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Links between illicit financial flows and peace and security

Query

What evidence exists for the interrelation between illicit financial flows from corruption and other sources and conflict/fragility?

Purpose

We are planning a global approach to combatting illicit financial flows from corruption and other sources and would like to include a short analysis of the relationship to peace and security in the project proposal.

Content

Summary

Illicit financial flows represent a growing challenge in the least developed countries, with annual global flows amounting to more than US$1 trillion. Corruption is estimated to account for around 3 to 5 per cent of those flows (Economic Commission for Africa 2014; Schneider 2008; Baker & Joly 2008).There is evidence that corruption and illicit flows are closely interlinked, with corruption playing a facilitating role in the generation and circulation of illicit flows. The literature recognises the importance of corruption in fuelling and maintaining conflict as well as creating the conditions in which conflict is likely to happen. This underlines the links between corruption, illicit flows and conflict.

There is anecdotal evidence that illicit flows may contribute to conflict and fragility by providing conflict, terrorist and criminal groups the financial means to conduct their operations and undermine peace. Similarly, illicit financial flows may contribute towards undermining a government's legitimacy by draining financial and material resources from public coffers. Lack of development and lack of legitimacy are powerful drivers for compelling citizens to engage in or support conflict.

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1. Illicit financial flows as catalysts for conflict and security

Illicit flows, corruption and conflict: an overview

Illicit financial flows typically refer to those illegally earned or transferred, within or across national borders (Reed & Fontana 2011). Illicit financial flows generally involve practices such as money laundering, bribery by international companies and tax evasion, as well as trade mispricing (OECD 2014). They constitute a form of illegal capital, which can be monetary (in electronic or physical cash form) or material (in the form of commodities and luxury goods).

These types of financial flows tend to be carried out discretely and in a clandestine manner so as to hide the origin or destination of the goods. They may arise from illegal or corrupt practices such as smuggling, fraud or counterfeiting; the source of funds may be legal, but their transfer may be illegal; and/or legal obligations relating to the funds, such as the payment of tax, have not been observed. They may be intended to finance other illegal activities, such as terrorism or bribery, or for the legal purchasing of goods (OECD 2014).

Illicit flows are intimately linked to large-scale corruption and there are many examples of kleptocrats such as Sani Abacha (Nigeria), Valdimiro Montesinos (Peru), Ben Ali (Tunisia) and Ferdinand Marcos (Philippines) transferring looted assets to other countries in order to launder the proceeds and/or hide them from domestic authorities. Transferring funds between multiple jurisdictions makes these funds hard to trace and therefore lowers the risk of this money raising a red flag or being linked to certain corrupt acts. According to some estimates, around 2.8 to 5.1 per cent of global illicit flows derive from corruption, while between 60 to 65 per cent may derive from tax evasion, with the remainder being attributed to other crimes (Economic Commission for Africa 2014; Schneider 2008; Baker & Joly 2008).

The exact scale of the problem is unknown, due to the methodological challenges associated with measuring a phenomenon that is by nature clandestine, which in turn makes it difficult to differentiate illicit financial transactions from legal financial transactions. While there have been several attempts to provide methodologies on how to quantify illicit financial flows (see Yallwe & Buscemi 2011 for an extensive list), there is no generally accepted way to measure them. Annual global illicit financial flows are estimated to be between US$1 trillion and US$1.7 trillion (Taylor 2013).

Similarly, gathering evidence about the links between illicit financial flows and peace and security is methodologically difficult and there are no detailed studies indicating a direct correlation between illicit financial flows and conflict. There is, however, anecdotal evidence that points to illicit financial transactions as a cause or enabler of many conflicts, especially in fragile states or in the least developed countries. There is a broad consensus among experts that illicit flows may contribute towards undermining peace and state legitimacy, as well as exacerbating conflicts and insecurity by providing terrorist and criminal groups with capital for their operations. Illicit flows drain the state of valuable resources that could otherwise be used to promote domestic development and security efforts. This is likely to erode public trust in institutions and political processes and can have a detrimental longer term effect on state legitimacy and thus undermine peace and stability within a state.

Furthermore, there is a large and growing body of research that points to a positive correlation between corruption / tax evasion and conflict (Billon 2008; Mauro 1995). This literature recognises the importance of corruption in both fuelling and maintaining conflict and creating the conditions in which conflict is likely to happen. Corruption can facilitate illicit financial flows in many ways. Tax and customs officials may be bribed into overlooking illicit flows of money and goods which they are in fact responsible for monitoring. Similarly, higher ranking officials may be bribed or coerced into executing policy favourable to the illicit transfer of funds to terrorist groups (in state capture scenarios, for example). A 2013 report by Global Financial Integrity found a negative correlation between illicit financial flows and the World Governance Indicator for control of corruption. According to the report, every percentile increase in the corruption control indicator showed a decrease in illicit financial flows (Kar & LeBlanc 2013).

An example from 1990s Colombia illustrates this situation perfectly. Paramilitary groups operating in Colombia had intricate financing schemes whereby corrupt public servants facilitated the transfer of funds to these groups. While many of these funds came from drug trafficking and personal financial endowments, it is suspected that a significant proportion of these funds derived from corrupt politicians themselves (Tate 2011). This case points to a clear link between illicit financial flows and corruption, as well as to a clear relationship between corruption and conflict.

Illicit financial flows and conflict

Conflict is a process whereby the interactions and disagreements between the state and citizens cannot be sorted out peacefully and violence arises between two or more parties. Internal state conflict arises when elites and powerful groups within the state disregard the legitimacy or authority of the government. This lack of legitimacy may be caused by extended periods of economic hardship or if such groups perceive a lack of good governance (Hussman et al 2012). Conflict ranges from peaceful disobedience to a full-scale civil war. Conflict severely undermines good governance as it tears away at the rule of law, accountability and civil order (OECD 2008).

Illicit financial flows are understood to be fundamental to keeping conflict active. Whether to maintain followers or to purchase weapons and supplies, capital is essential. Conflicting parties may want to keep the amounts and sources of this financial capital secret or hidden as it may derive from illegal sources, from external sources (which may prompt other states to financially assist opposing parties), or from the state itself, as is the case with bribery or embezzlement (Ralston 2014). According to Le Billion (2008), corruption by local and regional authorities and participation in the informal economy by ordinary people can also sustain chronic conflicts.

Illicit financial flows can also keep conflict going, even if the state is subjected to arms or trade embargos. Schneider notes that both states and arms dealers use illicit flows to keep conflicts funded and supplied by using hard-cash transfers or letters of credit issued by banks to exchange commodities for supplies (Schneider 2008). A well-known example of this is the alleged financing of neighbouring country conflicts by Liberian president Charles Taylor.

Special mention should be given to illicit financial flows related to extractive industries. Whether through mispricing, bribery or embezzlement, corrupt officials and executives of extractive companies can extract significant amounts of funds from the revenue generated by extractive industries. In addition to creating state budget deficiencies due to shortfalls in revenue, which in turn may undermine state legitimacy and fuel conflict in the longer term, this syphoning off of natural resources generates illicit flows and is likely to increase conflict in relation to gaining and maintaining control over natural resources and securing extractive revenue (Ralston 2014).

This was the case in Nigeria, as noted by Shaxson (2007). As natural resources were discovered in Nigeria, infighting within the government began to assure that the areas where these industries were most prominent would receive a larger share of the profits than others. The profits from these industries began to be syphoned off to increase regional leaders' power and to fund armed movements to support them. Nigeria was originally divided into three regions, but now has a total of 36 states where factions within them battle amongst themselves to control local state resources (Shaxson 2007).

In many cases, third parties such as multinational companies or domestic firms can exacerbate conflict by facilitating the flow of illicit funds. A 2010 Centre for International Forestry Research report, for example, notes the role of the forestry industry in facilitating trade flows that fuel conflict in Africa. Some timber companies act as middlemen between armed rebels and financial institutions, purchasing arms and materials, trafficking weapons and selling timber in exchange for part of the profits extracted from forestry in conflict zones (cited in Economic Commission for Africa 2014). Extracting minerals from conflict zones can be a lucrative business due to a lack of regulations and lower taxes on the extracted materials.

South Sudan provides a good example of the role of illicit flows of public money in funding conflict. South Sudan has suffered cycles of conflict and rebellion since independence, partly fuelled by popular and elite discontent over who should benefit from the fruits of its long struggle for liberation, or more specifically, the profits from the extractive oil industries. The vast extent to which money was leaving the country became apparent through a letter sent by the president to several public officials in his government. The letter stated that more than US$4 billion had been stolen from government coffers (Midgley et al 2014). Similar examples can be found in Sri Lanka (Lindberg &

Orjuela 2011), and Eastern Congo (Baker & Joly 2008).

Illicit financial flows and terrorism

Terrorist activities and terrorist groups are important contributors towards conflict and insecurity and increase a state's fragility. Terrorist groups can highlight and aggravate (sometimes in disastrous ways) the weaknesses of a state's system of governance and expose the flaws its security network. Moreover, terrorist groups can turn into direct armed opposition and lead states to engage in civil war.

There are numerous recorded incidences of illicit financial flows being used by terrorist organisations to secure financing (Midgley et al 2014). Many of these organisations, like the FARC forces of Colombia, illegally extract minerals such as gold or tungsten and sell them to large multinational companies to finance their activities (Bargent 2013; Gomez G & Centre for Public Integrity 2012). Similarly, transnational terrorist organisations like Hezbollah, Al Qaeda and Hamas have developed extensive multinational networks to finance themselves with the use of secret jurisdictions and off-shore banks (Baker & Joly 2008).

Illicit financial flows and crime

Crime has a profound effect on the stability and fragility of a state. Crime is an important indicator for the rule of law within a certain jurisdiction, as it highlights the degree to which authorities respect and enforce the law. Criminal organisations in particular act outside the law and jeopardise the rule of law and law enforcement. These organisations provide illicit goods and services or may provide legal goods and services through illicit means, thereby flaunting the laws of the state.

Criminal organisations can become powerful groups that decrease the legitimacy of the state. Criminal groups can buy themselves into power through corruption and bribery (also called state capture) and establish policies that are beneficial for their organisation's criminal projects. Favouring crime groups instead of the public interest can cause a huge blow to a state's legitimacy (Hussman et all 2012). Criminal organisations may also incite violent conflict in order to take advantage of lucrative opportunities brought about by conflict. For example, they may supply citizens on opposing sides of a conflict with commodities cut-off by the violence, or take advantage of a sudden diversion of state security resources to increase their existing operations (Cobham 2014).

Transnational criminal organisations employ illicit financial transactions to cover up the origin and use of profits derived from criminal activities. They tend to repatriate profits in order to avoid domestic law enforcement from detecting, seizing or freezing these funds (Shelley 2005). Profits from crime or generated by criminal organisations constitute the largest component of illicit financial flows in the world, making up an estimated 30 to 35 per cent of global illicit flows (Baker & Joly 2008).

Illicit financial transactions from crime may be facilitated by corruption in several ways. Corrupt law enforcement could minimise the number of transactions that are investigated or brought to court. Bribery and extortion may persuade officials to overlook illicit flows of goods and funds. Similarly, police can supply criminals with information regarding investigations, raids or impending arrests. In some cases, illicit financial flows can be carried out by public officials who use their positions of power to benefit criminal groups. For example, in Guinea the son of former President Lansana Conté was allegedly linked to the shipping of drugs from South America by plane and seized cocaine has routinely disappeared from custody (Ralston 2014).

The links between illicit flows from crime and security are also seen as a vicious cycle. Cockayne (2011) suggests that illicit flows from crime are spent in ways that undermine the state and support conflict, thus weakening the state's enforcement capacity and making illicit financial flows and crime less risky.

2. Illicit financial flows as impediments to development and state legitimacy

The fragility of a state is not only shaped by the forces that attempt to undermine or confront it, but also by its ability to provide essential goods and services for its citizens. If, for example, a state cannot ensure economic development and is not viewed as legitimate by its citizens, the ensuing grievances, frustrations and rejection of dysfunctional official institutions can play into the hands of extremist and criminal organisations.

State fragility is a particular problem after the cessation of hostilities in conflicts. The period labelled "peace-building" or "reconstruction" which directly follows conflict is particularly important as it sets the foundation for future quality of governance. The 2011 ' World development report also emphasises that strengthening legitimate institutions and governance to provide citizen security, justice, and jobs is crucial to break cycles of violence, in a context where one-and-a-half billion people live in areas affected by fragility, confl ict, or large-scale, organized criminal violence (World Bank 2011). Corruption and tax evasion, while also fuelling illicit financial flows, can significantly harm this process and lead to a renewal of hostilities. A study by Harpviken (2010) found that economic downturns caused by corrupt flows out of the country were prime triggers for conflict when a certain party did not benefit from corrupt resources themselves. One 2008 study found that ten out of 17 cases of post-conflict reconstruction saw significant increases in corruption following the conflict (Billion 2008).

Illicit financial flows and economic development

Economic wellbeing and quality of life are important factors for trust in and legitimacy of the state. There is significant evidence that illicit financial flows from corruption have a negative correlation with most indicators of development. Illicit flows from corruption take much needed state resources out of state budgets. This is a genuine concern in developing countries. According to a Global Financial Integrity report, the developing world lost an estimated US$5.9 trillion in illicit financial flows from 2002-2011 (Global Financial Integrity 2013) Illicit Financial Flows from Developing Countries: 2002-2011 http://www.gfintegrity.org/report/2013-global-report-illicit-financial-flows-from-developing-countries-2002-2011/. Limited state resources could mean lower spending on social programs (which could potentially quell unrest) or security spending (aimed to tackle crime and terrorism). Therefore, reduced budgets can aggravate the risk of conflict.

Furthermore, illicit financial flows are a key element of what has been referred to as "criminal debt" (Bolongaita 2006). During reconstruction, most post-conflict countries seek loans from international financial institutions to fund rebuilding efforts. If the funds from the loans are embezzled and illicitly exit the country, the average taxpayer would have to pay the interest on these loans without receiving any social benefit from them. If these debts cause significant drains on the overall economy, they might open the door to further conflict and social discontent.

A relevant case study is that of Yemen, which was the fifth largest source of illicit capital from the developing world between 1990 and 2008, with about US$12 billion leaving the country during that period (Hill et al 2013). Constant capital flight from the country both from public funds and through tax evasion led to years of poor economic development that culminated in the 2011 uprising against the government. Since then, instability and fragility have led to an increase in capital flight from Yemen, thus lowering the country's tax base and public resources, and creating a vicious cycle of conflict and economic disparity (Midgley et al 2014).

Illicit financial flows and state legitimacy

Political legitimacy is another important factor for avoiding state fragility and conflict. When citizens consider a government or institution legitimate, they are more likely to abide by its laws and are more likely to trust and support it. While corruption is common in many societies regardless of their risk of conflict, corruption on a grand scale or which is made conspicuous through major scandals involving political and economic elites might discredit and destabilise the broader political regime (Billon 2003). Both corruption and tax evasion themselves have been shown to have significant effects on state legitimacy. Tax evasion, for example, has been found to be directly correlated with trust and legitimacy (Hammar, Jagers, & Nordblom 2009). Similarly, perceptions of corruption have a significant negative correlation with trust and legitimacy (Hussman et al 2012).

There are some historical examples of conflict that commenced in part due to a lack of legitimacy brought upon by illicit financial flows. For example, in 1972 the US government decided to send financial aid to Nicaragua after it experienced a powerful earthquake. The governing Somoza regime embezzled most of the money intended to fund reconstruction. This is considered a major catalyst for the rise of the Sandinista movement and the beginning of the Nicaraguan civil war (Billon 2008).

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