refers to whether the organizations governed by the laws (e.g., CSPs tasked with following KYC rules) violate them. Using aliases, over the course of about two years, we approached nearly four thousand CSPs globally—each at least twice—and varied information about international standards as well as the risk associated with the approach to observe whether CSPs would comply with international standards and national statutes. In determining compliance, we considered whether CSPs required clients to provide required identity and residency documentation to set up a company.<sup>20</sup> In some conditions, we gave CSPs information about international standards, including penalties for noncompliance, and for U.S.-based CSPs information about enforcement of laws. We also varied the risk associated with the approach by posing as corrupt individuals or terrorist financiers. Importantly, CSPs were randomly assigned to different conditions to mitigate possible confounders.

The study offered a few important lessons. First, it compared formal and informal compliance measures, and demonstrated some vital differences, including that they only weakly correlate. Statutory compliance, as reported by FATF mutual evaluations, with recommendations 10 and 22 was not significantly related to the actual compliance rates found in the experiments, indicating that whether a country has adopted these recommendations has no apparent relationship with informal compliance.<sup>21</sup>

Second, receiving information about international standards, including penalties associated with noncompliance, did not change informal compliance levels relative to a placebo condition in which international standards were not invoked. Whether invoking FATF, the private Association of Anti-Money Laundering Specialists, penalties for not complying, or norms of appropriateness for complying, we did not observe appreciable change in actual compliance levels among CSPs.

Third, in the U.S. context, where a large number of service providers were compared across states specifically, in the likely event that U.S. states were systematically different from countries more generally, the study invoked the possibility that the Internal Revenue Service (IRS) would likely enforce penalties for noncompliance with international standards, something it has done aggressively in at least some cases. The IRS is the domestic agency that liaises with FATF and implements FATF standards in the country.<sup>22</sup> Informing CSPs in the United States that the IRS could take enforcement actions generated a statistically significant decrease in noncompliance, suggesting that at least some types of enforcement information motivate behavioral change. Given that national enforcement

mechanisms are familiar to prospective violators, this result is both important and relevant to the broader discussion of the effectiveness of global governance strategies.

Fourth, international standards prescribe a risk-based approach for CSPs to screen potential customers. Under the risk-based approach, CSPs and financial institutions are supposed to screen customers to determine the risk of their being linked to corruption and terrorism. In this sense, international standards have been designed to address these predicate crimes, among others. Thus, CSPs are supposed to screen customers to prevent IFFs that can in turn facilitate these predicate crimes. In the study, although a corruption treatment did not alter compliance levels, signaling possible connections to terrorism did decrease noncompliance. This suggests that the risk-based approach to KYC rules are partially successful.

Finally, in contrast to conventional wisdom about tax havens, descriptively the study found that CSPs in tax havens were far more compliant than those in Organization for Economic Cooperation and Development (OECD) and developing countries, a result that is statistically significant. The long-standing international scrutiny directed toward tax havens has possibly led to greater levels of compliance there relative to other countries, though this is only a conjecture, as the experiment does not capture historical trends or their explanations. Despite these levels of compliance, tax havens could still attract significant money because companies seek to avoid taxes, even if they do not necessarily evade taxes. If this conjecture is correct, it suggests optimism about the possibility that global standards will lead to national standards that will be enforced at the locus of compliance among CSPs.

#### *APPLYING EVALUATION METHODS TO MEASURES TO COMBAT ILLICIT FINANCIAL FLOWS*

Evaluating measures to combat IFFs, as defined in the macroeconomic sense, is unlikely to yield valuable conclusions about specific policy recommendations for at least two reasons. First, different policies are likely to deter different kinds of IFFs (e.g., a customs reform might decrease trade misinvoicing, whereas a shell company reform might decrease flows of bulk cash) and be highly geography-dependent (e.g., a shell company reform might affect IFFs to and from Guatemala differently than those to and from Zambia). Second, different types of IFFs likely yield different cost-benefit calculations (e.g., inflows versus outflows, customs evasion versus capital controls evasion, drug money versus terrorism, etc.). If the hope is to evaluate IFFs from a broader macroeconomic perspective, then a pre-post or cross-sectional (when the application of standards varies) design may be all that is possible, but such a design will only produce tenuous conclusions about bundled interventions (i.e., the conglomeration of global and national policies).

Scholars and policymakers should consider targeted evaluations of specific policies applied to disaggregated categories of IFFs. Disaggregation is critical not only to avoid the measurement challenges but also because it enables the use of rigorous impact evaluation designs, especially randomized evaluations. As rigorous and targeted evaluations accumulate, scholars and policymakers should attempt to aggregate evaluations. If targeted evaluations of narrower IFF categories happen, the evaluation approach that produces the most rigorous counterfactual should be prioritized. As the extended example from our study demonstrates, it is possible to evaluate narrower IFF areas while maintaining a rigorous evaluation approach and global focus.<sup>23</sup> Given that the locus of compliance for interna-

tional and national rules is primarily with CSPs and financial institutions, many more possibilities in this vein raise various directions for future research and policy evaluation.

Existing observational approaches, especially with regard to measuring trade misinvoicing, rely on strong assumptions that are unlikely to be overcome on their own. Governments could cooperate to carry out audit studies to generate more accurate measurements of trade misinvoicing or other indicators. In addition to measurement, randomizing certain strategies—say, at customs agencies—could enable audit studies that give precise estimates of causal effects. Possibilities include randomizing price or quantity of imports (or information about the imports) to customs officials, with country bilateral cooperation; and randomizing the ambiguity (or lack) of harmonized codes for comparison of the declarations at both borders.

While random assignment is a pivotal strength, we could not randomize international standards themselves. The study instead entailed randomization of information about the standards and risks, including on corruption and terrorism.<sup>24</sup> A critical question is whether—and which—other global or national strategies, or at least information about the global or national strategies, could be randomized to generate better counterfactuals for impact evaluation. One possibility is randomizing information about different FATF recommendations (e.g., politically exposed persons) to financial institutions.

Randomization will likely be impossible for evaluating many global or national strategies, but if isolating impact is important, perhaps other quasi-experimental strategies could be used to establish more appropriate counterfactuals. This raises a question of whether—and which—strategies would be amenable to quasi-experimental methods such as instrumental variables, regression discontinuities, or matching. Minimally, matching countries similar in many characteristics but different in their enforcement of global standards (such as country-by-country multinational corporation reporting or automatic exchange of tax information) could generate better counterfactual comparisons. Ideally, other methods such as regression discontinuities could be exploited, perhaps through the identification of thresholds that constrain the behavior of some financial institutions over others.

Although much attention has been given to measurement of IFFs, almost no work evaluates the effects of global governance strategies designed to curb IFFs. Progress in evaluation is unlikely to occur in the absence of a shift from the aggregate, macroeconomic level to consider the effects of global governance strategies on disaggregated financial flows.

## ENDNOTES

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## Security Dimensions of Illicit Financial Flows

*Jodi Vittori*

Although the role of illicit financial flows (IFFs) in hindering economic development is well understood, their implications for security—both national and global—have not received enough attention. IFFs are an important manifestation of “deviant globalization.”<sup>1</sup> Just as the free movement of capital is crucial to the international financial and trade systems, the cross-border movement of capital is important for a variety of illicit activities that undermine security.<sup>2</sup> IFFs, for instance, help make crime pay: they aid those associated with transnational organized crime to move and spend their ill-gotten gains. They are also integral to the financing of terrorist and insurgent groups, which threaten domestic and foreign security, imperil civilians and military personnel, and endanger U.S. allies and national interests. Moreover, the ability to launder, stash, and spend funds overseas enables corruption, which can destabilize countries and regions. IFFs can also undermine security forces, rendering them less able to respond to threats of criminality and terrorism.

The U.S. government and other actors can implement policies to help mitigate IFFs and the crime, terrorism, insurgency, and corruption they facilitate. These policies will not eliminate security threats in the United States or abroad, but they can assist law enforcement and the military to meet those threats and reduce the leverage of actors that foster state fragility. IFFs should be recognized as contributing to threats to the homeland, and national security agencies should make countering IFFs—by using national and global instruments—a priority.

### *ILLICIT FINANCIAL FLOWS MAKE CRIME PAY*

Joaquin Guzman has been described as an “obsessive entrepreneur with a proclivity for micromanagement,” perhaps not a surprise given that, in 2012, he ran a business with an estimated \$3 billion in revenue, on par with Netflix. His global logistic network rivaled that of Amazon or United Parcel Service (UPS), and his business controlled between 40 and 60 percent of the U.S. market for his products. Guzman—better known as El Chapo—headed the Sinaloa Cartel, a narcotics trafficking organization that continues to operate in as many as fifty countries.<sup>3</sup>

Moving criminal proceeds across such a large network is not easy. The Sinaloa Cartel and other illicit groups need to manage funds from customers, retailers, and wholesalers. Cartel leaders need to pay bribes to lower operating risks, reinvest profits into the cartel business, and ensure that all components of the supply chain—from coca and opium poppy growers to complex logistics networks—are funded, all while maintaining the lifestyles to which they and their families are accustomed. These activities involve substantial IFFs: if profits cannot be transferred throughout the supply chain to incentivize and pay for this criminal network, it will cease to function. American drug users spend about \$100 billion on cocaine, heroin, marijuana, and methamphetamines each year, and the U.S. banking system is “at the center” of the money laundering efforts of Sinaloa and other cartels.<sup>4</sup>

HSBC, for example, with its lax money laundering controls, allowed \$881 million in drug proceeds to be laundered over five years; a deferred prosecution agreement for the company ended in 2017.<sup>5</sup> In February 2018, the U.S. government fined the Dutch financial services company Rabobank for laundering millions and then obstructing the subsequent investigation.<sup>6</sup> In addition to the high-volume transfers through U.S. banks, illicit funds flow through alternate means such as trade-based money laundering and bulk cash smuggling.<sup>7</sup>

Although it would be impossible to eliminate all IFFs associated with narcotics supply chains, a thought experiment of what would happen if IFFs were eliminated highlights their importance. Without IFFs, international narcotics supply chains would soon break down, forcing drug suppliers into largely domestic production. Some narcotics could be produced more intensively for domestic consumption, as legalized marijuana production in the United States has demonstrated. Other narcotics, however, would be difficult to produce in quantities sufficient to meet the large U.S. demand without attracting attention of law enforcement. It would be difficult, for instance, to grow the huge fields of opium poppies needed to supply the growing U.S. market. Likewise, the coca plant can only grow in specific climates and altitudes—hence the critical role of growing regions in South America. Some Americans, faced with shortages or higher prices, would seek substitutes for their drugs of choice, just as those addicted to pharmaceutical opioids often switch to opium and fentanyl, which are cheaper and easier to buy. Overall, though, higher prices and the increased risks of drug production would likely decrease the number of new addicts, decrease the crime associated with international narcotics supply chains into the United States, and make it easier for the United States to manage the public health aspects of drug addiction. Combating IFFs associated with drug trafficking, then, is a worthwhile endeavor.

A decrease in IFFs would also decrease the rents available from drug activity globally. If the money generated from U.S. drug consumers could no longer make it back to international criminal networks abroad, narcotics supply chains through Central America to the United States would break down. Given that policies against IFFs associated with narcotics trafficking are also effective against other international criminal activity—such as human smuggling, oil bunkering, illegal mining, and financial flows associated with large-scale corruption and tax evasion—implementation of these anti-IFF policies would make transnational crime a more manageable security issue for the United States and other states in the hemisphere.

#### *ILLICIT FINANCIAL FLOWS FACILITATE TERRORISM AND INSURGENCY*

The world's largest terrorist and insurgent groups often rely on diversified and far-flung illicit financial operations. While individual terrorist acts are sometimes inexpensive, extended terrorist and insurgent campaigns require substantial funding and, often, IFFs. Large-scale terrorist and insurgent organizations need weapons, personnel, basic provisions, and logistical networks—all of which require financial resources.

Hezbollah, for example, with operations in Lebanon, Syria, and Iraq, makes substantial and well-documented use of IFFs.<sup>8</sup> The Sentry, an investigative organization, reported that BGFIBank, based in the Democratic Republic of Congo (DRC), had facilitated U.S. dollar-denominated transactions for well-known Hezbollah financier Kassim Tajideen and companies associated with him. This facilitation of terrorist finance occurred despite employees' written warnings about Tajideen's Hezbollah

ties to the bank's CEO—and adopted brother of DRC President Joseph Kabila—Francis Selemani Mtwale. The bank continued to move money for Tajideen and even requested that the U.S. Office of Foreign Assets Control unblock transactions after other banks refused to process them. The Sentry speculates that deals such as these could be linked to DRC's continuing instability, as Kabila seeks to remain in power through relationships with illicit actors.<sup>9</sup>

The self-proclaimed Islamic State has also used IFFs, stashing millions of dollars as its territory has shrunk in recent years. In March 2017, the Islamic State mandated the use of its own currency. As residents exchanged Syrian pounds, U.S. dollars, and other currencies for the new currency, the Islamic State moved a share of those funds out of its territory using currency exchanges and the *hawala* system.<sup>10</sup> One Iraqi legislator estimated that the Islamic State had smuggled \$400 million out of its former territory as it retreated.<sup>11</sup> The Islamic State could still siphon funds from abroad via extortion, smuggling, and other black-market activities. The availability of cross-border illicit transfer will likely both extend the life of the Islamic State and permit its network to carry out terrorist activities after its demise.

IFFs are often at the core of conflict networks. Indeed, many conflicts begin and persist because their supporting criminal patronage networks can be maintained. One example is the conflict in South Sudan, where warlords have used IFFs to facilitate both lavish lifestyles and ongoing conflict as they seek to capture the rents from the country's resource wealth and foreign assistance.<sup>12</sup> Recognition of the role that corruption, associated IFFs, and personal enrichment play in the South Sudanese conflict has principally driven UN sanctions against warlords in the region.

#### *ILLICIT FINANCIAL FLOWS ENABLE LARGE-SCALE CORRUPTION*

IFFs are linked to corruption (the abuse of entrusted power for private gain), which also has security implications.<sup>13</sup> The World Bank estimates that individuals and businesses pay \$1.5 trillion in bribes each year, about 2 percent of global gross domestic product, or ten times the value of overseas development assistance.<sup>14</sup> IFFs are involved in both the payment of large-scale bribes and the laundering of proceeds.

Corruption destabilizes countries. A 2015 study by the Institute for Economics and Peace (IEP) found that countries exhibit a "tipping point"—once a certain degree of corruption is reached, small increases in corruption lead to large decreases in peace.<sup>15</sup> Seven out of the ten lowest scoring countries on Transparency International's 2016 Corruption Perceptions Index were also among the ten least peaceful countries on the IEP's 2017 Global Peace Index.<sup>16</sup> Sarah Chayes, a senior fellow at the Carnegie Endowment for International Peace, has assessed that corruption is strongly correlated with state failure and with political instability, making a credible case for corruption as an under-recognized threat to U.S. national security.<sup>17</sup>

Natural resource-rich states in particular are associated with a higher likelihood of onset and longer duration of civil war, and many scholars have highlighted links between corruption and conflict dynamics. The availability of various natural resources—including petroleum, diamonds, and other nonfuel minerals, timber, and goods like coca leaves—seems to explain the prevalence of conflict.<sup>18</sup> Scholars explain this correlation variously.

Some scholars suggest that natural resource wealth makes governments administratively weaker and thus less able to prevent rebellions. Others focus on insurgency, arguing that natural resources increase the value of capturing the state, thereby encouraging conflict over prospective spoils. Insur-

gents, especially those in ethnically or otherwise marginalized areas, could seek independence in order to control locally generated revenues. Stanford University political scientist Jeremy Weinstein has argued that rebel groups with easy access to financing through natural resources or external patrons tend to commit higher levels of indiscriminate violence whereas those in more resource-poor situations carry out fewer abuses and are more targeted with their violence.<sup>19</sup> Still others assert that conflict and corruption are deeply intertwined in certain types of fragile states.<sup>20</sup>

IFFs are integral to these conflict dynamics. Predatory states, in various forms, certainly existed before contemporary financial globalization and associated illicit flows. IFFs, however, expand the rewards that violence entrepreneurs and their supporters can reap and allow those assets to be stored in offshore havens, accessible on short notice. Predatory states and the various warlords, terrorists, and insurgents who fight those states often highly rely on IFFs from natural resources sold overseas. Warlord states in Africa often feature patronage systems organized around rulers' control over resources and the rents they provide.<sup>21</sup> Whereas warlords in previous eras fought over grazing or agricultural land, their contemporary counterparts seek to control the oil underneath that land, bringing in multinational firms to extract and export that oil while providing a portion of the rents to the ruler. The same goes for resources such as alluvial diamonds or timber, which can be exported using the international trading system. The rents from these resource transactions no longer need to remain in the vicinity of the bandit ruler but can be stored or spent safely in foreign havens—in the form of real estate, art, and cash—via anonymous shell companies.

The Kabul Bank corruption scandal in Afghanistan underscores the links among IFFs, corruption, and security. In March 2004, the Afghan Central Bank granted Kabul Bank the first post-Taliban commercial bank license for Afghanistan's largest *hawala* operator, Sher Khan Farnood. With the license, Farnood's older *hawala* activities soon became entangled with what would become the largest bank in Afghanistan.<sup>22</sup> Kabul Bank was also linked to another *hawala*, the New Ansari Money Exchange. All of this made for a convenient one-stop shop for anyone seeking to move money into or out of Afghanistan through bulk cash smuggling, legitimate banking, *hawala*, trade-based money laundering, gold and minerals smuggling, or any combination of these. Customers of the various enterprises included legitimate nongovernmental organizations and businesses as well as illicit actors such as narcotics traffickers, corrupt politicians, and even the Taliban.<sup>23</sup>

The bank's insolvency in 2011 illuminated the links among IFFs, Kabul Bank, and the larger conflict, and threatened to erode Afghanistan's tenuous political stability. In the final accounting, over 90 percent of Kabul Bank's loan book—\$861 million—went to nineteen interrelated parties, including the brother of then President Hamid Karzai and close relatives of then First Vice President Mohammad Qasim Fahim. Revelations of these interest-free insider loans undermined the shaky financial system and threatened to lead to larger social unrest. The scandal also caused foreign donors to withhold aid payments and led to delays in disbursements of the Afghan Reconstruction Trust Fund, threatening World Bank projects in the country.<sup>24</sup> The scandal threatened the country's security sector as well. Afghan army salaries are paid by the U.S. government, mostly via electronic payments through Kabul Bank into individual soldiers'—and some police personnel's—bank accounts. Closure of the bank, avoided thanks to a bailout, would have meant both the loss of soldiers' savings in those accounts and the logistic means to pay them. The Afghan counterinsurgency campaign had rested on the idea that the United States and the North Atlantic Treaty Organization (NATO) would help build a legitimate Afghan government able and willing to protect its citizens and deliver services. The Kabul Bank scandal called into question the efficacy of the entire strategy.<sup>25</sup>

Links among IFFs, corruption, state fragility, and conflict are apparent in many other settings. For instance, in Venezuela, IFFs linked to corruption, petroleum, and narcotics trafficking have contributed to widespread impoverishment and significant rises in crime, social upheaval, and refugee outflows.

### *CORRUPTION AND ILLICIT FINANCIAL FLOWS AS FOREIGN POLICY TOOLS*

The links among IFFs, corruption, and national security are even more important given that some states export corruption as a means of illegitimately influencing and weakening other states.<sup>26</sup> IFFs play a critical enabling role.

Russia's use of corruption as an aspect of its foreign policy strategy provides the most salient example of this phenomenon. In *The Kremlin Playbook*, researchers at the Center for Strategic and International Studies show how "Russia has cultivated an opaque network of patronage" through five case studies: Bulgaria, Hungary, Latvia, Serbia, and Slovakia.<sup>27</sup> Russia uses the promise of "perpetual enrichment" and Russian state resources to "capture" critical individuals within states, who then spread this promise to other individuals, in what the authors call a contagion.<sup>28</sup> Much of this strategy is accomplished through the use of IFFs.<sup>29</sup> Russian interests could, for example, buy out large foreign companies that make substantial donations to political parties, or they could provide financial support to critical political or economic elites, often through offshore investments and anonymous companies.<sup>30</sup> Over time, the affected countries' economies and institutions become so compromised that the very state institutions created to fight back corruption are disabled. This also provides Russian agents opportunities for blackmail: captured governments risk collapse if their corruption is exposed. Corruption scandals, meanwhile, erode public trust in mainstream politics and politicians.<sup>31</sup> International measures to combat IFFs increase the difficulty of exporting corruption and limit its use as a form of statecraft.

### *ILLICIT FINANCIAL FLOWS AND SECURITY INSTITUTIONS*

IFFs facilitate global bads, such as corruption, crime, and terrorism. They can also undermine the security sectors that are supposed to combat them. Nigeria provides one example. In 2015, Sambo Dasuki, former national security advisor to the president, was charged with three dozen counts of money laundering and breach of trust. Dasuki was alleged to have withdrawn over \$2 billion from the Central Bank of Nigeria via phantom contracts—contracts created solely for the purposes of corruption, with no actual business activity toward fulfillment. The funds, ostensibly for the purchase of twelve helicopters, four fighter jets, and ammunition to fight Boko Haram, disappeared. At least part of that money was allegedly diverted to the failed bid to reelect Goodluck Jonathan.<sup>32</sup> This was not the first time that Nigerian national security funds ended up being moved illegally. A U.S. Department of Justice complaint against former President Sani Abacha documents how, in the 1990s, Abacha and his colleagues, including the National Security Advisor Ismaila Gwarzo, withdrew funds—again, ostensibly for national security purposes—from the Central Bank of Nigeria for unspecified emergencies and sent those funds overseas, including into U.S. and British financial institutions.<sup>33</sup>

Corruption, criminality, and associated IFFs undermine the ability of security forces to work effectively, as money earmarked for equipment, personnel, training, and other essentials is siphoned overseas. The corruption that leads to these large financial flows also provides incentives for government officials to purchase equipment as kickbacks rather than for national security needs. Corruption can damage esprit de corps, as soldiers see their military leaders using the defense budget for personal benefit rather than for the good of the troops and the nation. And corruption weakens the bond between the security sector and the citizens, as citizens come to see the sector as corrupt and even predatory.

Although many countries allocate large proportions of their budgets to security sector spending, the sector often receives little political or financial oversight: a prescription for grand corruption. Transparency International's Government Defense Anticorruption Index is illuminating in this regard. Of the 118 countries that Transparency International assessed in 2015, sixty-three were at high or critical risk of corruption in their defense sectors. Many countries do not allow meaningful parliamentary oversight of their defense sector. Even in NATO, only five of the thirty-three member and partner states allowed parliamentary committees unimpeded powers to review secret spending on defense and security. Only two countries—New Zealand and the United Kingdom—were listed in band A for having the lowest risk for corruption in their defense sectors (the United States was placed in band B).<sup>34</sup>

## RECOMMENDATIONS

Given the important links between IFFs and a host of national security issues, the U.S. government should take action to mitigate these threats.

### Close U.S. Money Laundering Loopholes

The United States is among the worst violators when it comes to ease of money laundering and tax avoidance. The Tax Justice Network ranked the country second (only after Switzerland) in its 2018 Financial Secrecy Index, which measures a combination of financial secrecy and the scale of offshore financial activities.<sup>35</sup> Likewise, the Financial Action Task Force (FATF), the international body that sets standards for anti-money laundering and combating the financing of terrorism (AML/CFT), noted in December 2016 that the U.S. regulatory framework does not hold institutions and professionals such as lawyers, investment advisors, real estate agents, and trust and company service providers to minimum international standards.<sup>36</sup> The United States could facilitate even more IFFs going forward. With the European Union cracking down on money laundering by implementing public registries of beneficial ownership of companies and trusts, and the United Kingdom forcing similar rules on its overseas territories, the United States will be one of the last major Western financial centers that permits anonymous shell companies and trusts. Priorities for closing off these loopholes include the following:

*Pass beneficial ownership legislation.* Four bipartisan bills that require companies to disclose their beneficial owner(s) when incorporating and to keep those registers up to date are currently in the Congress. One, which has both House and Senate versions, is the Corporate Transparency Act of 2017 (H.R. 3089/S. 1717). Another is the True Incorporation Transparency for Law Enforcement Act.

Parts of H.R. 3089 on beneficial ownership had also been in the Counter Terrorism and Illicit Finance Act; the beneficial ownership language in the bill is currently being renegotiated in committee.<sup>37</sup> These bills restrict beneficial ownership registries to law enforcement and banks rather than create public registries. These bills already have the support of major banks, the Fraternal Order of Police, other law enforcement advocacy groups, and major investors. They serve as a starting point for beneficial ownership legislation.

*Ensure high levels of due diligence.* The U.S. Department of the Treasury should ensure that investment advisors, bank holding companies, security broker-dealers, lawyers, accountants, and trust and company service providers comply with the anti-money laundering standards and due diligence to which banks are held. The Treasury Department should do this by lifting the 2002 temporary exemption to the USA Patriot Act, which grants those involved with real estate deals a waiver from anti-money laundering and due diligence checks. Also, the department's temporary order requiring title insurance companies in seven cities to provide beneficial ownership information for all-cash, high-end real estate purchases, due to expire in September 2018, should be made permanent and cover the entire United States.<sup>38</sup>

### **Implement Stronger Standards for Security Assistance**

The United States should press for implementation of stronger transparency, accountability, and counter-corruption standards for security assistance to other countries. IFFs in security sectors have especially pernicious effects, as these allow for the breakdown of the rule of law, provide impunity for some actors, and incentivize security sector actors and state leaders at times to value insecurity and authoritarianism over democratic reforms, human rights, free media, and open markets. The following efforts should be undertaken:

- The United States should encourage countries to develop and undertake voluntary standards for security sector integrity, especially in procurement. The standards should commit participants to maintain the maximum degree of openness and oversight by parliaments, the media, and citizens, and commit to keeping only the most crucial national security information secret. Mechanisms for at least some parliamentary oversight of secret budgets should also be established. The United States, where select members of critical congressional committees have the ability to review classified budgets and are briefed on classified programs, is an important example.
- Countries should limit secrecy in security sector-related contracting to items and services crucial to national security. The vast majority of contracts should follow the Open Contracting Global Principles and associated data standards, which seek to make government procurement contracting more transparent, fair, and competitive. All government procurement contracts, especially those associated with the security sector, should require contractors and subcontractors to declare their beneficial owners and should include corruption clauses to allow for contract termination upon evidence of corruption. These contracts should also include clawback clauses, which allow money that benefited terrorist, criminal, or corrupt purposes to be paid back to the host government. Governments should establish compliance offices to vet contractors and subcontractors.
- Countries should improve reporting and auditing of security sector spending, especially enabling parliamentary and civil society oversight of security-related budgets. Ukraine's Independent De-

fense Anti-Corruption Committee and the upcoming audit of the country's main export firm, Ukroboronprom, can be models for improving security sector oversight in highly corrupt and conflict-ridden environments.<sup>39</sup>

- The United States, along with other major exporters of security sector goods and services, should increase oversight of and restrictions on exports to countries considered by the World Bank and Transparency International to be highly corrupt and at high risk for corrupt activities.

IFFs underpin a variety of global bads that threaten U.S. interests at home and abroad. A number of priority issues for the United States—including narcotics supply chains, terrorism, insurgency, and state fragility—are facilitated by these flows. Strategies for fighting these threats will be undermined unless combating IFFs becomes a central element of U.S. security policy.



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## Leveraging Beneficial Ownership Information in the Extractive Sector

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Regulatory and public pressure to increase transparency about the real people who own, control, or gain substantial economic benefits from companies—also known as beneficial owners—is growing globally. The demand for such disclosures is linked to increasing awareness that hiding beneficial ownership can facilitate corruption and financial misconduct.<sup>1</sup> Innovations around beneficial ownership disclosure in extractive sector licensing highlight a new opportunity for coordination on legal frameworks and data platforms that cut across commercial sectors, agency mandates, and national jurisdictions to combat illicit financial flows (IFFs) yet still maintain flexibility for customization to meet challenges and risks in specific administrative and sectoral contexts.

### *INNOVATIONS IN THE EXTRACTIVE SECTOR*

Nearly one billion people live in poverty in countries that are rich in oil, gas, and minerals but manage these resources poorly.<sup>2</sup> In these countries, conflicts can arise between local actors who enjoy few direct benefits from or face increased harms as a result of extraction and those who are seen to profit from the sector, either legally (e.g., through local employment, revenue sharing, and community development) or illegally (e.g., through corruption and self-dealing). Legal frameworks and regulatory systems in resource-rich countries often lack integrity mechanisms, transparency, and accountability, which can make corruption more difficult to detect, prevent, and prosecute. Natural resource transactions are also often opaque, complex, and transnational. And citizens need to have information regarding extractive sector deals, given that natural resources belong to the state and state authorities are supposed to manage these assets for public benefit. Collectively, these factors have contributed to demands for beneficial ownership transparency in the extractive sector.

Global trends around beneficial ownership transparency are still rapidly evolving. One emerging picture is that sector-specific beneficial ownership disclosure requirements have primarily been aimed at local or national levels (e.g., in luxury real estate acquisitions), while regional and international efforts have been broader and non-sector-specific (e.g., financial due diligence and corporate registration requirements covering all types of commercial endeavors). Innovations in extractive sector licensing transparency could represent a hybrid approach, with sector-specific beneficial ownership disclosure requirements emerging from an international multistakeholder body.

In 2016, the public disclosure of beneficial ownership information became a requirement in the Extractive Industries Transparency Initiative (EITI), an international standard for extractive sector

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This paper is based on research undertaken as part of existing programming of the Natural Resource Governance Institute.

transparency developed jointly by governments, civil society, and companies, and implemented by national multistakeholder groups in more than fifty countries. By 2020, EITI countries must request, and companies that apply for or hold extractive licenses or contracts in such countries must disclose, beneficial ownership information. The EITI Standard also requires that these disclosures identify any beneficial owners who are government officials or their close associates—referred to as politically exposed persons (PEPs).<sup>3</sup> In meeting these core requirements, implementing countries have flexibility in determining how they institutionally, legally, and procedurally pursue such disclosures.

Part of what motivated this EITI requirement were scenarios in which improper conduct related to beneficial ownership was linked to corruption and IFFs. A study of one hundred cases of corruption in extractive sector licensing gives a sense of the scale of the problem: over half of the cases involved a PEP as a hidden beneficial owner.<sup>4</sup> Foreign or domestic firms sometimes seek out a PEP to whom they can give a beneficial ownership stake in an exploration and production company (or in a subcontractor enterprise) in exchange for preferential treatment in attaining an extractive license or in the terms of a contract. A PEP sometimes sets up an entity to conceal his or her beneficial ownership stake in a company and uses his or her influence to ensure that the company obtains an extractive license or other preferential treatment. To comply with the host country's local content requirements, a foreign firm sometimes enters into a joint venture agreement with a domestic company or enlists domestic subcontractors, and a PEP may hold a beneficial ownership stake in these local entities.

Scenarios like these can violate host country laws that prohibit PEP ownership and self-dealing in government transactions. A recent Natural Resources Governance Institute (NRGI) review of more than fifty mining and oil laws found that about half of them contained prohibitions on PEPs holding interests in companies applying for extractive licenses. Such scenarios could also entail violations of both international and host country anti-bribery legislation, particularly if a firm did business with a PEP's company as a quid pro quo for receiving a license.

If one or more cross-border transactions is involved, the transfer of funds used to acquire or financial returns stemming from an illegally obtained extractive license could constitute IFFs. Such flows could include bribery payments to obtain the license, proceeds from selling a license, profits from licensed exploration or production, or subcontractor takings. Beyond the initial license allocation, maintaining an interest in an extractive project can give a PEP a mechanism for diverting funds on a sustained basis.

## *PART OF BROADER MOMENTUM*

Collecting beneficial ownership information has been part of regional and international policy frameworks to reduce IFFs for some time. The Financial Action Task Force (FATF) includes ascertaining and verifying the identity of beneficial owners in certain risk-based recommendations on due diligence that financial institutions should conduct before establishing business relationships, conducting transactions, and opening accounts. In 2014, the Group of Twenty (G20) adopted high-level principles on beneficial ownership transparency.<sup>5</sup> And between late 2017 and early 2018, the European Union passed the fourth and fifth Anti-Money Laundering Directives, which require companies registered in member states to disclose beneficial ownership information on national registers that will be interconnected to enable the exchange of information among countries, and to put in place verification mechanisms regarding beneficial ownership information.<sup>6</sup>

A consortium of transparency-focused nongovernmental organizations launched OpenOwnership in 2017 to build a public global beneficial ownership register and develop a universal open data standard for beneficial ownership information.<sup>7</sup> A number of national beneficial ownership registers are already active. In 2016, for example, the United Kingdom launched a public beneficial ownership register, referred to as the people with significant control (PSC) register. In May, the country's parliament adopted legislation requiring the beneficial owners of companies registered in UK overseas territories to be disclosed on public registries by the end of 2020.

What these policies and platforms have in common is their breadth: they apply to anyone opening a bank account or any company pursuing registration. This broad scope is critical, as governance challenges related to beneficial ownership cut across jurisdictional and sectoral lines. However, certain sectors in which particular corruption and IFF risks are especially acute warrant more targeted approaches.

The extractive sector represents such a high-risk circumstance. Another high-risk sector is luxury real estate. After the *New York Times* reported that international buyers, some of whom were under investigation in various international jurisdictions, were using shell companies to purchase expensive Manhattan apartments, the U.S. Department of the Treasury began requiring title insurance companies to collect beneficial ownership information about buyers making all-cash purchases of high-value residential real estate in certain cities and counties.<sup>8</sup> The department has indicated that cases involving foreign corrupt officials informed the establishment of this policy and the focus on certain sought-after locations, including New York City and counties in California, Florida, Hawaii, and Texas.<sup>9</sup> Following similar news coverage about hidden ownership of real estate in London, the United Kingdom recently announced that foreign entities that own UK real estate will need to publicly disclose beneficial owners on the PSC register by 2021.

#### *TRANSPARENCY ONLY A STARTING POINT*

The push to raise global awareness about the risks of hidden beneficial ownership has gained ground largely due to compelling cases emerging at critical moments, as with the Panama Papers leak and Global Witness' coverage of the OPL 245 case, combined with the clarity of messaging on the need to increase transparency.<sup>10</sup>

The disclosure of beneficial ownership information is certainly an essential starting point in the fight against IFFs. Basic building blocks—such as a comprehensive legal definition of “beneficial owner” and timely mechanisms to systematically collect, update, and preserve information on changes in beneficial ownership—need to be put in place for an effective transparency regime. However, as with any transparency measure, beneficial ownership disclosures will be most useful if they advance efforts to deter, detect, and penalize illegal conduct. Thus, mechanisms that require companies to disclose their beneficial owners will likely do more to curb corruption and IFFs if they are complemented by

- government and company policies that define and prohibit certain inappropriate beneficial ownership interests (e.g., stakes that create conflicts of interest);
- active screening of beneficial ownership information for risk factors indicating potential corruption;
- workable systems for verifying the accuracy of disclosed information; and

- reliable enforcement of sanctions when illegal activities are identified.

Verification and due diligence are already part of many beneficial ownership norms and policies, especially with respect to financial institutions. However, more broadly, the screening and verification of beneficial ownership information remain insufficient. Transparency International recently found that no G20 country requires authorities to verify the beneficial ownership information collected in company registers.<sup>11</sup>

Verifying beneficial ownership information can be challenging. In the award of extractive licenses, administrators may be unable to locate conclusive evidence that a PEP is or is not a hidden beneficial owner of a company when seeking to verify information that companies have provided. Given these challenges and in light of limited resources within government agencies tasked with reviewing beneficial ownership information, a targeted and risk-based approach should be considered for certain sector-specific applications.

Utilizing such an approach in the extractive sector could mean that in-depth verification measures are triggered when preliminary screening indicates manifest deficiencies in submitted beneficial ownership information (e.g., a company claims it has no beneficial owner or that its beneficial owner cannot be identified, or a company identifies another company as the ultimate beneficial owner) or if other risk factors indicate suspicious activity (e.g., a company fails to meet technical or financial criteria but is still shortlisted or awarded government contracts). The World Bank has recently launched a manual that outlines good practices utilizing a risk-based approach to improve integrity due diligence in extractive licensing processes, including regarding beneficial ownership.<sup>12</sup>

#### *CROSS-SECTORAL, INTERAGENCY, AND CROSS-JURISDICTIONAL COORDINATION NEEDED*

Implementing effective deterrence, screening, verification, and enforcement measures will require legal frameworks and data platforms that cut across commercial sectors, agency mandates, and national jurisdictions, yet still leave flexibility for customization to meet particular challenges and risks in specific administrative and sectoral contexts. A case involving corruption and IFFs often includes registering a company, opening a bank account, obtaining a government license or contracts, and purchasing real estate, all as part of a single corrupt endeavor taking place across several countries. Awareness that problematic beneficial ownership relationships can be concealed at each of these stages in a transaction offers an opportunity to build linkages among the incorporation, banking, extractive sector, and real estate spheres.

Commercially, a unified front across these spheres could increase global pressure on legal, financial, and other service providers to develop stronger professional codes of ethics, better customer due diligence frameworks, and improved risk assessment mechanisms to reduce the extent to which these intermediaries enable inappropriate or illegal beneficial ownership linkages. Coordinated efforts could demand more proactive industry leadership from publicly listed companies, which generally do not make stand-alone beneficial ownership disclosures in light of their distributed ownership but which often partner with privately held companies and could exert commercial pressure for improved transparency. Such coordination would also be critical to fulfilling the potential and managing the risks that frontier tools, such as blockchain and other distributed ledger technologies, could eventually bring to tracking beneficial ownership information.

At the country level, interagency coordination and information-sharing could also help spread some administrative burdens and financial costs associated with screening and verification, although additional specialized review and evaluation would likely still be required to meet certain agency-specific screening needs and timelines. Such coordination could also help distribute the political will needed to tackle challenges related to problematic beneficial ownership linkages, especially given that power differentials can vary widely among the relevant agencies, including the registrar general, financial intelligence unit, banking regulator, mining and oil ministries, anticorruption agency, and law enforcement.

In the area of sanctions, establishing legal prohibitions on self-dealing, conflicts of interest, and bribery are foundational for beneficial ownership information to help curb corruption and IFFs. If a country's laws allow a company to give an official a beneficial ownership stake in exchange for an oil license or if a mining minister can lawfully award a mining license to a close family member's company, then disclosures of such companies' beneficial owners could raise questions among citizens or journalists about the appropriateness of such behavior but fail to offer concrete mechanisms to prevent such self-dealing.

Thus far, sanction efforts have relied on anti-bribery legislation in the home countries of extractive companies, notably the Foreign Corrupt Practices Act in the United States. Enforcement of such home-country legislation remains critical. But given that many resource-rich countries are undertaking legal reforms to embed beneficial ownership transparency in their extractive sectors, a real opportunity exists to address underlying anticorruption policy gaps in these host countries at the same time. This would mean establishing clear prohibitions on certain PEPs holding extractive company interests that present conflict-of-interest risks and on companies seeking linkages with PEPs that raise corruption concerns. NRG, for instance, has developed model legal provisions that can help countries incorporate such anticorruption provisions into extractive licensing guidelines, along with template provisions on collecting and publishing beneficial ownership information as part of license applications, screening beneficial ownership information in applications for manifest accuracy and corruption problems, and scrutinizing corruption risks in selected awardees.<sup>13</sup>

Transnationally, broader coordination across these spheres would be valuable around standard-setting and information-sharing and could help alleviate some of the mixed messaging regarding best practice noted below. Stronger anticorruption legal frameworks that span both home country and host country legislative frameworks would not only provide clearer guidance to well-intentioned officials and companies about what constitutes inappropriate beneficial ownership linkages but also lay the groundwork for better enforcement against officials and companies that cross the line. On the data front, the global beneficial ownership register and data standard are good examples of platforms and standards that facilitate broad international coordination. More broadly, increased coordination on beneficial ownership regimes is also warranted among international organizations focused on tax evasion and those with a corruption focus.

### *PRIORITIZATION AND PHASED APPROACHES NEEDED*

At the same time, broad efforts on beneficial ownership transparency and scrutiny need to be tempered with a recognition of sector- and country-level differences and needs. One pragmatic reason for this is the difficulty of getting many countries and sectors to agree on what constitutes best practice. This is already an issue for beneficial ownership transparency.

In some contexts, for instance, transparency standards mandate proactive public disclosure of beneficial ownership information, while in others sharing such information only among relevant authorities or upon request is considered sufficiently transparent. These differences can exist even among similar mechanisms: beneficial ownership disclosures related to luxury real estate in the United States are only shared with relevant authorities, while the United Kingdom plans to make such information public. Similarly, the United Kingdom has built a national register of beneficial owners that is public, but the beneficial ownership register being considered in the United States under the draft Counter Terrorism and Illicit Finance Act entails access only for relevant authorities. Similar differences exist among broader regional and international norms, as beneficial ownership standards promoted by FATF and the G20 focus on accessibility for relevant authorities, while EU and EITI standards require public disclosure.

Defining a single approach to best practice can be difficult because beneficial ownership information plays a role in tackling different governance challenges, in different institutional contexts, and on different timelines. How a registrar general would seek to collect and use beneficial ownership information when reviewing a company's application to register a company differs from how a bank would seek to gather and analyze such information when conducting due diligence for an account applicant, which in turn differs from how a mining ministry would obtain and consider such information when seeking to reduce conflict of interest risks during mining license allocations. Greater assessment is needed about what these varied approaches to using beneficial ownership information have in common and how harmonized legal policies and centralized data platforms can support coordination on these shared aspects, as well as increased understanding of how sectoral needs differ and what sorts of flexibility and customization will be essential.

Adding to this complexity, many of the countries trying to roll out new beneficial ownership norms face major political, technical, and financial constraints that make it difficult to implement multifaceted beneficial ownership plans that seek to tackle multiple policy objectives. Given such limitations and facing a bombardment of mixed messages about how best to collect and use beneficial ownership information, a real risk exists of countries implementing a grab bag of half measures that expend considerable resources but are too diffuse to have any real effect on reducing corruption.

For example, resource-rich countries are already grappling with how to allocate resources to meet FATF requirements on beneficial ownership information-sharing among relevant authorities while also meeting public beneficial ownership disclosure requirements under EITI. The momentum and buzz around registers in the United Kingdom and European Union have resulted in some EITI countries pursuing national beneficial ownership registers that cover all sectors. While such ambitious plans should be supported, starting with a targeted effort to collect and publish beneficial ownership information regarding extractive license-holders and applicants could prove to be more risk-responsive and rapid in terms of legal reforms and practical implementation.

To mitigate the current mixed messaging about best practice, international standard-setting bodies that promote beneficial ownership disclosure should coordinate more on global messaging and country-level planning. Such coordination would need to occur regarding legal policies, as well as data standards and platforms. On the policy front, clarity of global messaging would be greatly enhanced if international bodies that focus on beneficial ownership information-sharing among relevant authorities proactively indicated support for countries that choose to establish public disclosures, even if such bodies do not focus on public disclosure in their own efforts.

In countries with limited financial and human resources, planning around beneficial ownership transparency should include consideration of the following coordination and prioritization options:



- convening an interagency coordination committee that includes agencies that work on incorporation, banking, and the extractive sector, as well as relevant anticorruption and law enforcement agencies;
- prioritizing public beneficial ownership disclosure in the sectors that present the most pressing potential corruption risks and economic losses, and ensuring that the ultimate use of such disclosures to tackle these governance challenges is what shapes the planning process;
- maximizing harmonization and interoperability across core components of beneficial ownership legal frameworks and data platforms (e.g., beneficial owner definitions and company identifiers) while enabling flexibility for sector-specific customization or additions to meet particular agency needs and contexts; and
- developing a phased approach to broadening beneficial ownership transparency coverage as resources and capacity increase.

## ENDNOTES

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## Financial Authorities Confront Two Cryptocurrency Ecosystems

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Within the cryptocurrency space, two separate ecosystems are evolving. This will likely require strategies from financial authorities looking to counter illicit finance threats. One ecosystem is the above-ground, formal sector of cryptocurrency companies that largely accommodate anti-money laundering/know-your-customer (AML/KYC) regulations and are working to promote a business culture of compliance, which this arena mostly lacked in its earliest years. The other ecosystem is underground and consists of actors, platforms, and tokens that are more resistant to the regulatory pressures that undercut anonymity. This underground environment is currently smaller and much less developed than the formal one, but it offers little to no corporate accountability to law enforcement and will likely enable substantial illicit financing should it scale up.

### *THE ABOVE-GROUND CRYPTOCURRENCY ECOSYSTEM*

The conventional banking sector is becoming more comfortable with cryptocurrencies, even establishing formal partnerships with industry actors to facilitate direct purchase of digital currencies through bank accounts.<sup>1</sup> The proliferation of blockchain analysis firms offering tools to assess the AML risk of cryptocurrency users and investigate suspicious transactions is giving cryptocurrency exchanges the ability to identify and deter illicit activity on their platforms.<sup>2</sup> Some business due diligence firms are also helping the cryptocurrency industry use watch-list databases, similar to those used by banks, to vet customers during the identification verification process.<sup>3</sup> These initiatives—although they do not eliminate illicit activity—create a compliance environment that enables self-policing by exchanges and makes law enforcement intervention easier when suspected illegal activity is detected. This essentially makes cryptocurrency exchanges similar to other decades-old money service businesses, such as Western Union or MoneyGram, in which crime and fraud exist but at an acceptable rate, sufficiently addressed by mitigation procedures. The U.S. Department of the Treasury acknowledges these regulatory limitations in its most recent National Money Laundering Risk Assessment, which points out that while AML practices help curb illicit finance, they do not eliminate it.<sup>4</sup>

While AML/KYC standards for cryptocurrency exchanges are not upheld equivalently nor necessarily agreed upon among financial regulators in all countries, progress is being made to address regulatory gaps across jurisdictions. For example, a study of bitcoin transaction data for digital currency exchanges from 2013 to 2016 showed that European exchange services processed a disproportionately large number of transactions from illicit sources such as darknet markets compared to North American exchanges.<sup>5</sup> This is likely because the United States, in 2013, and Canada, in 2014,

issued clear guidance for local cryptocurrency businesses to follow the same AML regulations as other money transmitters while EU authorities did not formally bring European crypto-businesses under AML regulations until the European Commission officially updated its AML directive in late 2017.<sup>6</sup> European cybersecurity officials are aware of the increasing role of cryptocurrencies in crime. Europol in recent years has held annual virtual currency conferences for European law enforcement and cryptocurrency exchange companies to share information and lessons learned.<sup>7</sup>

The Group of Twenty (G20) recently acknowledged the importance of developing global regulatory standards for cryptocurrency use.<sup>8</sup> Although the G20 has not articulated what standards the regulation should entail, the group announced that it will make specific recommendations in October 2018, in consultation with the Financial Action Task Force (FATF).<sup>9</sup> Outlining a global standard can help minimize opportunities for AML arbitrage. At present, illicit actors in regulated jurisdictions can easily access cryptocurrency exchange websites based in poorly regulated locations. Setting international standards will not result in high performance across all jurisdictions, but it would help institutions such as FATF address the growth of the cryptocurrency space as it evaluates nations' AML and combating the financing of terrorism (CFT) capacity. FATF has a notable influence on major cryptocurrency exchanges. In May 2018, South Korea's largest cryptocurrency exchange, Bithumb, announced that it would not serve customers who are citizens of FATF's Non-Cooperating Countries and Territories, designated as such for having insufficient AML measures in place.<sup>10</sup> Furthermore, with the Treasury Department recently announcing that it could begin adding digital currency wallet addresses to its Specially Designated Nationals blacklist, cryptocurrency exchanges will be pressured to take steps to ensure they are not violating sanctions by transacting with designated wallets.<sup>11</sup>

### *THE UNDERGROUND CRYPTOCURRENCY ECOSYSTEM*

While the developments discussed above represent a step in the right direction for establishing an AML-compliant cryptocurrency ecosystem, a countertrend is developing simultaneously, undermining their efficacy: some cryptocurrency developers are pushing for blockchain infrastructure and platforms that operate outside the reach of AML compliance measures. A small part of this trend is reminiscent of the de-risking phenomenon: stricter AML/CFT regulations in the banking sector after the 9/11 terrorist attacks caused banks to reduce their exposure to high-risk populations; this pushed many potential consumers into informal markets, particularly for cross-border money transfers.<sup>12</sup> Discussions about de-risking in the cryptocurrency space are rare and seemingly premature, given that the blockchain industry's formalization is in its infancy. By averting services from high-risk jurisdictions and customers, cryptocurrency businesses can lessen their individual compliance risk; however, doing so will not eliminate the demand for cryptocurrency transactions among high-risk consumers. Workarounds and unregulated exchange platforms will likely capture that demand. For example, several websites currently offer cryptocurrency exchange services with little to no identification verification.<sup>13</sup>

The growth of the noncompliant cryptocurrency ecosystem today is fueled not by the externality of de-risking but by the willful development of anonymous cryptocurrency tokens by some programmers as well as the existence of exchanges that unabashedly advertise their lack of KYC requirements. As cryptocurrency investors and traders discover that blockchain forensics tools make it easier to de-anonymize transactions and compromise the privacy levels of popular cryptocurrencies

such as bitcoin and Ethereum, many users are seeking cryptocurrencies with stronger anonymity features and less traceability, such as Monero and Zcash.<sup>14</sup> This is not surprising because a strong libertarian ethos motivated the rise of bitcoin in the wake of the 2008 financial crisis when cynicism and distrust of the banking sector intensified.

In response to the perceived dwindling of privacy in the cryptocurrency space, some software developers are building decentralized cryptocurrency exchanges that facilitate trading without taking possession of users' tokens and without requiring customer identity verification. These platforms work through software-encoded smart contracts that simply transfer values between addresses of different cryptocurrencies and do not need central servers to store and move tokens, as regular cryptocurrency exchanges do. This trading structure minimizes the risk of hackers attacking servers to steal tokens, but it also eliminates token custodianship. Lacking central servers could encourage some decentralized exchanges to operate with less regard for legal requirements usually attached to jurisdictions. In fact, one decentralized exchange site published a blog post in February 2018 highlighting a critical benefit of its service—that it operates with “no KYC.”<sup>15</sup> Criminals tend to be early adopters of new technologies and thus are likely to take advantage of these more anonymous ecosystems, adapting and innovating as opportunities arise to transact outside of regulated spaces.<sup>16</sup> Therefore, ensuring that cryptocurrency exchanges enforce KYC requirements has become all the more important.

### *RECONCEIVING REGULATORY FRAMEWORKS*

The growth of a bifurcated cryptocurrency sphere means that financial authorities will have to address both philosophical questions and tactical challenges in implementing regulatory and enforcement frameworks. One question, for instance, is whether an underground cryptocurrency ecosystem is akin to the underground cash economies that operate in parallel to many formal financial sectors. In the world of fiat currencies, authorities could try to bring the informal sector into the formal economy, but underground economies are unlikely to completely disappear. However, underground fiat money and underground cryptocurrency markets are structurally different.

Large amounts of fiat cash cannot be transported across borders easily. Moving volumes in the billions, or even hundreds of millions, in cash requires planes or caravans of trucks; such movements are inherently conspicuous and need sophisticated schemes to conceal. However, transferring cryptocurrency units across the globe is no more technically difficult when the value is in the millions of dollars than when it is in the hundreds. The only thing likely preventing the widespread movement of illicit funds in untraceable, anonymous cryptocurrencies right now is the relatively low level of capitalization and liquidity of tokens such as Monero. Decentralized exchanges, though growing in number, account for perhaps 1 percent of cryptocurrency trading, according to blockchain technology experts.<sup>17</sup> The underground cryptocurrency ecosystem has not yet scaled to serve as the primary place for transaction.

This bifurcation, while important for conceptual purposes, is not always clear, nor is it static. If a business running a decentralized exchange decides to implement KYC protocols for its users, it would join the above-ground ecosystem. And many experts would argue that centralized exchanges with poor AML practices and elusive owners such as BTC-e—which was notorious for facilitating money laundering before it was shut down by law enforcement in 2017—are underground operations.<sup>18</sup> Still, the differing technical features should not be ignored, as they necessitate different regu-

latory and enforcement approaches. For the most part, the same investigative and enforcement techniques used to go after conventional money transmitters with poor AML practices can be used to address owners of centralized exchanges. However, the greater decentralization and built-in anonymity of the most nascent cryptocurrency innovations make traditional law enforcement methods inadequate. Authorities should be prepared for untraceable coins and no-KYC exchanges to become more prevalent.

Countering illicit activity associated with the underground cryptocurrency system will require innovation. The blockchain forensics tools that work well in analyzing bitcoin transactions are mostly ineffective at tracking Monero, for example. And while law enforcement can easily subpoena owners of centralized exchanges, compelling them to provide information about customers suspected of illicit transactions, many decentralized exchange platforms keep no records at all of user identities.

Strategies relying on intervention and enforcement by centralized entities are not fit for the underground cryptocurrency ecosystem. Financial regulation authorities should instead consider decentralized approaches. The bitcoin protocol was groundbreaking in developing cryptography and game-theory technology to incentivize disparate actors across the globe to confirm transactions and authenticate a growing, distributed ledger. Enforcement officials should work with blockchain technology experts who share their goal of minimizing illicit finance in the cryptocurrency system. Government and industry experts should explore together how cryptocurrency platforms could be leveraged to support AML aims, whether by making cleaner coins more valuable or by crowdsourcing and validating reports of illicit transactions and actors. Additional, more suitable, strategies will become apparent as the technology evolves and becomes widely adopted, and as traders, investors, and regulators learn more about the cryptocurrency system.

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## Appendix: Evaluation Strategies for Global and National Measures Against Illicit Financial Flows

The construction of a rigorous counterfactual is the most fundamental consideration for evaluating the impact of global governance strategies.\* That is, for a given global governance strategy (e.g., anti-money laundering policy), it is critical that some subjects of study receive the policy treatment whereas others do not, and that both of those sets of subjects otherwise be identical (or highly similar) in every respect. Only then, through explicit comparison with subjects that did not receive the policy treatment, can an evaluation establish that those that did receive the treatment changed their behavior accordingly.

A rigorous counterfactual can be constructed in several ways, which are broadly categorized as experimental, quasi-experimental, and observational approaches. The most credible are experimental and quasi-experimental approaches. In the discussion below, global governance strategies are referred to as programs or treatments that one seeks to evaluate. Given the goal to attribute any differences in outcomes to the program and not to other factors, these other possibilities are referred to as potential confounders.

### EXPERIMENTS

The defining feature of an experiment is that subjects are randomly assigned to treatment or control conditions. Randomization to treatment and control is often considered the ideal approach to identify causal impact because random assignment makes the control and treatment groups' characteristics, in expectation, identical. In other words, through random assignment, the control group constitutes a rigorous counterfactual because it is theoretically identical to the treatment group, except that the treatment group receives an intervention. Any difference in outcomes between the two groups can only be attributed to the intervention, given that the groups are identical in every other respect. In this respect, experiments have high internal validity and can offer the most credible answer to the question of whether global governance strategies work. To use randomization, a few prerequisites must be satisfied: it must be possible to give the treatment to some entities, but not others; the treatment needs to be uniform or consistent in its application; there must be a sufficient number of entities to enable balancing of possible confounding factors; and threats to validity, such as attrition, noncompliance, and interference, must be preventable. Michael Findley and the coauthors provide

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\* This appendix surveys major impact evaluation methods and examines their strengths and weaknesses. For detailed and technical discussions of these various impact evaluation approaches, see Alan Gerber and Donald Green, *Field Experiments: Design, Analysis, and Interpretation* (New York: W. W. Norton, 2012); Rachel Glennerster and Kudzai Takavarasha, *Running Randomized Evaluations: A Practical Guide* (Princeton, NJ: Princeton University Press, 2013); and Joshua D. Angrist and Jorn-Steffen Pischke, *Mastering Metrics: The Path From Cause to Effect* (Princeton, NJ: Princeton University Press, 2014).

one of the few examples of randomized evaluations in the research of illicit financial flows.<sup>†</sup> Of course, it is not always possible to carry out a randomized study, and therefore quasi-experimental strategies need to be employed.

## QUASI-EXPERIMENTS

In the event randomization is not possible, other methods to produce a rigorous counterfactual need to be considered. When necessary, impact evaluators typically consider several quasi-experimental approaches: regression discontinuity designs (RDDs), difference in differences, instrumental variables, and matching.

- *Regression discontinuity designs:* RDDs can be used to evaluate programs with arbitrary and strictly enforced eligibility cutoffs. Typical implementations include selection into a program based on, for example, income status just above or below a threshold. From a causal identification perspective, it is extremely important that participants and nonparticipants—who are just above and below the cutoffs—are identical in every respect except that some are assigned to the program whereas others are not. As such, any differences in outcomes should be attributable to the program and nothing else. RDDs can be especially useful because they balance both observable and unobservable potential confounders. However, it is often difficult to identify programs that are implemented based on the arbitrary and strictly enforced eligibility criteria. Unlike randomized evaluations, RDDs can be used for ex-post evaluation, as long as sufficient data exists.
- *Difference in differences:* This design couples a before-after comparison of program participants with a cross-sectional design of participants and nonparticipants. In this case, changes in outcomes over time for program participants can be compared to changes in outcomes over time for nonparticipants. If relevant assumptions are satisfied, difference-in-differences analyses can account for observable and unobservable potential confounders. The most difficult assumption to satisfy, however, is that of parallel trajectories. That is, had the program not existed, the two groups—program participants and nonparticipants—would have had identical trajectories over the period in question, an assumption that is difficult to satisfy in practice.
- *Instrumental variables:* This approach is often used after a program is implemented and seeks to separate possible confounding information from unique program information that can be referred to as plausibly exogenous program effects. An instrumental variables approach works by identifying a third variable that is highly correlated with the program but uncorrelated with other factors that could affect the outcome of interest. In an intent to treat analysis, the original randomization is used as an instrument for program uptake. Otherwise, some other third variable could be used. In either case, if satisfied, the instrumental variable approach helps separate the unique program effects from confounders. If a suitable instrument can be found—a difficult task in most cases—then observable and unobservable potential confounders can be ruled out in reaching conclusions about the effect of the program.

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<sup>†</sup> Michael G. Findley, Daniel L. Nielson, and J. C. Sharman, *Global Shell Games: Experiments in Transnational Relations, Crime, and Terrorism* (Cambridge: Cambridge University Press, 2014).

- *Matching:* This approach uses observable characteristics to create matches of participants and non-participants. That is, using statistical algorithms, one creates matched pairs in which the entities in the pairing are identical (or highly similar) in all respects except that some are program participants whereas others are not. If such balance can be created through matching, then any differential outcome should be attributable to program status. A difficult challenge with matching approaches is that any potential confounders that are unobservable cannot be accounted for unless one can include observable factors that are plausibly correlated with the critical unobservable factors.

## OBSERVATIONAL DESIGNS

It is not always possible to produce a rigorous counterfactual through experimental or quasi-experimental methods. In such cases, impact evaluations sometimes employ standard regression-based statistical analyses, time series analyses such as pre-post comparisons, cross-sectional comparisons such as participant-nonparticipant comparisons, or qualitative approaches such as process tracing.

- *Multiple regression:* In a regression framework, program participants and nonparticipants are compared while controlling for other factors that could explain the differences. The pivotal assumption is that control variables included in the model capture all relevant ways in which the two groups of subjects may differ. In other words, one must ensure that all characteristics that could be correlated with outcomes—both observable and unobservable—are captured in the regression. Of course, unobservable characteristics cannot be included in a regression analysis and therefore cannot be ruled out with any confidence.
- *Pre-post comparisons:* In such a design, evaluators compare outcomes for participants both before and after a program has been implemented. In this case, the comparison group includes the participants themselves before the program was implemented. The pivotal assumption here is that the program was the only factor influencing changes in the measured outcomes over time. Unfortunately, many factors can change concurrently with the program and can affect the outcomes for the participants, and yet it is extremely difficult to separate the effects of the program from those of potential confounders.
- *Participant-nonparticipant comparisons:* In this design, the evaluation relies on comparing the outcomes of program participants and nonparticipants only after the program is implemented. The pivotal assumption is that participants and nonparticipants are identical, especially in that they are equally likely to enter the program. Unfortunately, many reasons explain why some are selected (or select) into programs whereas others are not (or do not), including motivation to take up the program or fitting the demographic of needing the program. Preexisting differences between participants and nonparticipants are likely more responsible for differences in outcomes than the program itself.
- *Qualitative approaches:* Sometimes quantitative and qualitative strategies are pitted against each other, but this is likely a false dichotomy. Both should be used in tandem, wherever appropriate. Interviews and focus groups are critical for getting at mechanisms, exploring ideas that evaluators had not thought of, and allowing interactions across respondents through focus groups. By themselves, such approaches cannot produce credible inferences, but they can help add important context and details otherwise missing from other impact evaluation methods.

## Acknowledgments

These discussion papers were presented at the “Global Governance to Combat Illicit Financial Flows: Measurement, Evaluation, Innovation” workshop at the Council on Foreign Relations (CFR). I wish to thank the authors of the discussion papers and the workshop participants, whose comments contributed to these final, published versions. I am particularly grateful for the concluding workshop comments and ongoing advice offered by Mary Beth Goodman and Edwin M. Truman. Nancy Boswell, Danielle Brian, Danielle Lindholm, and Matthew Taylor also offered valuable advice during the planning of the workshop.

The workshop could not have taken place without the organizational and editorial contributions of Kyle Evanoff, CFR research associate, and the oversight and support of Megan Roberts, former associate director of CFR’s International Institutions and Global Governance program (IIGG). Stewart Patrick, James H. Binger senior fellow in global governance and IIGG director, presided over the workshop session on evaluating global efforts to combat illicit financial flows. Patricia Lee Dorff, CFR editorial director, and Sumit Poudyal, CFR assistant editor, were instrumental in seeing that these papers were published in an accurate and timely fashion. This publication is part of the International Institutions and Global Governance program and was made possible by the generous support of the Robina Foundation.

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*October 2018*

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