Helpdesk Research Report: Money Laundering and Poverty Reduction
04.11.09

Query: What links, if any, are there between tackling organised crime and corruption through money laundering and the impact upon poverty reduction?

Enquirer: DFID Caribbean

Contents

1. Overview

The general conclusion of this report is that there is no discernable link between money laundering and poverty, or by extension, between anti-money laundering (ALM) initiatives and poverty reduction. There is however some discussion of the impacts of money laundering on economic growth and development more generally. There is also substantial evidence of the impact of broader anti-corruption initiatives on poverty reduction, although this is outside the scope of this query. For a good overview of the debate, see this U4 Anti-Corruption Resource Centre Helpdesk response on 'Tackling forms of corruption that affect the poor most' (2005) http://www.u4.no/helpdesk/helpdesk/query.cfm?id=62

Money laundering and economic development

The debate on the link between money laundering and economic development is split into two broad camps. Firstly, it is argued that money laundering has negative impacts for developing country economies through:

- increased crime and corruption
- reduced foreign investment
- weakened financial institutions
- compromised economy and private sector
- damaged privatisation efforts
- loss of tax revenue

Others argue, however, that this link is at best tenuous given that it is largely based on the contested role that the financial sector plays in economic development.

More widespread is the scepticism about the extent to which AML initiatives are beneficial to economic development. This is partly due to difficulties of measurement but there is broader scepticism as to how well suited AML policies are, especially for developing countries. AML regulations are generally expensive to implement, are designed to fit developed rather than developing economies, and their effectiveness in reducing and deterring financial crime is unproven. A further issue is the opportunity costs of governments diverting money from development programmes to meet AML standards.

AML initiatives are seen as particularly inappropriate for preventing and detecting money laundering in predominantly cash-based economies or in countries where reliance on parallel or informal transfer systems is the norm, as is the case in many developing countries. They are also seen as unduly restrictive on financial service providers working with low-income people, such as micro-finance institutions.

A further widespread concern regarding the AML regime relates to the motivation for developing states to comply with international standards. Some authors have argued that that fear of the consequences of being blacklisted and the desire to please international partners are much stronger drivers than any domestic pressure to counter money laundering.

Asset recovery

It is often assumed that assets recovered as a result of AML initiatives could provide much-needed funding for development programmes. However, there are a number of challenges involved in recovering assets, including the legal complexity of recovery cases, the costs involved and political obstacles. Evidence from asset recovery in the past suggests that monitoring the use of recovered assets is also a significant challenge. Adhering to sound practice in public financial management is complicated because resources are fungible and systems tend to be weak. Furthermore, tracking systems tend to be perceived as intrusive and therefore require political will to implement. In the literature reviewed for this report, there was no evidence of recovered assets being used to support criminal justice systems. In the cases of Nigeria, Peru and the Philippines, assets were instead channelled through normal budgetary channels or earmarked for specific programmes unrelated to combating money laundering.

2. Money laundering and economic development

Bartlett, B. L., 2002, 'The Negative Effects of Money Laundering on Economic Development', Report for the Asian Development Bank, Dewey Ballantine LLP, New York
http://www.adb.org/documents/Others/OGC-Toolkits/Anti-Money-Laundering/documents/money_laundering_neg_effects.pdf

This paper argues that, although difficult to quantify, money laundering damages the financial-sector institutions that are critical to economic growth, reduces productivity in the economy's real sector by diverting resources and encouraging crime and corruption, and can distort the economy's external sector to the detriment of long-term economic development. Developing countries' strategies to establish offshore financial centres (OFCs) as vehicles for economic development are also impaired by significant money-laundering activity through OFC channels. Effective anti-money-laundering policies, on the other hand, reinforce a variety of other good-governance policies that help sustain economic development, particularly through the strengthening of the financial sector.

The paper also offers a counter argument the view that developing-country governments should not devote scarce resources to policies designed to reduce money laundering activity (pp 1-2):

- *Money-laundering results in a flow of capital to developing countries*. This argument is not supported by the data and money laundering facilitates illicit capital flight from developing economies.
- *Developing-country governments should not be spending their limited resources on preventing crime in developed economies*. The data suggests that much of the economic damage done by money laundering through developing-country channels is at the expense of developing economies.

- *"The imposition of anti-money-laundering financial regulations discourages the use of developing-country banks and encourages citizens to move their savings offshore.* On the contrary, there is evidence that a stronger financial regulatory regime encourages the use of the financial system subject to such regulation.

World Bank and IMF, 2006, 'Reference Guide to Anti-Money Laundering and Combating the Financing of Terrorism', Second Edition
http://siteresources.worldbank.org/EXTAML/Resources/396511-1146581427871/Reference_Guide_AMLCFT_2ndSupplement.pdf

Chapter II of this guide argues that money laundering has particularly significant economic and social consequences for developing countries, because those markets tend to be small and, therefore, more susceptible to disruption from criminal influences. It also has significant economic and social consequences for countries with fragile financial systems because they too are susceptible to disruption from such influences. "Ultimately, the economy, society, and security of countries used as money-laundering platforms are all imperiled." (p II-2)

The guide lists the adverse implications for developing countries as:

- increased crime and corruption
- reduced foreign investment
- weakened financial institutions
- compromised economy and private sector
- damaged privatisation efforts

Nevertheless, it is conceded that the magnitude of these adverse consequences is difficult to establish, given that they cannot be quantified with precision, either in general or specifically for individual countries.

Williams, D., 2008, 'Governance, Security, and 'Development': The Case of Money Laundering', Centre for International Politics, City University, London
http://www.city.ac.uk/intpol/dps/WorkingPapers/D_Williams%20Governance,%20Security%20and%20Development.pdf

According to the author of this paper, "… it is very hard to find any substantial evidence for the impact of money laundering on economic growth and development." (p. 2) He argues instead that "… the concern with anti-money laundering is best seen as part of the process of the 'securitization of governance'." (p. 3) In his view, World Bank and IMF claims about the detrimental effects of money laundering are based on the overstated role that the financial sector plays in economic development. Quoting Dani Rodick, he notes how "foreign trade and investment have become the ultimate yardstick for evaluating social and economic policies of governments in developing countries." (p. 16)

The author goes on to argue that the lack of evidence for the developmental impact of money laundering is almost inevitable given the difficulties of measuring the extent of money laundering and of designing robust tests of its impact on development variables, especially given that many developing countries have a host of imperfections in their financial systems, and that 'development' is the result of a highly complex causal process.

In addition, he notes, there are potentially significant costs to developing countries from participating in the international anti-money laundering (AML) regime. Much more work is needed to show that the costs of participating in the regime really are worth bearing because of their developmental benefits.

Sharman, J. C. and Mistry, P. S., 2008, 'Considering the Consequences: The Development Implications of Initiatives on Taxation, Anti-Money Laundering and Combating the Financing of Terrorism' Commonwealth Secretariat. London
http://books.google.com/books?id=RyiIUj4s88QC&dq=Considering+the+Consequences:+The+Development+Implications+of+Initiatives+on+Taxation,+Anti-Money+Laundering+and+Combating+the+Financing+of+Terrorism&printsec=frontcover&source=bl&ots=lYKQsHyTJ9&sig=GJyyeaIyp4HRFL7JFLHFUArIfdw&hl=en&ei=-7_uSuLcBIS6jAf7v9iWDQ&sa=X&oi=book_result&ct=result&resnum=1&ved=0CAgQ6AEwAA#v=onepage&q=&f=false

This study aims to assess the impact of recent multilateral regulatory initiatives on taxation, anti-money laundering and combating the financing of terrorism on small Commonwealth international financial centres (IFCs). Specifically, it assesses the costs and benefits of such initiatives for Barbados, Mauritius and Vanuatu, finding that they have had a significant net negative impact, given that more of the scarce public revenues of these states has been diverted towards regulating their international financial services (IFS) sectors.

In Barbados, over 27 percent of corporate services providers (CPSs) state that compliance costs have increased so much that they are now thinking of exiting the market. Vanuatu spent four times as much public money regulating the IFS sector in 2005 than it did in 2000 whilst the sector now provides only half the money it did in 2000. In Mauritius, CPSs have witnessed a sharp decline in their profitability.

According to the study, the single most important factor explaining the adoption of these new international standards in all three countries has been fear of the consequences of being blacklisted. The most common benefit indentified has been the enhancement of the reputation of the IFC. Yet respondents were unable to identify any associated increase in competitiveness or other tangible benefits.

Sharman, J., 2006, 'The Cost of the International Anti-Money Laundering Regime to Developing Countries: Damned if they Do, Damned if they Don't?" Paper presented at the annual meeting of the International Studies Association, San Diego

This paper argues that developing states face significant costs in adopting new international Anti-Money Laundering (AML) standards, but that there are also serious costs for these states in failing to comply with these standards. Current AML regulations are generally expensive to implement, are designed to fit developed rather than developing economies, and have uncertain effectiveness in actually reducing and deterring financial crime. Yet despite these shortcomings, states that refuse to join the regime have been subject to pressure from G-7 governments and particularly the Financial Action Task Force, leading to disinvestment pressures and hindered ability to use international financial networks.

The paper further argues that international bodies have taken little regard of the costs of AML, particularly the indirect costs that accrue to the private sector and individual customers, especially in the developing world. Indirect costs in both rich and poor countries have meant that it is harder for people to open bank accounts, transfer money across borders and to set up charities. A further issue is opportunity costs, for example when African and Caribbean governments divert money from anti-AIDS programmes to meet FATF standards. What makes these costs particularly burdensome is that there is very little knowledge about whether AML laws and standards work. Surprisingly, and despite the large sums of time and money spent on diffusing and implementing AML standards, the international organisations behind them show relatively little interest in measuring their effectiveness, either in an absolute sense or in terms of cost effectiveness.

Part of the reason for the diffusion of AML standards into the developing world is the coercive practice of blacklisting by the FATF. The paper speculates that the continuing proliferation of AML laws is the result of socialisation by international organisations, and that being a member of the regime has now come to stand as a marker of progress and modernity for states, independent of any actual effect in suppressing criminal finance. For example, the fact that Albania, Vanuatu, Egypt and Canada have almost identical AML laws and organisational structures is not because they all face similar problems in this area or have similar financial systems, but because they are coerced into complying with the AML regime.

See also:
Sharman, J., 2008, 'Power and Discourse in Policy Diffusion: Anti-Money Laundering in Developing States', International Studies Quarterly, Vol. 52, pp 635–656

Moshi, H., 2007, 'Fighting Money Laundering. The Challenges in Africa', ISS Paper 152, Institute of Security Studies, South Africa
http://www.iss.co.za/dynamic/administration/file_manager/file_links/PAPER152.PDF?link_id=28&slink_id=5097&link_type=12&slink_type=23&tmpl_id=3

This paper argues that uncontrolled money laundering activities are detrimental to development in a number of significant ways: they increase the profitability of crime, promote corruption and have a negative effect on good governance. They damage critical financial sector institutions, and they may discourage foreign investors and reduce a country's access to both foreign investment and foreign markets.

A key argument of the paper relates to the fact that, throughout Africa, there is a significant cash-based and parallel economy in which money circulates outside the conventional financial system (p 7). Alternative value transfer and remittance systems play an important, valuable and legitimate role in most African economies. In many instances, these systems are critical to the functioning of national economies. There is some evidence that criminals are increasingly using and abusing these alternative remittance systems, and there is concern that this practice may become even more widespread as the controls over the international banking system become more effective. Yet current international standards do not appear to advance practical and realistic methods of preventing and detecting money laundering in predominantly cash-based economies or in countries where reliance on a parallel banking system and informal value transfer methods is the norm. The paper calls for better information and research in this area.

Hernandez-Coss, R., Egwuagu, C., Isen, J. and Porteous, D., 2005. 'AML/CFT Regulation: Implications for Financial Service Providers that Serve Low-Income People', World Bank, Washington http://siteresources.worldbank.org/EXTAML/Resources/396511-1146581427871/AML_implications_complete.pdf

According to this paper, "[i]llegitimate financial holdings, assets, and enterprises are unreliable sources of investment capital for sustainable economic development. Among other effects, money laundering destabilizes national economies by increasing the demand for cash, increasing the volatility of interest and exchange rates, and even contributing to higher inflation. […] Countries with weak enforcement of AML controls could damage their reputations in international financial markets, and thus may not attract international flows such as foreign direct investment and/or donor funding."

The paper goes on to summarise the implications of the international framework for AML for financial service providers working with low-income people. These include, most notably, microfinance clients who are typically low-income, do not own assets that are conventionally accepted as collateral, may be self-employed, or may have uneven streams of income. Microfinance transactions are also generally very small—whether they are savings, credit, or transfer. Thus, by definition, such institutions are at lower risk from money laundering. The main challenges for these financial service providers in complying with AML measures arise from the requirement to undertake customer due diligence and to absorb the potential costs involved in implementing new regulation. Additional challenges include internal control and surveillance and record keeping.

The paper recommends that regulators and financial service providers serving low-income clients need to work together to strike a careful balance between regulation and sustainability and client needs by:

- Gradually implementing regulations
- Taking a risk-based approach and applying reduced or simplified measures for microfinance institutions
- Creating appropriate exemptions

3. Asset recovery

United Nations Office on Drugs and Crime and World Bank, 2007, 'Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan', World Bank, Washington
http://siteresources.worldbank.org/NEWS/Resources/Star-rep-full.pdf

Chapter 2 of this report (pp 8-12) presents some estimates of the sums of money being laundered worldwide, cautioning that these should be taken as, at best, "rough approximations". Estimates include:

- 2 to 5 percent of global GDP (Camdessus 1998), which amounts to $800 billion to $2 trillion in current U.S. dollars, as an estimate of the total funds involved in various illegal activities (IMF).
- $3.4 trillion as an upper bound (cited in Reuter and Truman 2004). This number is based on estimates of the unobserved economy
- $20 billion to $40 billion (2001 Nyanga Declaration). This is an estimated stock of assets acquired by corrupt leaders of poor countries, mostly in Africa, and stashed overseas.
- $500 billion in criminal activities, $20 billion to $40 billion in corrupt money, and $500 billion in tax evasion per year (Baker and others 2003; Baker 2005).
- 25 percent of the GDP of African states lost to corruption every year, amounting to $148 billion (U4 Anti-Corruption Resource Centre 2007).

According to this report, however, the true cost of corruption far exceeds the value of assets stolen by the leaders of countries. This would include the degradation of public institutions, especially those involved in public financial management and financial sector governance, the weakening if not destruction of the private investment climate and the corruption of social service delivery mechanisms for basic health and education programmes, with a particularly adverse impact on the poor.

In this context, the report argues that the development pay-off of Stolen Asset Recovery (StAR) initiative (launched in 2007) is expected to be significant. Even a portion of recovered assets could provide much-needed funding for social programmes or badly needed infrastructure. Every $100 million recovered could fund full immunizations for 4 million children or provide water connections for some 250,000 households. The total benefit would far exceed that associated with the asset restitution itself, assuming that the released funds are well spent.

Experience from Nigeria, Peru and the Philippines (p 25), however, shows that monitoring the use of recovered assets is a significant challenge. Adhering to sound practice in public financial management is complicated because resources are fungible and systems tend to be weak.

Furthermore, tracking systems tend to be perceived as intrusive and therefore require political will to implement:

- *Nigeria:* Nigeria received some $500 million in 2005 from Switzerland as part of the restitution of assets stolen by Sani Abacha and kept in Swiss banks. The stated purpose for the money was for incremental funding of MDG-related activities in the budget (such as health, education, and rural infrastructure programs). Nigeria followed good practice principles in using these resources as general revenues, and expending them through its usual public financial processes. However, because the funds arrived later that expected, Nigeria had to take on new debt and there were complications in tracking spending, compounded by weaknesses of the Nigerian public financial management system. Nevertheless, a World Bank Public Expenditure Review found that the funds had generally been used in accordance with stated policy.
- *Peru:* Peru recovered approximately $180 million over a five-year period beginning in 2001. On October 28, 2001, the government set up the Fund for Special Administration of Money Obtained Illicitly to the Detriment of the State (FEDADOI) to allow the appropriate and transparent management of the proceeds of corruption recovered by the state. While money from the fund went through normal budgetary channels, the specific allocations were determined by board members of FEDADOI. Spending items were not clearly set out in advance and the funds were used to supplement the annual fiscal budget of agencies that had an appointed member on the FEDADOI board, resulting in questionable spending allocations.
- *The Philippines:* The largest single cash remittance from looted Marcos funds was made in February 2004, when $624 million was taken out of escrow and remitted to the Philippines Treasury. All receipts from assets recovered went through an off-budget fund called the "Agrarian Reform Fund," to be spent on agrarian reform programs. In October 2006, the Commission on Audit noted that a significant portion of the recovered assets were used to finance excessive, unnecessary expenses unlikely to benefit the agrarian reform beneficiaries. Monies were also found to have been used to procure items at inflated prices, while many spending items were not among the approved priority projects.

U4 Anti-Corruption Resource Centre, 2007, 'The Recovery of Stolen Assets', U4 Brief, U4, Bergen
http://www.cmi.no/publications/file/?2751=the-recovery-of-stolen-assets

This brief argues that asset recovery programmes can be enormously profitable. Nigeria recovered over $700 million of the money stolen by Abacha, and over $600 million was returned to the Philippines from the loot plundered by Marcos. Over a period of 15 years the United States recovered over $6 billion from cases involving misconduct contributing to the savings-and-loan crisis of the 1980s and 1990s. Those cases cost less than $1.5 billion, yielding a 425% return.

The brief outlines the primary problems with asset recovery as political will and the ease of instantaneous electronic transfers of large sums across borders. Countries that are the victims of government corruption are often impeded by the fact that individuals still in power are the perpetrators or beneficiaries of corruption, while countries that are the recipients of stolen funds are sometimes reluctant to move against powerful interest groups such as banks. Where the political will exists, interests of sovereignty and inconsistent legal requirements are the main obstacles. While there have been notable successes in a handful of high profile cases, a huge challenge remains to systemise procedures for the thousands of cases involving hidden assets in the $100,000 to $5 million dollar range. A further challenge is that there is no large body of practitioners with substantial expertise in this area either inside or outside governments.

A number of measures are recommended to limit the costs of asset recovery and increase the probabilities of substantial recoveries, including:

Victim countries:

- Coordinate early with officials in recipient countries
- Simplify criminal actions and concentrate on the largest losses with the highest probability of success
- Establish non-criminal avenues for recovery
- Maintain good practices with regard to disposition of all assets recovered.

Recipient countries:

- Intensify political will / enact conforming legislation:
- Freeze assets
- Consider criminalising unexplained, substantial increases in wealth of public officials
- Provide technical support and minimise political impediments to asset recovery

Donors:

- Compare the laws and practices of their country with the standards set forth in the UNCAC to have greater ability to hold recipient countries to account
- Fund "gap analyses" in developing countries
- Fund training, technical assistance and capacity building
- Establish a trust fund for significant cases
- Pressure governments to make legal systems compatible

Webb, P, 2005, 'The United Nations Convention Against Corruption. Global Achievement or missed Opportunity?', Journal of International Economic Law, Vol. 8(1), pp 191–229
http://www.assetrecovery.org/kc/resources/org.apache.wicket.Application/repo?nid=a93a6b18-a33e-11dc-bf1b-335d0754ba85

This paper offers a critique of the United Nations Convention Against Corruption (UNCAC). Of particular relevance are pages 206-212 which deal with asset recovery. To date, the recovery of assets derived from grand corruption has been hampered by at least four major obstacles:

- First, these cases are usually enormously complex and require a sustained effort by experts in forensic accounting, money laundering, and the civil and criminal laws of different countries.
- Second, pursuing assets overseas is highly expensive due to the need to retain experts, transport evidence and witnesses, translate testimony, and carry out investigations and prosecutions in a number of countries.
- Third, a common legal complication in recovery actions is straddling the boundary between civil and criminal proceedings because each type involves different procedural safeguards, burdens of proof and remedies.
- Fourth, asset recovery actions raise complicated political considerations. The requesting state party may face internal political obstacles from supporters of the former leader or senior officials who allegedly transferred the assets. On the other hand, the requested state party may have concerns about the political legitimacy of the requesting state's government, the motivations behind the recovery efforts, or the fate of the returned assets if corruption is still ongoing.

The author concludes that, "[t]he impact of the asset recovery provisions should therefore not be exaggerated; they focus attention on a certain aspect of corruption that afflicts developing countries, but do not supply a panacea to their problems." (p 212)

See also:
Pieth, M., 2008, 'Recovering Stolen Assets', Basel Institute on Governance, Basel
Available from BLDS: http://blds.ids.ac.uk/cf/opaccf/detailed.cfm?RN=273828

This book discusses past 'success stories' of asset recovery (the recovery of the assets of Sani Abacha, Ferdinand Marcos and Vladimiro Montesinos) and the concrete challenges for the future with regard to search, seizure, confiscation and repatriation of stolen assets. It also provides perspectives on the role of technical assistance and donors in asset recovery and the likely impact of the UNCAC.

4. Additional Information

Author:
This report was prepared by Andrew McDevitt andrew@gsdrc.org

Contributors:
Mick Moore, Institute of Development Studies
Eleni Tsingou, University of Warwick
Thomas Naylor, McGill University
Jacqueline Harvey, Newcastle Business School
Louis de Koker, Deakin University
Donato Masciandaro, Boncconi University
David Williams, City University
Denis Osborne, Governance consultant
Gernot Klantschnig, University of Nottingham Ningbo, China

Websites visited:
Asian Development Bank, African Development Bank, World Bank, IMF, U4 Anti-Corruption Resource Centre, The Eastern and South African Anti Money Laundering Group (ESAAMLG), Financial Action Task Force on Money Laundering (FATF), Egmont Group, Journal of Money Laundering Control, International Money Laundering Information Network (IMOLIN), The Basel Institute on Governance, Tax Justice Network, Symposium on Economic Crime, The International Association of Anti-Corruption Authorities (IAACA), Global Financial Integrity, United Nations Office on Drugs and Crime (UNODC), Cross-Border Crime Colloquium, Asset Recovery Knowledge Centre, CMI, Transparency International