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Europe Beyond Aid: Illicit Financial Flows

Policy Responses in Europe and Implications for Developing Countries

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Abstract

Illicit financial outflows affecting developing countries have been estimated to as much as one trillion dollars. These estimations may not be generally endorsed, but there seems to be consensus on the negative effect of international illicit flows on international security and governance, and on development finance. This paper summarizes the current understanding of illicit finance and its relevance for developing countries. It analyzes European contributions to making development finance less illicit and based on three case studies of Belgium, Luxembourg and Spain, it also provides in-depth analyses of national policies. The paper concludes that the EU has the tools to ensure a more transparent financial system, and further proposals are currently being discussed which will likely lead to improved financial transparency within Europe. However, their direct potential impact on developing countries remains uncertain.

Europe Beyond Aid Consultation Report Series

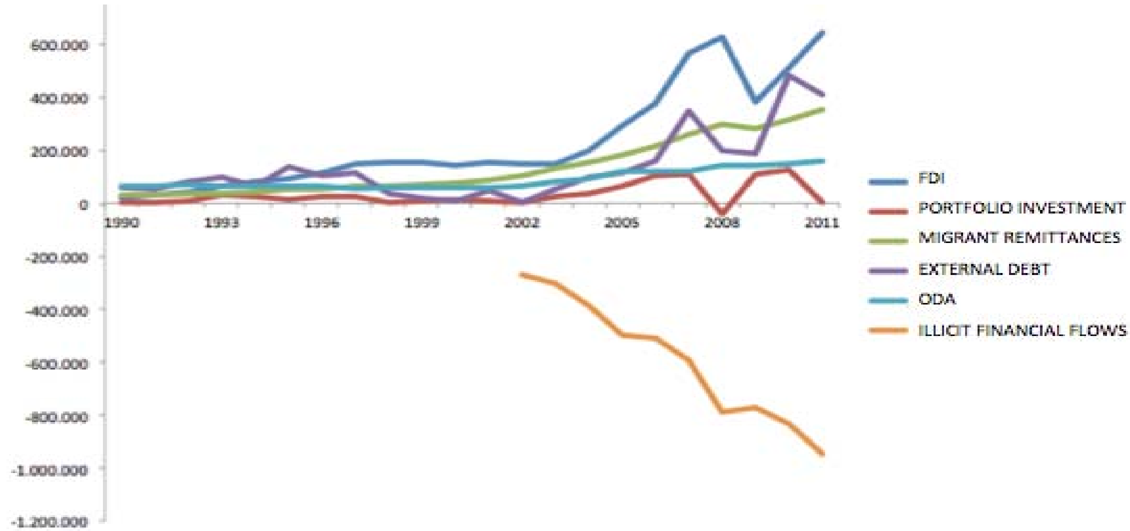
Europe Beyond Aid uses the Commitment to Development Index (CDI) to examine European countries' collective commitment to development on seven cross-border issues: aid, trade, finance, migration, environment, security, and technology. We calculate a consolidated score for the 21 European countries included in the CDI to track their pursuit of development-friendly policies. In 2014 the Center for Global Development launched a series of discussion papers for public consultation. Our goal is to press for a broader and more informed discussion about how European policies can improve.

By December 2016, we will synthesize the expert consensus on the seven themes of the CDI into a comprehensive and specific policy agenda for European countries setting out practical, evidence based conclusions on how they can improve their policies which affect development and global poverty. Please, share your comments, suggestions and ideas by email to pkrylova@cgdev.org. We look forward to hearing from you.

Introduction

Illicit financial outflows from developing countries in 2011 have been estimated at US$946.7 billion by researchers from Global Financial Integrity (Kar and Leblanc, 2013). The volume of such international transactions implies not only problems in terms of security and governance – organized crime, corruption, tax fraud – but also a major difficulty for development finance. According to the mentioned institution, "for each dollar developing nations receive in foreign aid, ten in illicit money flow abroad"[1]. In Figure 1 below, these estimates are shown in comparison with aid and other financial flows addressed to developing countries.

Figure 1. Global development finance and illicit outflows in developing countries



Source: Kar and Leblanc (2013), OECD (2014d), and World Bank (2014)

These estimations may not be generally endorsed, but there seems to be consensus on the relevance of international illicit flows and their impact on developing countries (Claessens and Naudé, 1993; Cobham, 2014). For that reason, the Commitment to Development Index (CDI) which scores and ranks rich countries on how they assist poor countries in seven policy areas, including via financial policies – monitors countries' efforts in combating illicit flows (Center for Global Development, 2013). As explained further in this paper, because secrecy is the defining feature of illicit flows, this index correctly approaches policy commitment against illicit flows by taking into account the implementation of financial transparency measures supported by a high degree of international consensus.

In order to gauge such commitment, the CDI integrates an annual survey carried out by the Tax Justice Network (and synthesized into another index, called the Financial Secrecy Index (FSI))[2]. The FSI assesses not only different countries' policies with regards to financial transparency ('secrecy scores'), but also the relative weight of each country in the global financial system (share of the market for offshore financial services). The

[1] For more details see http://www.gfintegrity.org/

[2] The Tax Justice Network is an independent international network dedicated to research, analysis, and advocacy in the area of international tax and international financial regulation.

CDI, focused on policies, does not integrate the FSI itself, but only its secrecy scores[3]. These scores (awarded on a scale of 1 to 5) are listed in Table 1:

Table 1. Financial Transparency Scores in the CDI

Country	Score (1-5)
Denmark	5
Finland	5
Ireland	5
Poland	5
Spain	5
Sweden	5
Australia	4
Belgium	4
France	4
Greece	4
Hungary	4
Italy	4
Norway	4
Portugal	4
United Kingdom	4
United States	4
Canada	3
Czech Republic	3
Netherlands	3
New Zealand	3
South Korea	3
Austria	2
Germany	2
Japan	2
Luxembourg	2
Slovakia	2
Switzerland	1

Source: Center for Global Development (CGD)

As part of the Europe Beyond Aid project – a CGD initiative that uses the CDI data and framework to analyze Europe's overall contribution to development – this paper will regard Europe as if it were a single country. Section 2 provides information on Europe's overall performance in financial transparency by

[3] When assessing a country's commitment to development, analysis must focus on its policies and disregard the potential impact of such policies. That is why the secrecy score (and not the FSI itself) has been integrated in the CDI. In this paper, we will refer to both the CDI's financial transparency subcomponent and to the FSI, using the CDI to help illustrate a larger picture of performance in this area, and the FSI to break down such performance into different policy measures.

aggregating results from the European countries, breaking down the aggregated score into different indicators and comparing the results with those of non-European countries.

In Section 3, the paper interprets these data by collecting qualitative complementary information: Why is Europe's financial system the way it is? Does it depend on EU Institutions, or is it the result of national policies? Is Europe effectively contributing to global development finance through financial transparency?

Finally, the paper will draw on prior description and analysis to provide some policy recommendations in order to improve both financial transparency and its impact on development.

The paper also includes a first section that provides information on the methodological bases of this work: the conceptualization of illicit flows, the various attempts to quantify them, and a summary of the different indicators synthesized into the financial transparency subcomponent of the CDI.

1. What are illicit financial flows (IFFs), and how big are they?

The concept of illicit financial flows

Reuter (2012) defines IFFs as flows which are themselves illegal within a regime that has some democratic legitimacy (for example, corruption or tax evasion) or else funds that are the indirect fruits of illegal acts. Taking a similar approach, Jansky (2013) explains the term by classifying IFFs into three groups: illegal (or criminal), individual illicit, and corporate illicit (or commercial):

1. Illegal or criminal financial flows: illegal activities such as "money laundering, drug and human trafficking, smuggling, illegal trade with weapons, counterfeiting, corruption, bribery, customs fraud, or terrorist financing".
2. Individual illicit financial flows: associated with tax avoidance, tax evasion, and other illicit and illegal practices by individuals. Although their amount is not large, they are very visible in the media and in politics.
3. Corporate illicit flows: tax evasion, tax avoidance, profit shifting, and other similar practices by corporations and other legal entities (including transfer pricing manipulation or abusive transfer pricing).

The problem with this categorization is that legal assessment is required in order to determine whether a certain financial transaction belongs to any of these categories (Cobham, 2014). Other authors (Blankenburg and Kahn, 2012) focus on the harm done by these flows and consider an illicit flow to be any financial transaction having a negative impact on an economy; but this is too vague a definition and can include very different situations (speculative flows, investments with negative spillovers, etc.) outside the consideration of policy makers and analysts when addressing IFFs.

Furthermore, Cobham (2014:3) points out that "a strictly legal definition of IFF is therefore likely to result in systematically – and wrongly – understating the scale of the problem in lower-income, lower-capacity states. For this reason, such a definition should be rejected". He proposes a conceptualization of IFFs as hidden flows, and that is the starting point of this paper. We see illicit flows as financial transactions that are deliberately hidden from the legitimate authorities of a country, although we also find very relevant Jansky's

(2013) classification differentiating flows that are hidden along with their activities of origin or destination (presumably criminal activities) from flows that are hidden totally or partially in order to avoid regulations that would affect the flow itself (for instance, tax regulation).

Quantification of illicit flows

The defining feature of IFFs as hidden flows demonstrates the difficulty of measuring them. Obviously, financial transactions and assets that remain obscured from public authorities are not accessible to statisticians. However, there have been several quantitative approaches to the phenomenon that could be grouped in two categories: macro-analytical methods, which intend to measure IFF volume by discovering gaps in official macroeconomic data; and micro-analytical methods, which analyze in depth a particular source of IFFs at a micro scale, then estimating their size at a global scale[4]. Table 2 below offers a comprehensive summary.

[4] Claessens and Naudé (1993), at the request of the Debt and International Finance Division of the World Bank, compiled the different methodologies used to quantify international illicit flows, all of which were macro-analytic methods. They provided the following classification: (1) the residual method, which measures the residual of the sources of funds over the "uses of funds" in the balance of payments; (2) the Dooley Method, which seeks to measure the variations in stock of privately held foreign assets that do not generate income, as reported to domestic authorities; (3) the Hot Money Narrow (HMN) Method, which calculates private capital flows directly by taking the negative of errors and omissions and private short-term capital flight from the balance-of-payments; and (4) the trade mis-invoicing method, which identifies invoicing biases by comparing data from the IMF's Direction of Trade (IMF-DOT) with national reports. These authors concluded that the results obtained through the various methodologies did not differ widely.

Table 2. Quantitative approaches to illicit flows

Approach	Scope	Year	Institution	Concept	Method	Amount	Reference
Macro	Global	2011	Global Financial Integrity (NGO)	Illicit gross outflows from developing countries	Residual method plus trade misinvoicing	US$946.7 billion	Kar and Lebanc (2013)
	Global	1998	International Monetary Fund	Money laundering transactions	Identification of a consensus range among experts	2-5% GDP	Camdessus (1998)
	84 developing countries	1991	The World Bank	Non-reported financial transactions	WB residual, Dooley, trade misinvoing and Hot Money Narrow	US$10-92 billion	Classens and Naudé (1993)
Micro	Global	2007	StAR	Stolen assets in developing countries		US$20-40 billlion	StAR (2007)
	Global	2011	UNODC	All criminal proceeds, including tax evasion	Meta-analysis of country estimates	US$3.1 trillion (1.7-4.5% GDP)	UNODC (2011)
	Global	2011	UNODC	The drug economy	Drug traffic case studies and estimates of market size	US$870 billion	UNODC (2011)
						(1.5% of GDP)	UNODC (2011)
	UK	2004	UK Office of National Statistics	Criminal activities (excluding tax evasion)	Estimating the market size of drugs, prostitution, selling of stolen goods and illicit gambling	1.2% GDP	UNODC (2011)
	Germany	2007	Germany - IMF	Criminal activities (including tax evasion)		2.3% GDP	UNODC (2011)
	Italy	2009	SOS Impresa (NGO)	Criminal activities (excluding tax evasion)	Estimates related to the income of organized crime	7.7 % GDP	UNODC (2011)

Source: own elaboration

In the end, despite several attempts at mounting relevant institutional support, no institution has yet adopted a method that allows the international community to measure this problem or to regularly monitor its evolution.

How does the international community see IFFs?

IFFs, as defined in this paper, have not exactly been a focus of attention for the international community. The United Nations Office on Drugs and Crime (UNODC) and the World Bank (WB) both use the term "illicit flows", but the issue of concern for the G7, the G20, and the OECD has historically been "money laundering", which is the process of transforming the proceeds of crime into seemingly legitimate proceeds (EC, 2013).

The G7 first addressed the need to prevent the use of the financial system for money laundering in 1989, and it launched the Financial Action Task Force (FATF) to increase transparency and international cooperation in this field. The FATF determines regularly upon certain quality standards for financial legislation, and it evaluates their implementation by member countries. Although the FATF is an OECD-based task force, its recommendations are spread throughout the world via regional organizations somehow associated to the FATF (including GAFILAT in South America, GAFIC in the Caribbean). Negative evaluations by FATF have resulted in grey or black lists of countries that have conferred a negative reputation effect on their financial systems, and this has motivated many countries to join international cooperation in this field.

Over the last decade, the FATF has explicitly widened its mandate to combat terrorism financing, which results from the same technical measures but refers to yet another dimension of the problem: the financial system can also be used to channel resources (of legal origin or not) to criminal activities regarded as international terrorism.

More recently, following a similar procedure, tax evasion and tax avoidance have been added to the list of international challenges to be addressed through increased financial transparency. The G20 meeting in Saint Petersburg of 2013 expressed concern about an international tax system that seeks to avoid double taxation but results in no taxation at all for certain multinational companies. Following the G20 meeting, the OECD supported this agreement by designing an action plan against tax-base erosion and profit shifting (BEPS).

At the UN, there are two main initiatives that deal with IFFs directly or indirectly: UNODC, the UN body for fighting against illicit drugs and international crime, and the Stolen Asset Recovery (StAR) Initiative, with participation by the World Bank. These WB and UN initiatives are more inclusive from a development approach, and they look at IFFs in general terms, trying to capture the overall problem through rigorous concept definition and ambitious metrics. However, it is OECD-supported initiatives that are currently leading the legislative agenda on financial transparency.

What does the CDI's financial transparency component measure?

The CDI intends neither to measure IFFs nor how they are effectively curtailed by public action. Consistent with its goal of assessing rich countries' commitment to development, it informs on whether or not a country has put in place different financial transparency measures that form part of the international consensus on how to cope with IFFs. Its indicator Number 6, for instance, assesses whether or not multinational companies are required to provide country-by-country financial reporting, which is a key measure of the

BEPS action plan. Its indicator Number 11 simply scores negatively those countries which do not comply with FATF recommendations, according to its own evaluation system (see Table 3).

In other words, the rationale of the CDI sees IFFs as a problem of transparency and is consistent with international agreements on how to curtail them.

Table 3. Measuring financial transparency in the CDI

Concept	Dimension		Key Financial Secrecy Indicators (KFSI)
FINANCIAL TRANSPARENCY	TRANSPARENCY OF BENEFICIAL OWNERSHIP	1	Banking Secrecy: Does the jurisdiction have banking secrecy?
		2	Trust and Foundations Register: Is there a public register of trusts/foundations, or are trusts/foundations prevented?
		3	Recorded Company Ownership: Does the relevant authority obtain and keep updated details of the beneficial ownership of companies?
	KEY ASPECTS OF CORPORATE TRANSPARENCY REGULATION	4	Public Company Ownership: Does the relevant authority make details of ownership of companies available on public record online for less than US$10/€10?
		5	Public Company Accounts: Does the relevant authority require that company accounts are made available for inspection by anyone for a fee of less than US$10/€10?
		6	Country-by-Country Reporting: Are all companies required to comply with country-by-country financial reporting?
	EFFICIENCY OF TAX AND FINANCIAL REGULATION	7	Fit for Information Exchange: Are resident paying agents required to report to the domestic tax administration information on payments to non-residents?
		8	Efficiency of Tax Administration: Does the tax administration use taxpayer identifiers for analysing information efficiently, and is there a large taxpayer unit?
		9	Avoidance of Promoting Tax Evasion: Does the jurisdiction grant unilateral tax credits for foreign tax payments?
		10	Harmful Legal Vehicles: Does the jurisdiction allow cell companies and trusts with flee clauses?
	INTERNATIONAL STANDARDS AND COOPERATION	11	Anti-Money Laundering: Does the jurisdiction comply with the FATF recommendations?
		12	Automatic Information Exchange: Does the jurisdiction participate fully in Automatic Information Exchange such as the European Savings Tax Directive?
		13	Bilateral Treaties: Does the jurisdiction have at least 46 bilateral treaties providing for information exchange upon request, or is it part of the European Council/OECD convention?
		14	International Transparency Commitments: Has the jurisdiction ratified the five most relevant international treaties relating to financial transparency?
		15	International Judicial Cooperation: Does the jurisdiction cooperate with other states on money laundering and other criminal issues?

Source: Own elaboration from TJN (2013d)

2. How transparent is the European financial system?

The FSI is intended to be a tool for mapping secrecy jurisdictions around the world and for signaling the most likely destinations of international illicit flows. The CDI builds its financial transparency subcomponent on the secrecy score received by 27 rich countries in the FSI and groups 21 of them as if Europe were a single country. In this section, we look first at European countries' scores in the FSI, then at Europe's overall performance in the CDI, finally breaking down the aggregated score into different indicators using the complementary information available on the FSI webpage[5].

European countries in the Financial Secrecy Index

Paradoxically, the top positions in the FSI ranking are occupied by tax havens (see Table 4 below). Moreover, there are only two EU member states among the best 10 performers (Hungary and Sweden, in 9th and 10th place, respectively) of the 17 EU members assessed by this index[6]. These results might be striking but, actually, they respond to two main factors. On the one hand, the FSI is calculated for a selection of 80 countries including a large number of tax havens. Secondly, one of the two components of the FSI (the global scale weight) is a quantitative assesment of the financial activities of the country and, therefore, tends to score large economies negatively[7].

Table 4. Best performers in financial secrecy (lowest FSI values in 2013)

#	Jurisdiction	FSI value	Secrecy score	Global scale weight
1	St Kitts & Nevis	18.5	80	0.000
2	Maldives	21.1	79	0.000
3	Cook Islands	25.3	77	0.000
4	Dominica	26.9	79	0.000
5	Samoa	31.0	88	0.000
6	Monaco	38.8	75	0.000
7	Andorra	43.4	76	0.000
8	Brunei Darussalam	50.6	84	0.000
9	Hungary	54.7	40	0.056
10	Sweden	55.7	32	0.440

Source: Tax Justice Network (2013d)

There are three European countries in the top 10 of worst performers: Switzerland, Luxembourg, and Germany (also, Cayman Islands holds an administrative relation with the United Kingdom). Of these three European countries, two are members of the EU and the Eurozone (Table 5). In short, European countries and EU member states appear to be scattered across the 80-country ranking, suggesting that there is no such thing as a "European" or "EU member" profile for jurisdictions when it comes to financial transparency.

[5] See http://www.financialsecrecyindex.com. The authors are thankful to Markus Meinzer, Tax Justice Network, for his introduction to the FSI methodology and data.

[6] It should also be noted that several jurisdictions maintain some sort of administrative or institutional relations with the United Kingdom and/or New Zealand (St Kitts and Nevis, Maldives, Cook Islands, Dominica, and Samoa) (Table 4).

[7] This component may be "undervaluing" the importance of anti-financial transparency policies. Take, for instance, the case of the top performer, St Kitts and Nevis. This jurisdiction records a FSI value of only 18.5, but this is mainly due to an extremely low global scale weight (0.000), as its secrecy score is among the highest (meaning worst) of the overall selection of 80 countries.

Table 5. Worst performers in financial secrecy (highest FSI values in 2013)

#	Jurisdiction	FSI value	Secrecy score	Global scale weight
1	Switzerland	1,765.3	78	4.916
2	Luxembourg	1,454.5	67	12.049
3	Hong Kong	1,283.4	72	4.206
4	Cayman Islands	1,233.6	70	4.694
5	Singapore	1,216.9	70	4.280
6	USA	1,213.0	58	22.586
7	Lebanon	747.9	79	0.354
8	Germany	738.3	59	4.326
9	Jersey	591.7	75	0.263
10	Japan	513.1	61	1.185

Source: Tax Justice Network (2013d)

The secrecy score index shows a very different landscape, with a concentration of European countries, and more specifically European member states, at the top of the list. In this case, there does indeed seem to be an EU profile (Table 6). The top 9 performers are members of the EU, and the top 12 are all European countries; there are 15 European countries and 14 EU members among the top 20 performers.

Table 6. Best performers in financial secrecy (lowest secrecy scores in 2013)

#	Jurisdiction	FSI value	Secrecy score	Global scale weight
71	Sweden	55.7	32	0.440
66	Denmark	63.1	33	0.605
56	Spain	111.4	36	1.504
47	Ireland	155.5	37	2.646
69	Portugal (Madeira)	57.9	39	0.092
54	Italy	119.0	39	0.748
21	United Kingdom	361.3	40	18.530
72	Hungary	54.7	40	0.056
43	France	191.0	41	2.141
50	Norway	142.8	42	0.667
64	Malta	78.1	44	0.079
40	Belgium	199.3	45	1.031
32	India	254.6	46	1.800
44	Australia	168.2	47	0.394
39	Netherlands	204.9	50	0.430
53	Latvia	128.1	51	0.090
48	New Zealand	151.4	52	0.126
29	Brazil	283.9	52	0.768
41	Cyprus	198.9	52	0.264
36	South Africa	209.8	53	0.260

Source: Tax Justice Network (2013d)

Moreover, according to Tax Justice Network data, the average of the sum of the 15 key financial secrecy indicators (KFSIs) for the whole set of countries (5.00) is well below the average sum of the 24 European countries included in the sample (7.11), and below that of the 17 EU member states assessed by the index (8.20).

Europe (as one) in the CDI's financial transparency subcomponent

The CDI simplifies the data shown in Section 3 for the purpose of this research by: (1) reducing the scope of the index to developed countries; (2) scaling the secrecy score to a 1-to-5 range; and (3) aggregating the results of European member states, as if Europe were a single country. These are the results:

Table 7. Financial transparency ranking in the CDI, Europe as a single entity

Rank	Country	Score (1-5)
1	United States	4
2	Europe	3.6
3	Canada	3
4	New Zealand	3
5	South Korea	3
6	Japan	2

Source: Center for Global Development (CGD)

Breaking down the European secrecy score

As per Table 3, the financial transparency ranking provided by the CDI results from the calculation of 15 key financial secrecy indicators (TJN, 2013d). Thus the 3.6 score received by the EU in financial transparency can be broken down into 15 policy measures grouped in five categories broken down in Table 8.

Table 8. Europe's commitment to development breakdown

Transparency in…	Beneficial ownership	Corporate information	Tax and financial regulation	International standards and cooperation	Overall
Austria	12%	50%	35%	43%	36%
Belgium	39%	50%	33%	85%	55%
Denmark	27%	50%	88%	86%	67%
France	43%	50%	43%	87%	59%
Germany	20%	17%	30%	76%	41%
Hungary	46%	17%	65%	89%	60%
Ireland	47%	57%	43%	92%	63%
Italy	26%	57%	50%	93%	61%
Luxembourg	18%	50%	15%	47%	33%
Netherlands	32%	17%	50%	81%	50%
Portugal	46%	17%	70%	89%	61%
Spain	47%	17%	80%	91%	64%
Sweden	25%	50%	88%	88%	68%
United Kingdom	39%	50%	43%	93%	60%
The EU	*33%*	*39%*	*52%*	*81%*	*33%*
Norway	46%	33%	75%	66%	58%
Switzerland	12%	0%	13%	47%	22%
EUROPE	*33%*	*36%*	*51%*	*78%*	*54%*

Source: Center for Global Development (CGD)

Beneficial ownership is the least transparent issue of the European financial system, according to the CDI. No European country obtains and keeps updated details of the beneficial ownership of companies; and banking secrecy partially persists in some countries like Switzerland, Austria, and Luxembourg. Moreover, several jurisdictions do not prevent or control activities by trusts and foundations.

Requirements of corporate transparency in Europe (public access to the identity of their owners and their financial statements, and country-by-country reporting) are also low, according to the CDI. This is due to the fact that information is not always public[8].

Scores on tax and financial regulation are more positive for Europe, although half of the countries do not collect information on payments to non-residents, which affect the capabilities of a country to automatically exchange relevant information with other countries. In this field of international cooperation, Europe receives its best score due to the number of signed cooperation agreements, along with its progress in meeting FATF standards. All European countries of the CDI are currently members of this task force.

A closer look at the performance of European and EU countries in this index also reveals an important level of heterogeneity among both groups. Currently, the variance of the added KFSI is lower for the entire

[8] The index also scores negatively those registries which are officially public but not easily accessible to the public, meaning that they are neither free nor accessible on line.

selection of countries (5.18) than for the group of 24 European countries (5.87). Contrarily, EU member states show more homogeneity as the variance of the added KSFI for this group is only 2.43. By specific indicators, the variance of the selected European countries is higher than the variance of the entire set of countries in 8 out of 15 KFSIs – banking secrecy, trust and foundations registering, recorded company ownership, public company ownership, public company accounts, country-by-country reporting, fit for information exchange, efficiency of tax administration, and automatic information exchange. So, in general terms, it can be said that there is no Europe-wide method of dealing with financial secrecy.

Indicator by indicator, the 17 EU member states ranked in this index show more consistent behaviour. The variance of this group is above the variance for the entire selection of countries in only four indicators – trust and foundations registering, public company ownership, public company accounts, and fit for information exchange. These results suggest, on the one hand, that there might be some sort of EU profile of countries and, on the other, that there may be four areas of policy making where European institutions could push for greater levels of financial transparency.

3. Qualitative analysis of financial secrecy measures in Europe

The data provided in Section 2 show that there are different degrees of financial transparency within the EU, although there is certain homogeneity in some specific aspects of transparency. This raises two questions that require a more qualitative approach to this issue: why some European countries are more transparent than others, and whether or not the EU Institutions are actually reducing certain transparency gaps within the Union. Also, given the final purpose of this research, a deeper analysis should provide information on whether or not financial transparency measures in Europe are actually impacting on developing countries.

Figure 2. Qualitative research on financial transparency in the EU.
Methodological note

Research questions:
- Why are some European countries more transparent than others?
- Are the EU Institutions actually reducing transparency gaps within the Union?
- Are financial transparency measures in Europe having a positive impact on developing countries?

Research technique:
Semi-structured interviews

Informers:
Public officers dealing with IFFs, belonging to different policy areas and countries.

Policy areas:
- Police and home affairs
- Taxation and customs
- Finance and market regulation

Countries:
- Spain
- Belgium
- Luxembourg (finally declined to be interviewed)
- The EU Institutions

Date and place of interviews:

Madrid and Brussels, November 2014

In order to answer these questions, three countries showing different degrees of financial transparency in the CDI were selected for an in-depth analysis. These countries were Spain, Belgium, and Luxembourg, which scored at 5, 4, and 2 points respectively in the financial transparency subcomponent of the CDI. Previously, qualitative information about the causes and consequences of their degree of financial transparency was collected trough interviews with public officers dealing with financial regulation and the fight against illicit flows, from different angles and at both country and EU levels.

Although the administrative architecture differs in each country, the informers can be grouped into three wide policy areas: police and home affairs; taxation and customs; and finance and market regulation. Following international standards, all administrations involved in identifying suspicious financial transactions are interconnected and coordinated by a single unit which acts as a contact point for other jurisdictions – the intelligence finance unit. This unit was included in the interview plan in all cases. When relevant, policy officers in development cooperation departments were also contacted.

The starting point of all these interviews was the different scores of the selected countries in the CDI (see Table 9), along with an open questionnaire reflecting the underlying logic of the financial transparency subcomponent of the CDI. Questions about specific transparency measures, both pending and achieved, were framed under a larger assessment of the problem of illicit flows and its different dimensions, including the development dimension, and the difficulties in and opportunities for tackling the problem through financial regulation and other means.

Table 9. Selected cases for an assessment of financial transparency in Europe

Country	CDI scores*		Financial secrecy scores				
	Overall	**Financial Transparency**	Beneficial ownership	Corporate	Tax regulation	International Cooperation	**Total**
Spain	**5.1**	**7**	47%	17%	80%	91%	**64%**
Belgium	**6**	**5.6**	39%	50%	33%	85%	**55%**
Luxembourg	**5.5**	**2.8**	18%	50%	15%	47%	**33%**
Europe	**5.1**	**5**	33%	36%	51%	78%	**54%**

** Scores in the CDI are scaled in a way that the average score for the year of reference was 5.*

Source: Center for Global Development (CGD)

Spain

Spain receives the maximum score in financial transparency awarded by the CDI, even though it still receives 36 secrecy points out of 100. In other words, the country meets more transparency criteria than most of the countries ranked in the index, but it still has some progress to make in order to be fully transparent. Other European countries in a similar position are Denmark, Finland, Ireland, Poland, and Sweden.

The high transparency ranking of Spain (similar to, say, Sweden) might seem contradictory given the incidence of corruption in the country, as reported by newspapers and surveys such as the Corruption Perception Index. However, transparency in the financial system is merely a tool for identifying the proceeds from illicit activities, and it does not measure the *exposure* of a country to those activities, which may depend on other factors (for instance, transparency in the public sector).

This positive assessment of the Spanish financial system in the FSI is consistent with the Financial Action Task Force (FATF) mutual evaluation, and with the self-assessment conducted by its public officers during the research interviews. Spain was the first country to complete the mutual evaluation under the 2012 FATF Recommendations on anti-money laundering and counter-terrorist financing measures, and the nation obtained a very positive assessment from its peer countries. The recently released report concluded that Spain "has created a strong system to combat money laundering and terrorist financing" (FATF, 2014).

As per the FSI, Spain performs best in two areas: international cooperation (having signed 46 bilateral tax information sharing agreements by 2012, and fully participating in Automatic Information Exchange), and financial regulation (its tax administration shows efficiency in collecting information both on its own taxpayers and those of other countries). On the other hand, its most negative scores have to do with public access to corporate information, and with limitations to keeping track of beneficial ownership. The latter, which is among the hot topics in current international debates, could be surmounted in coming years, according to the FATF: "measures for enabling access to beneficial ownership information, in particular, the

notary profession's Single Computerised Index, are an example of good practice in the context of Spain's legal system" (FATF, 2014:6). This recent development was probably not captured by the 2013 edition of the FSI.

In any case, the interest here is in understanding why Spain performs better than the majority of European countries. According to the interviews, the road map of the country in financial legislation has been the same as for other European countries: namely, the 2003 and 2012 FATF recommendations. When asked about the influence of EU legislation on their performance, the answer was that so far the added value has been low for countries complying quickly and thoroughly with FATF recommendations.

So, why does Spain comply faster and more fully than most countries with FATF recommendations? Interviewees from the Spanish police agency (*Cuerpo Nacional de Policía)*, the Finance Department (*Tesoro,* which hosts the secretariat of the Spanish Intelligence Unit), and the Tax Administration (*Agencia Española de Administración Tributaria*), all considered their professional commitment to this issue to be a strength of the country. The impression was that the information system of the State is becoming more robust and sophisticated every day, time being the only constraint to giving national authorities full access to any and all financial information. No political obstacle whatsoever was mentioned when addressing the different measures in place or in progress, and even reluctance from certain parties including banks was considered irrelevant. Going deeper into the causes of this evident consensus, the explanation seemed to be the country's exposure to organized crime (mainly drug traffic entering the European continent through Spain) and its background in fighting the terrorism of ETA and Al Qaeda. The latter organization has been fought in close cooperation with the US, which is the highest performer in the CDI's financial transparency subcomponent.

Regarding the impact on development of such policies, two main conclusions were drawn from the interviews in Spain. First, the information available does not say much about development impact, and second, despite of the lack of information, these policies will probably have no direct impacto n developing countries in the short term. The fight against illicit flows is monitored by way of activity indicators that show, for instance, the number of suspicious operations reported, or the number of international exchanges of information. However, the Spanish administration does not keep track of the final outcomes of those activities (for instance, the amount and breakdown of illicit financial assets identified in Spain and returned to third countries). This information can only be provided by judiciary authorities, which are not integrated into the information system governed by the Spanish Financial Intelligence Unit.

Furthermore, Spain itself does not monitor or report on the problem of illicit flows. The interviewees could only mention some figures provided by international organisms, such as the UNODC estimates on the global drug economy, or a study on VAT fraud commissioned by the EC. The Spanish interviewees in the Tax Administration mentioned only two studies on very specific issues of their concern: losses associated with cigarette smuggling from Gibraltar, and VAT fraud within Spain.

Regarding the impact on developing countries, despite the lack of quantitative data, some conclusions were advanced. First, interviewees did not refer to the development dimension of illicit flows. Secondly, the international exchange of information is only fully developed at the European level, and partially at the OECD level. On this point, interviewees highlighted the relevance of current technical cooperation initiatives aimed at reinforcing administrative capacities in developing countries, in order that they meet international standards and fully benefit from information exchange. Spain participates in these types of programs, being

especially active in Latin America and North Africa. Also, interviewees mentioned that following the chute of certain regimes in developing countries, specific international initiatives allow those countries to recover stolen assets.

Belgium

Belgium stands at a median position in the financial transparency subcomponent of the CDI, having received a score of 45 in the 0-to-100 secrecy scale of the FSI. It is rated in this index as a moderately secretive jurisdiction, but the nation also receives positive comments due to "its dramatic improvement of its score of 59 in 2011. Its ranking has improved because of a decision to move significantly away from banking secrecy and [to] embrace automatic information exchange" (TJN, 2013b).

Indeed, Belgium not only participates fully in Automatic Information Exchange, it is one of the most active countries in signing bilateral agreements for tax information sharing. However, in other aspects of the survey, its results are not so clear: bank account ownership is no longer secret, but beneficial ownership is still difficult to trace; trusts cannot be established under the Belgian law, but foreign trust operations in the country have legal recognition; tax-related information is efficiently managed in general terms, but it does not include details of payments to non-residents; etc.

Belgian interviewees responsible for the Belgian Financial Intelligence Unit (CTIF), the police department, taxes, customs, and finance agreed with the TJN report (2013b) that the fight against illicit flows in Belgium has been reinforced in recent years due to specific legislation and international agreements passed during the Di Rupo government between 2011 and 2014. They also stated that further progress in financial transparency will depend upon the degree of commitment of the new government. Unlike in Spain, consensus in Belgium around financial secrecy is not so clear. Financial transparency is confronted within the political debate with other values such as business freedom, professional secrecy, personal data protection, etc. Even when such debates are resolved in the political arena and new legislation is passed, it is systematically questioned in the Supreme Court based on the right to privacy.

In this context, the interviews revealed that reporting and communication activities by the administrations involved in anti-money laundering activities, including the police, have had a positive impact on public opinion and, in the end, on the political process. The best example of this is the annual report of the Financial Intelligence Unit in Belgium and its media coverage. However, as in the case of Spain, they do not themselves produce or use statistics on illicit flows.

When asked about the implications of the reinforcement of anti-money laundering activities in Belgium for developing countries, some cases of trafficking of illegal workers were highlighted; but as in the case of Spain, the informers stated that most Belgian international cooperation in this field involves developed countries.

Luxembourg

Luxembourg is ranked second (least transparent) in the Financial Secrecy Index, following Switzerland. As shown in Table 3, other European jurisdictions in the top ten of this Index are Germany and Jersey. Focusing on legislation and not taking into account the size of the financial market, Switzerland would still be in the most secretive category (scored with 1 point in the CDI), but Luxembourg would increase its score to the same level as other European countries like Germany, Slovakia, and Austria (see Table 1).

Indicator by indicator, Luxembourg is only compliant with the requirement for companies to make their accounts available in public records. However, this has no effectiveness in fighting against international illicit flows if not accompanied by other measures. Company ownership details are not maintained in public records, payments to non-residents are not compiled by tax authorities, and Automatic Information Exchange has not been put in place. The FATF evaluation for Luxembourg for 2010 provided a very negative assessment of the implementation of anti-money laundering standards, even though this evaluation was based on the 2006 recommendations, which are less demanding than those of the Spanish evaluation performed in 2014.

Unfortunately, this assessment was not countered by Luxembourg representatives, who rejected participation in the interviews requested in the framework of this research. Informers from other countries did mention that Luxembourg, although a participant in all coordination activities at the EU level, is not very active in information exchange, and they agreed that this is a problem undermining transparency efforts in their own jurisdictions.

Despite the consequent limited contribution of this research to understanding the case of Luxembourg, there is much information available on the motivations of that country to neither curtail bank secrecy nor implement anti-money laundering standards more rapidly. According to TJN, Luxembourg accounts for 12% of the global market for offshore financial services, and it is the second largest investment fund center (TJN, 2013c).

The EU Institutions

Most financial transparency measures are framed under anti-money laundering strategies and, after September 11, 2001, under the global fight against terrorism. More recently, the financial crisis has been motivating new measures in OECD countries in order to increase tax authorities' control vis-à-vis multinational companies. Responsibilities around these policy areas are mostly kept by member states.

However, no matter what the purpose of these measures, they focus on the common market of financial services, where the EU holds the role of ensuring the free movement of capital. This provides a legal basis for the EU to directly adopt legal measures intended to reduce cross-border complexity and market fragmentation. Also, the failure to meet international standards, such as FATF recommendations or the OECD's BEPS action plan, may have a negative reputational impact on the financial system and require an intervention by the Monetary Union Institutions[9]. Obviously, if there is a clear consensus among member states, mere coordination in this field can also be fostered both within the framework of EU Foreign Policy or the Home and Justice agenda.

Mainly based upon a common market rationale, several pieces of legislation on financial information have already been passed and are regulating some of the key aspects in the fight against illicit flows. A new Accounting Directive adopted in 2013 (EU, 2013), for example, introduces some disclosure requirements for the extractive industry and for loggers of primary forests; these are considered a step forward in country-by-

[9] The legal and political bases for EU Intervention in this field can be found in the preamble of several EU directives and regulations: the III Anti-Money Laundering Directive, the Cash Controls regulation, or the Accounting Directive

country reporting, which is a key indicator of corporate transparency regulation (see Table 3). A regulation on information accompanying bank transfers (EC, 2006) curtails a specific aspect of banking secrecy throughout the EU. The III Anti Anti-Money Laundering Directive, which is currently in force, makes compulsory for member states certain FATF recommendations like the setting up of a financial intelligence unit. Furthermore, the EU has put in place other controls not taken into account by the FSI, but oriented to control illicit flows. This is the case of the regulation on cross-border Cash Controls (EU, 2005), forming part of the Union's customs legislation.

Moving further toward the design and adoption of a common legislative framework, the EU also seeks the even and coordinated application of such legislation by the different national authorities. This is the goal of the EU Financial Intelligence Unit (FIU) platform, an informal group set up in 2006 by the Commission in order to reinforce international cooperation in the AML agenda at the EU level[10][11]. Finally, the EU participates as an observer in different fora addressing this global issue, mainly the OECD and the FATF[12].
Despite such a diversified tool kit (legislation, participation in global fora and agreements, and reinforced informal cooperation at EU level), EU member states like Luxembourg or Slovakia show very low performance in the FSI. The only explanation for this is that the EU, when adopting common compulsory rules for all European countries, have opted for a soft version of international standards, so that relatively secretive practices remain compatible with European Law. The paradox is that since some member states like Spain or Sweden have opted for strict observance of FATF recommendations, EU financial rules and procedures are not homogeneous, and cross-border complexities and legislative loopholes persist.

In recent years, several stronger legislative proposals have been issued by the EU but have not yet been adopted. These include the IV AML directive, implementing new FATF recommendations already successfully implemented in some member states; more demanding regulation on information accompanying bank transfers; and enlargement of the country-by-country reporting requirements to embrace a larger group of companies. Also, the regulation on cash controls at the external borders of the EU is currently under revision, in order to assess whether or not certain limitations should be moved to the international information exchanges.

According to the interviews with EU officers, regardless of the different legal bases and political motivations for EU action in this field, the adoption of every specific measure encounters obstacles in the European political debate, similar to those found in Belgium. Transparency is confronted with other values like the elimination of administrative burdens in the financial service market, or data protection. This debate involves some lobbies, such as the business service professionals, which openly support financial secrecy as part of professional secrecy. The debate, as in the case of Belgium, can also range beyond the EU trialogue and end up at the EU Court of Justice, which has recently rejected mass data retention by telecommunication companies and created serious doubts about like practices in the banking sector.

[10] One of the most visible contributions of the EC to European coordination among FIUs is probably FIU.Net: a decentralized computer network supporting information exchange among European FIUs. See www.fiu.net

[11] A larger – but probably less demanding – informal group has existed at the global level since 1995: the Egmont Group.

[12] Officially, the EU is a full member of the FATF, but it is not subject to mutual evaluation, as member countries are.

According to EC officers, details of sentences passed down by the EU Court of Justice show that systematic control of financial transactions can continue and even be reinforced, but that its legal bases need to ensure guarantees around respect for individual privacy. Also, the debates within the Council and the European Parliament will probably prove less balanced in the future, as an international political momentum exists for financial transparency. First, the evolution of the international fight against terrorism shows that new and more effective measures may still be required, and that European citizens and residents also form part of terrorist networks such as the Islamic State movement. Second, tax incomes in OECD states are decreasing, while prosperous multinational companies from the IT sector avoid taxation thanks to loopholes in the financial system.

In this context, some interviewees highlighted the importance of political leadership, considering as a good example the UK's David Cameron, who has not only changed the UK vote as regards beneficial ownership registries but who is now pushing for similar changes not only within the Council but throughout the Commonwealth. The UK proposal, however, would only affect companies, maintaining secrecy for certain legal entities like trusts, thus representing a major obstacle to the of tracing beneficial ownership in many cases.

From the perspective of the CDI, it must be said that neither the preambles of the relevant directives and regulations nor the arguments raised during interviews with EC officers show awareness of the development dimension of this agenda. The exception to this would be the above-mentioned Accounting Directive on country-by-country reporting. The impact assessment of this Directive was based in a definition of the problem that is worth quoting here (EC, 2011):

> "Multinational Corporations (MNCs) operate in many foreign jurisdictions but detailed information on their activities in the countries in which they operate is often not within the public domain. This lack of transparency in country-by-country financial data stands in the way of greater government accountability, in particular in some resource-rich developing countries for the income received from exploiting natural resources such as oil, gas, minerals and forests. Proponents of CBCR state that if payments made to a particular government by MNCs were known, citizens and other interested parties would be better able to demand that the government accounts for how these incomes have been spent, which in turn can foster economic growth and help to reduce poverty, corruption and internal conflict."

Finally, regarding policy accountability, both EC documents and interviews show that the Commission recognizes "the importance of providing policy-makers with better intelligence about the dimension of the problem" (EC, 2013:12). The impact assessment of the IV AML Directive, where this problem is stated, relies on IMF figures from the 1990s and a UNODC report that covers only certain organized crime activities.

The Cash Controls regulation has specifically mandated the EC to collect and systematize data on cash movements across the EU's external borders. This is currently done on a monthly basis, and reports are issued quarterly. Eurostat channels this information along with activities of the FIUNet and publishes an Annual Report on Money Laundering in the EU; but once again, this basically recounts surveillance activities, rather than estimating illicit flows and their evolution. The report fails even to provide the amount in Euros of those suspicious transactions reported through the cash control system. Still, this has been demanding

work for Eurostat, which has recognized that member states' statistics compiled in the report did not meet "the stringent requirements of the European Statistics Code of Practice" (EU, 2013). Despite these limitations, the annual Eurostat report is a good start toward improving knowledge and accountability in this policy area every year.

4. Policy recommendations: Is Europe the solution?

Three main conclusions can be drawn on the previous findings. First, the EU does have the tools to shape a more homogeneous and transparent financial system within its territory, as well as more effective cooperation with third countries; but at present it has only ensured certain minimal criteria. This is why some EU countries (like Luxembourg) receive such a negative assessment from international NGOs and institutions, while other European countries stand as best performers in transparency rankings.

Second, we are presently at a critical juncture for increased transparency, and the current situation will probably change in the near future. The counter-terrorist financing strategies and post-crisis reactions against tax avoidance by multinational companies are converging into a financial transparency agenda. The EU Institutions will very likely adopt new and stricter legislation on anti-money laundering activities, cash movements, bank transfers, and accounting procedures. All these measures will be drivers for international transparency standards designed by FATF.

However – and this is the third and main conclusion of our research – this will have a very low impact on development finance in the short term. Measures currently under discussion will certainly improve the access of national authorities to financial information of different kinds, and they will very probably increase information exchanges among European countries. However, as per our interviews, there is nothing to suggest that European Financial Intelligence Units are planning to enhance their communication with African or Caribbean counterparts. Even if the European administrations are willing to share information with developing countries, exchanges will also depend on those developing countries' capacities to carry out investigations, as well as bilateral cooperation agreements with each EU member state.

Therefore, following these conclusions, three main policy recommendations can be addressed to the EU Institutions.

1. *Improve understanding of illicit financial flows and improve accountability around their curtailment in the EU*

   Despite growing interest in IFFs and attempts to quantify the problem, all the institutions involved in this policy recognize the limited nature of the information pertaining to this problem, and that the available data are being provided by disparate actors in a non-systematic manner.

   The Eurostat report on anti-money laundering would be the adequate tool to improve understanding of IFFs and accountability around their curtailment in the EU. Currently, the report informs on the number of suspicious transactions reported to European financial intelligence units. Based on that same idea of suspicious flows, but combining different approaches and focusing on policy outcomes rather than activities, this report could be significantly improved.

First, the report should approach the phenomenon at a macro scale, following the different methodologies supported by the WB in the 1990s but only in use by certain NGOs. These methods may be of arguable value because they consider as illicit flows what are sometimes simply statistical gaps. However, instead of completely abandoning these methods, they can be used to provide figures on suspicious flows at a macro scale.

The large figures on suspicious flows could be accompanied by the aggregation of information on suspicious financial transactions as reported to the FIUs (cash movements, fund transfers, etc.). While the current version of the report informs only on the number of transactions, a more sophisticated version should include the volume in Euros, as well as some relevant qualitative information, such as country of origin or destination.

Finally, figures on suspicious flows and transactions could be complemented with information on policy impact, mainly drawing on police and judiciary information. This way, the authorities and public would receive some feedback on how the reporting of suspicious transactions triggers police investigations, judiciary measures and, in some cases, asset recovery.

2. *The European Parliament (EP) and Council should accept EC proposals on financial transparency*

The EC has already designed some of the legislative measures that can significantly improve financial transparency in Europe, along with member states' performance in the FSI, and in the FATF mutual evaluations. The IV AML, a new regulation on information accompanying bank transfers, and adoption of the country-by-country reporting as a general financial reporting criterion, are two examples. Other innovative solutions may still be needed to effectively address the problem of beneficial ownership, but in most cases, the challenge is at the EP and Council. Knowing that political momentum for financial transparency is currently present, the EC should recommence a trialogue on old proposals aimed at increasing transparency in Europe.

Also, a more comprehensive political debate should address whether or not a single market and monetary union necessitates a single financial intelligence unit, or common regulation for banks and other actors of the financial system. Alongside this, it might prove more efficient for the global system to evaluate the EU under the FATF standards, instead of analyzing and issuing recommendations for 28 different jurisdictions and negotiating information exchange agreements jointly.

3. *Contribute to more inclusive international cooperation against financial flows, and favor new sources of development finance for the post-2015 agenda*

As explained above, increased financial transparency in Europe is a necessary but not sufficient condition for curtailing illicit financial outflows from developing countries. In order for the financial intelligence system to effectively contribute to development finance, developing countries should have access to the information currently channeled by European FIUs. This will occur only when developing countries have similar capacities in the relevant policy areas (police and home affairs, taxation and customs, and finance and market regulation), and when there is a global agreement on data protection and the use of sensitive personal information.

Technical cooperation and an institutional set-up based on regional initiatives seem to be the way to increase those capacities. So, considering the expertise of the EU in both types of cooperation, a thematic program on this field could be launched within the framework of the development policy. The coming debates on the post-2015 development finance agenda will be a good opportunity to discuss how this type of assistance should evolve.

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