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Parallel Economy: *Tax Evasion, Economic Crime and Money Laundering*

The problem of economic crime

Introduction

Many countries suffer from high levels of economic crime, which hinder their efforts to achieve sustainable economic growth. Particular problems include:

- **tax evasion.** Individuals and corporations systematically under-report or fail to declare their income for tax purposes, using anonymous bank accounts to hide the true situation, or relying on cash transactions;
- **evasion of exchange and capital controls.** Money is taken out of the country through over- and under-invoicing, or direct smuggling of currency or high value items, in breach of legal requirements;
- **corruption.** Government officials are bribed to award government contracts to particular firms or to divert aid flows.

These crimes have a number of common features. For instance they all rely on concealment of the movement of money, either across national boundaries or within a single country, and they are all ultimately tied into the financial system.

Financial and economic deregulation

A number of countries have deregulated their economies in order to improve both productive and resource allocative efficiency. The trend towards financial and economic deregulation has both a positive and a negative impact on the problems of economic crime. By removing the regulations and restrictions that are subject to abuse, certain forms of economic crime automatically fall away – it is impossible to have a crime of exchange control evasion if there are no exchange controls.

At the same time deregulation could bring freedoms that can be abused by criminals, particularly those involved in other forms of activity that remain as economic crimes, such as tax evasion and corruption.

It is important therefore to consider how the approaches to tackling money laundering discussed in Part 3 can be used to combat the laundering of the proceeds of economic crime.

Factors which complicate the combating of economic crime

There are a number of factors that have tended to make co-ordinated action against economic crime difficult. These include:

- different national definitions of offences. In some countries, for instance, tax evasion is not treated as a criminal matter;
- unclear border lines between criminal and non-criminal behaviour. What may in one case be treated as the legal payment of commissions to intermediaries may in another case count as bribery;
- the refusal by many countries actively to assist in the exchange of information and collection of taxes by another. Similarly countries with no exchange controls are often unwilling and unable to assist in monitoring the controls that are imposed by another country.

Some of the issues are dealt with in more detail below.

Tax evasion

Tax evasion and tax avoidance

Public attitudes towards tax evasion are complicated by the generally held view that the payment of tax is something to be avoided as far as possible. This view contributes to an ever-growing "tax avoidance industry", serving corporations and individuals (particularly wealthy individuals) and advising them how to minimise their tax liabilities. This often involves running as close as possible to the line that separates what is legal – "tax avoidance" – and what is illegal – "tax evasion".

Such an approach to tax law is bound to have an impact on the attitude that individuals and corporations have to tax law. It becomes an obstacle rather than an important element of the national infrastructure, and is thus treated with contempt rather than with respect.

This unfortunate situation, common to both developed and developing countries, is compounded by the complex nature of many tax regimes and the different methods by which tax law and other aspects of criminal law are enforced.

The legal treatment of tax evasion

In many countries tax evasion may frequently be pursued through civil, rather than criminal means. This is usually because the prime objective for the revenue authorities is to recover tax revenues, rather than to punish the tax evader. Such cases are usually treated outside the criminal courts, and settled through repayment of money, often coupled with an administrative fine.

In some countries tax evasion can ***only*** be dealt with through civil procedures. Under these circumstances international co-operation based on any form of dual criminality cannot be used to act against a suspected tax evader.

Many countries have taken the decision to exclude tax-related offences from their money laundering legislation. In other countries the offences are still subject to the money laundering legislation, but information that might relate to the laundering of the proceeds of fiscal offences are not passed to the revenue authorities. Other countries have, however, involved their revenue authorities directly in their anti-money laundering regimes, and can effectively offset some or all of the costs of their operations against recovered tax revenues as well as against the confiscated proceeds of other crimes.

The attitude of financial institutions

Financial institutions are often key elements in the "tax planning industry". They are used by individuals and corporations in the process of tax planning and asset handling. This puts them in a difficult position when money laundering legislation is applied.

Financial institutions will frequently have insufficient information to determine whether a customer's activities – clearly aimed at minimising tax liabilities – represent avoidance or evasion. There will be a strong temptation for the institution not to "rock the boat", but instead to turn a blind eye and hope for the best.

Issues for discussion

Do sufficient channels of communication exist between law enforcement and revenue authorities to allow effective co-operation in following up money laundering cases? To what extent might financial institutions be encouraged to co-operate with the revenue authorities without their losing the trust of their legitimate clients?

As was discussed in Part 3, the co-operation of financial institutions is a major element of an effective anti-money laundering regime. It will be natural for financial institutions to seek to assist their clients rather than the tax authorities. Any heavy-handed action by the revenue authorities against financial institutions is likely to strength-

en this attitude, and thus to reduce the effectiveness of the regime as a whole. Thus the application of money laundering legislation to tax evasion must be carefully handled.

Bribery and corruption

Introduction

Bribery and corruption potentially throws up similar definitional problems. The borderline between legal and illegal payments may in some cases be as hard to police as that between tax avoidance and tax evasion. A more crucial problem however is that of international treatment of such payments. In particular there may be differences between the criminal treatment of the ***making*** of illicit payments and the ***receiving*** of corrupt payments.

International action against corrupt payments

There have been two recent international initiatives to respond to the problem of corrupt payments. The first has been taken by the OECD, which has drafted a recommendation designed to outlaw corrupt payments. The principal target of the recommendation has been commercial enterprises seeking contracts with developing country governments. The recommendation brings OECD countries more closely into line with the United States Foreign Corrupt Practices Act.

The second initiative is the establishment of a new non-governmental organisation, Transparency International (TI), which is working with governments, multilateral agencies and commercial companies to tackle the problems of bribery and corruption. One of the main areas of TI's early activity has been the creation of draft contract terms, which aim to ensure that contractors and subcontractors do not make corrupt payments while engaged in government contracts.

Money laundering legislation and corrupt payments

These two initiatives may, in time, provide a widely accepted basis for international co-operation to tackle corrupt payments directly. Meanwhile, however, money laundering legislation can assist in this.

Where financial institutions know their customers, and therefore can recognise abnormal financial flows within customer accounts, they should become suspicious of the large financial flows generated by corrupt payments. Government officials will tend to have a fairly regular flow of income, from the government, with a limited range of outside sources of funds. Payments from foreign corporations, or large deposits of cash arising from bribes, will therefore be noticeable. Provided that financial institutions are alert, they will be able to pass on indications of such illicit behaviour to the relevant authorities, as discussed in Part 3.

Issues for discussion

How can Commonwealth countries ensure that corrupt payments can be recognised clearly as such? How can governments ensure that corruption does not occur within the regulatory system itself? How can financial institutions guard against corruption?

Tackling money laundering in the informal financial sector

Introduction

In many Commonwealth countries it is recognised that there is a significant "parallel economy", in which money circulates. Because they are open to use by those seeking to avoid taxation or regulatory control, the existence of parallel economies is of direct relevance to efforts to combat money laundering.

Parallel economies, and within them, "informal financial institutions", often have origins in traditional social structures. However they are currently used to allow the circumvention of tax-

ation or certain aspects of government regulation (such as exchange controls). By their nature, parallel economies and those that operate within them avoid the scrutiny of government and law enforcement agencies, even when their activities are not strictly illegal, or are in practice condoned by government.

These circumstances tend to generate fertile ground for money launderers, who use the parallel economy to move money that is not merely seeking to avoid regulation, but in fact derives from serious criminal activity. Clearly this is distinctly unwelcome in itself, in that it offers another route for money laundering. It also has damaging effects on others who participate in the parallel economy by bringing them into contact with organised crime. Many people who facilitate the movement of money through informal financial institutions, while recognising that their activities are not strictly legal, do not see them as ***actually criminal.*** Their behaviour in other respects is likely therefore to be fully within the law. Once they have become corrupted by contact with organised and serious crime, however, this may change, making them less easy to monitor and control.

The impact of money laundering legislation

In those countries where a significant "parallel economy" exists, one effect of implementing anti-money laundering legislation in the formal financial sector may be to drive criminal business and other rent-seeking activities into the informal sector.

It is, in theory, possible to apply legislation directly to the informal financial sector, requiring customer identification and record keeping in the same way that it is required of formal financial institutions. In practice such an approach will not work. With no regulation and no supervision it would not be possible to identify which individuals or families were operating as informal financial institutions. With little or no written information within the network, as is often the case, it would be difficult to establish what transactions had occurred, and who was involved. There would certainly be no realistic prospect of suspicions being reported.

Alternative approaches to tackling the informal sector

Since the informal sector is not susceptible to a direct approach, it is necessary to consider indirect approaches. In practice these will tend to involve reducing the attractiveness of the informal sector to money launderers.

Wealth in the informal sector may be held in a number of ways, including real estate – where the difference between the "white" or declared price of property and the "black" or actual price represents an unrecorded asset. However for criminals using the parallel economy it is necessary for the wealth to be more easily transferable. This may involve holdings of gold, silver or precious stones, which are easily transportable. More often, however, it will be in the form of money in bank accounts which cannot be directly connected to the individuals to whom it belongs. Large scale activity in the parallel economy must therefore involve accounts at formal financial institutions.

The interface between the formal and informal sectors may provide an opportunity for tackling the problem. Financial institutions should, for instance, be encouraged to pay particular attention to the accounts that they suspect relate to informal sector operations – including foreign currency accounts and accounts held by trusts or offshore companies, whether or not the account holders are suspected of direct involvement in money laundering.

The use of informal financial systems to move money internationally is a particular problem for investigators tackling money laundering. International co-operation in tackling cases of laundering through the parallel economy may be of some value, particularly if it can increase understanding of the operation of the parallel economy in different countries.

Restrictions on the use of cash

At a broader level, the cash basis of the parallel economy can be tackled by measures aimed at

reducing the use of cash. Where it is practical, salaries could be paid directly into bank accounts. Modern electronic methods of money management, such as the greater use of credit and debit cards, could be encouraged. For many Commonwealth countries this would however be a major undertaking, and would need to be addressed as a long term project rather than as a quick fix.

An effective intermediate step might however be to outlaw the use of cash payments for transactions above a certain size. Large transactions would require the involvement of financial institutions. This would ensure that those involved in the transactions were subject to formal identification, the transactions would be recorded, and the process would be subject to the money laundering controls applying in the formal economy.

Such an approach could be introduced gradually, beginning with a relatively high threshold, and gradually reducing it as the financial system developed in response to the opportunity that this would present.

Issues for discussion

Can the interface between the formal and informal sector be more effectively controlled? Are existing initiatives to improve tax collection and to deregulate the economy likely to be useful in tackling money laundering in the informal sector? Can these initiatives be fine tuned to improve their effectiveness in this context.

Cash transaction reporting systems

Introduction

The application of money laundering legislation to tax evasion and other forms of economic crime has the potential to improve government finances through increased levels of tax recovery. Where the fiscal benefits are potentially very high, there is scope for the introduction of a **cash transaction reporting (CTR) system.** This approach is outlined in FATF Recommendation 24.

How a CTR system works

Under a CTR regime financial institutions would report any transaction above a fixed threshold involving cash, or "near cash" (eg travellers cheques, bearer bonds and other easily negotiable monetary instruments) to the central unit. It would be possible to require the reporting of telegraphic transfers of money into and out of the country above the same limit (or alternatively of any size), and also the physical importation or exportation of cash or "near cash" above a fixed limit, to the same unit. This information would then be put on a database and thus made available to investigators.

Regimes of this sort are in place in Australia (where the threshold is AUS$10,000) and the United States (where the threshold is US$10,000). Experience suggests that such systems are expensive to operate. AUSTRAC, the central unit in the Australian system, received over 750,000 reports in 1993, and its operating budget for that year was about Aus$ 15 million.

The costs of AUSTRAC can be compared to the benefits, not merely in combatting the laundering of the proceeds of drug trafficking and other similar forms of crime, but also in recovering tax revenues that might otherwise have escaped the system. The Australian Tax Office (ATO) estimated that the CTR system led directly to the recovery of around AUS$30 million of revenue that would otherwise not have been paid in the first four years of AUSTRAC's operation. This is roughly equivalent to the operating costs of AUSTRAC over that period. There may have been additional benefits from the deterrent effect of the system on tax-payers who might otherwise have tried to evade paying tax. The ATO have said that they are looking to make more use of AUSTRAC data in future, which should lead to an even greater recovery of

tax for relatively little additional expenditure.

A well run CTR system can potentially cover its costs. If resources and expertise were available to establish and maintain a computer-based CTR system, **and the data was available to revenue authorities to use to pursue tax evasion,** this might be an attractive option for some Commonwealth governments. However, without an ongoing commitment to manage the large volumes of data generated, financed through recovered revenue, it is likely to be more of a burden than a benefit. In the early years of such a system the capital investment would be large, with returns initially low. The CTR approach therefore requires a clear long term commitment if it is to work.

The draft model law does not contain provisions establishing a CTR system. However the Australian Financial Transaction Reports Act 1988 offers an example of this approach which could be modified by other Commonwealth countries wishing to adopt such a system.

Issues for discussion

Is there sufficient commitment to support the large initial investment that an effective CTR system entails? Is the necessary infrastructural and technological base available to ensure that the system will be maintained? Is the scale of tax recovery likely to justify the operating costs?

Reducing the use of cash

Introduction

Legislation to combat money laundering tends to concentrate on the formal financial sector. However, not all economic activity involves the formal sector. The problems of the parallel economy have been discussed above. More generally, a high degree of cash intensiveness in an economy, even where this is not associated with tax or regulatory evasion, reduces the need to use financial institutions and hence increases the ease with which launderers can handle criminal proceeds. Measures to reduce the use of cash increase the difficulty – and therefore risk – to launderers of handling large quantities of cash. The more uncommon large cash transactions are, the more likely it is that they will be reported as suspicious, and thus the more likely that those relating to criminal activity will be identified.

The benefits of reducing cash intensiveness

Alternatives to cash have additional benefits, both for governments and for the private sector. Payment of wages directly into bank accounts, rather than in cash, is now a legal requirement in some Commonwealth countries, and contributes to preventing tax evasion, as well as reducing the costs and security risks of administering large quantities of cash.

The use of cheques, credit cards and debit cards reduces the costs to banks and other financial institutions of cash handling, and the development of stored value cards increases the convenience of using "electronic cash" while reducing the risks of theft and counterfeiting.

The effect of these measures is to encourage financial flows out of cash and into institutions, where they can be more effectively monitored and controlled. While this offers clear benefits to legitimate users of the financial system it greatly increases the risk to criminals, who are more likely to be required to explain the source of their money. However, the transitional issues have also to be recognised e.g. the higher cost of credit card transactions, credit card fraud, etc.

The costs of reducing cash intensiveness

It is important to recognise that such measures tend to require considerable investment by financial institutions and the Central Bank in order to work effectively. In the short to medium term the necessary investment may pose problems for small scale commercial enterprises. In many countries reliance on cash as a means of exchange is culturally embedded and there is a

distrust of cheques and other modern forms of payment. In some countries where there is a large rural population with limited access to banking there is no practical alternative to cash.

Clearly any move to reduce the use of cash must be considered as a long term initiative. Its value in combatting money laundering complements its advantages in terms of economic efficiency and potentially improved revenue collection.

Issues for discussion

What scope exists within Commonwealth countries to reduce dependence on cash? What steps are possible in the immediate and the longer term? How can financial institutions be encouraged to take action in this area? What measures can be taken to increase public confidence in alternatives to cash?