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THE SHADOW ECONOMY

Illicit Financial Flows and Germany

Abstract

This paper outlines the issue of illicit financial flows, their problems for Germany and the weaknesses in Germany's oversight system. As one of the worst ranked countries on the Financial Secrecy Index, but also one of the wealthiest countries in the World, Germany has both a challenge to set its own house in order and a unique role to play in preventing impoverishment elsewhere through illicit financial flows. These problems are not unrelated and much can be done domestically that would have a global impact.

Introduction

Illicit Financial Flows (IFFs) seriously damage the ability of countries to raise public resources and as such are a direct threat to their development.

This working paper highlights both Germany's vulnerability to IFFs as well as Germany's responsibility to curb those flows in the interest of its obligations to contribute to global development through the Sustainable Development Goals.

Starting with a discussion on what illicit financial flows actually are, it then discusses how Germany is affected by illicit financial flows, before discussing Germany as a safe haven for illicit financial flows. This paper then concludes with recommendations for how to improve Germany's record when it comes to illicit financial flows and how to ensure it better lives up to the Sustainable Development Goals.

1. What are Illicit Financial Flows?

The term Illicit Financial Flows (IFFs), emerged in the 1990s and was initially associated with capital flight (World Bank, 2017). While the term has gained much traction since then, there is still no one definition of what it encapsulates. Within the confines of this research, IFFs are understood as the international movement of capital associated with any illegal activity.

The elements of such definition are:

a) International movement - a cross-country movement of capital involving two or more nations.
b) This capital being part of illegal activities – either as the result of illegal acts (for example corruption, drug trafficking, or illegal mining) or used for illegal purposes (for example, the financing of terrorism).

Corruption – a common source of IFFs

IFFs are deeply connected to corruption. Corruption enables the mechanisms through which illicit capital is obtained and supports the process of moving illicitly obtained capital or capital designed for illicit purposes.

For the purposes of this paper, we will understand corruption as "the abuse of public power for private benefit or profit". Similar versions of this definition are used by the World Bank, Transparency International and others (Amundsen, Sissener, & Søreide, 2000).

According to the United Nations Convention Against Corruption, corruption includes activities such as bribery of national public officials; bribery of foreign public officials and officials of public international organizations; embezzlement, misappropriation or other diversion of property by a public official; trading in influence; abuse of functions; illicit enrichment; bribery in the private sector; embezzlement of property in the private sector; laundering of the proceeds of crime; and concealment and obstruction of justice (UNCAC, 2004).

Money laundering - the process of incorporating IFFs into the legitimate economy

The proceeds that results from any illegal activity, including corruption, drug trafficking, human trafficking, illegal mining, wildlife crimes, and tax evasion, are generally large and need to be spent or invested without evidence of their illegal source.

To avoid attracting the attention of law enforcement agencies, criminals often seek to erase any link between themselves and the proceeds of crime by 'laundering' money before spending or investing it in the legal economy (OECD, 2009). Money laundering is therefore the group of activities through which criminals aim to legitimize - or clean - criminal proceeds.

The Money Laundering Awareness Handbook created by the Organisation for Economic Co-Operation and Development (OECD) differentiates between :

- Placement, which are the methods to bring criminal proceeds into the financial system when still un-laundered;
- Layering, or how criminals conceal the illegal origin of funds;
- Integration, or creating an apparent legal origin for criminal proceeds, enabling them to be used 'normally' and without suspicion for personal benefit.

Money laundering can take place nationally or across several countries in any of these stages. It is at the international level, where money laundering combines with illicit financial flows.

Secrecy Jurisdictions - the facilitators of IFFs

Tax havens are jurisdictions with an enabling financial environment that allows businesses and individuals to hide their wealth from oversight, and which are used often to avoid domestic taxation or the proceeds of corruption. Jurisdictions well-known for this environment in the media include: Andorra, Luxembourg and Monaco in Europe, Hong Kong and Singapore in Asia, and the Cayman Islands, the Netherlands Antilles, and Panama in the Americas (Hines, 2007).

The term 'tax haven' however does not describe the greater problematic that surrounds taxation and legislation adopted to attract greater investment and economic activity through strong levels of confidentiality in financial transactions, and other terms such as 'offshore' (Palan, 2009) or 'secrecy jurisdiction' (Cobham, Jansky ,́ & Meinzer, 2015) are often preferred.

Secrecy jurisdictions are places (Tax Research UK, 2010):

- ❖ That intentionally create regulation for the primary benefit and use of those not resident in their geographical domain;
- ❖ Have regulation designed to favour individuals who do not live in their territories, undermining the legislation or regulation of another jurisdiction;
- ❖ Guarantee a deliberate, legally-backed veil of secrecy that ensures that those outside the jurisdiction making use of its regulation cannot be identified.

These secrecy jurisdictions undermine the rule of law, since they facilitate the flow of illicit capital. As an example, in the case of a business, the legislation in secrecy jurisdictions does not favour the supply of information such as who manages the entity or the scale of transactions the entity has entered into. Secrecy jurisdictions therefore play a role as the facilitators in the transfer of illegally obtained capital.

IFFs and the Sustainable Development Goals

The Sustainable Development Goals (SDGs) are the objectives set by the 2030 Agenda for Sustainable Development adopted in 2015 by heads of state and government at the United Nations Summit in New York.

SDG 16 is to provide access to justice for all and build effective, accountable and inclusive institutions at all levels. One of the targets to achieve this goal is the reduction of illicit financial and arms flows. The adoption of this target emphasizes the importance of combating IFFs at an international level since they are detrimental to the development of many countries.

2. How is Germany affected by IFFs?

With these definitions in mind, to what extent is Germany affected by these illicit financial flows? In this section we will consider three elements: tax evasion, organised crime and terrorism and describe the role of IFFs in each and their relationship to Germany.

Germany is the home of six of the 100 largest companies in terms of market capitalization and is a major exporting country (PwC, 2017). Due to Germany's market share in the global economy, one key area of loss for the country due to the movement of illicit capital is the evasion and avoidance of relevant taxes by companies and private individuals (Jorg Alt, 2016).

This point is well highlighted by the Cum-Ex financial scandal which rocked the country's financial sector. The case involved a number of participants including banks, stockbrokers, tax advisers, foreign shareholders and lawyers. It was alleged that the State lost about *€32 billion* due to the tax tricks of dividend stripping adopted by the actors (Tax Justice Network, 2018).

CUM/EX CUM/CUM SCANDAL

The Cum/Ex/Cum/Cum scandal involved a much disputed loophole in the law which allowed banks to assist foreign investors to receive a tax refund which they legally ought not to claim.

It worked this way - a day before payments of annual dividends, a German bank sold shares owned by a foreign investor to a local buyer. The local buyer immediately claimed a refund on the dividend due on those shares without withholding tax that the foreign investor would not have been eligible to receive.

As soon as the dividends had been paid out, the bank resold the shares to the original foreign investor and all parties involved shared the profit made from the scheme.

In a cum/cum trade, a withholding tax refund was claimed only once, while cum/ex were short sales with the withholding refund claimed multiple times (despite the withholding tax paid only once).

Those involved included about 40 respected banks, companies and other financial institutions both in Germany and in the City of London. (Tax Justice Network, 2018).

As reported by many German newspapers, the loophole in the law which created the opportunity has since been closed (Handelsblatt Global, 2017). However, the lessons remain that in instances where German policy makers and legislators do not take the right steps to block avenues for the movement of illicit capital, the State will eventually be the loser.

According to Global Financial Integrity, the proceeds of commercial tax evasion through trade mispricing constitute the largest component of illicit capitals across the globe, with Germany being a major financial hub (Global Financial Integrity, 2009:1). Collecting these taxes that are currently evaded and or avoided by individual taxpayers and companies could be used for the public good.

Organised crime

Due to current laws and regulations, Italian mafia clans are motivated to move and have indeed been reported as moving north into Germany (The Guardian, 2017). In addition to declining opportunities and a police clamp down in Italy, mafia clans are supposedly moving to Germany as they can acquire real estate, register trusts (due to limited public beneficial ownership laws), invest in German businesses and open chains of restaurants, bakeries, funeral services and vineyards for the purpose of laundering illicit capital (DW, 2006).

Petra Reski, a journalist chronicling mafia's growing influence in Germany believes that the country has the highest mafia presence in Europe after Italy as mafia clans "….are looking for safe investment opportunities that allow them to launder money, so inevitably they get drawn to the wealthier parts of Europe, and in particular areas where there are already people and business with connections back to Italy" (The Guardian, 2017).

An attendant problem with the rise of mafia clans is an increase in organised crime more generally. Recent news reports show the continued efforts of German and Italian intelligence to clamp down on mafia clans in different German cities, including the arrest of 170 'Ndrangheta members in late 2017 (DW, 2018). However, as long as these operations remain ad hoc, motivation to operate in Germany will not decrease and there is likely to be a resultant increase in organised crime.

Terrorist finance

In its summary of key findings, the 2010 Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism by the Financial Action Task Force (FATF) noted that:

> [m]any indicators suggest that Germany is susceptible to money laundering and terrorist financing, including because of its large economy and financial centre, as well as its strategic location in Europe and its strong international linkages. Substantial proceeds of crime are generated in Germany, estimated to be € 40 to € 60 billion, inclusive of tax evasion, annually (FATF, 2010: Para 2).

Although the FATF noted in its 2014 Report that Germany had made a number of improvements since its last report, the risk of terrorism financing remains high due to the fact that Germany is a secrecy jurisdiction and the deeply shrouded beneficial ownership structure (FATF, 2014).

3. Germany as safe haven for IFFs

According to a study published by the Tax Justice Network, Germany was ranked seventh, out of a total of 112 countries, in the 2018 Financial Secrecy Index. The level of secrecy of German financial infrastructure, for example with regards to company ownership and country-by-country reporting, is lower than the average of countries studied. However, the study argues that because Germany accounts for more than five percent of the global market for offshore financial services, it is at great risk of facilitating illicit financial flows (Tax Justice Network, 2018).

Serious loopholes in national legislation and poor enforcement of tax and anti-money laundering regulations are an issue in Germany (DW, 2018). The Außensteuergesetz from 1972, for instance, which includes legislation on controlled foreign corporations, is restricted in its tax collections because of tax planning and EU laws (DW, 2018).

Although some new laws have been adopted to prevent money laundering and fight tax evasion, including a ban on newly issued bearer shares and the implementation of the EU's 4th Anti-Money Laundering Directive, these laws also include some loopholes (Tax Justice Network, 2018).

Beneficial ownership

One of these loopholes relates to a public beneficial ownership register. Beneficial owner is defined as "a person who has effective ownership of a security or other property without actually holding title to it. This especially refers to holding voter proxy or investment power over a share or transaction, whether directly or indirectly" (Merriam Webster, n.d.).

It is important to know the real - beneficial owner - of a company as this is a common way to hide wealth from authorities. While Germany now has a beneficial ownership law, in some cases, when no owner can be identified, a legal representative can be listed as beneficial owner as well. This means that the obligation to report to the central agency is not applicable. In Germany the obligation to report is therefore placed on the owner him - or herself in cases of indirect control, meaning that the legal entity in Germany can no longer identify the beneficial owner. Public access to the register is also limited to restricted public authorities, banks and those with a legitimate interest (Tax Justice Network, 2018), meaning that public oversight on real ownership is limited.

Tax administration

In terms of tax evasion and money laundering, Germany suffers from a fragmented tax administration. After the Second World War, Germany was prevented from creating a central tax administration by the Allied Powers. This led to a decentralized tax collection by each individual state. Although each of the 16 states was responsible for its tax audits and its costs, the tax revenue had to be distributed to the other states. This caused a culture of lax tax enforcement as no incentives existed to collect taxes (DW, 2018). To this day some areas in Germany attract businesses due to its low corporate tax rates in distinct locations.

Another problem connected to tax evasion is a weak structure of tax enforcement in Germany. It is criticized as being low-tech and under-resourced (Tax Justice Network, 2018). For instance, tax authorities lack approximately 16,000 tax investigators and tax auditors. Some states like Bavaria have not increased the number of tax auditors for several years. This leads to a number of tax audits not being made (DW, 2018).

Enforcement

In addition to the above problems, it is difficult to track money laundering and tax evasion convictions in Germany because of the lack of public statistics. This makes it more difficult to evaluate if progress has been made in this field or not (Tax Justice Network, 2018). The information that does exist indicates a low number of fines and convictions, which highlights weaknesses in the policing of anti-money laundering rules (Tax Justice Network, 2018).

Asset recovery

Another field in which Germany is lagging behind is asset recovery. Although Germany has been able to recover €6 million per year from the Italian mafia in the last 10 years, it is estimated that €100 billion are laundered in Germany every year. After the Arab spring Germany also froze billions of dollars from Libya, Tunisia and Egypt, highlighting the lax oversight of anti-money laundering rules (Tax Justice Network, 2018).

While all of these facts highlight the problems Germany is having with tax evasion and money laundering, most of these information is unknown to citizens. A study conducted by CiFAR with a total of 115 students, showed that most of the interviewees were surprised to hear about Germany's challenges and its role as a tax haven. When asked for solution, around 95% were in favour of more transparency in tax reporting in Germany, while 92% were concerned with the amount of tax evasion and Germany's capability to react.

Within Germany, Deutsche Bank and BASF have both been implicated in reports of tax evasion. BASF, a chemical giant in Germany, was apparently able to avoid approximately €200 million in taxes per year between 2010 and 2014 because of its operations abroad (Tax Justice Network, 2018). Deutsche Bank, ranked number six among the world's largest private banks, reportedly helped customers to maintain hundreds of offshore entities in tax havens (ICIJ, 2013). Frank Wehrheim, the former head of the tax investigation unit in Frankfurt, holds Deutsche Bank responsible for "aiding and abetting tax fraud, money laundering and similar crimes" which rarely can be investigated due to complicated structures in tax havens (ICIJ, 2013).

Conclusions

Illicit financial flow are a serious problem that all countries have committed to fighting through the Sustainable Development Goals. Germany as a wealthy and influential international actor has a particular responsibility to ensure it is doing all it can to prevent illicit financial flows at home and abroad.

While Germany has made significant steps forward in aligning national law with international standards, the short examples provided in this working paper illustrate that much more needs to be done to ensure it has the laws, policies and practice in place to make tangible progress in fighting illicit financial flows.

Recommendations to the government

- ❖ Acknowledge the serious threat that illicit financial flows pose for both the German and the global economy and make a clear commitment to ending them
- ❖ Demonstrate leadership in fighting illicit financial flows by swiftly and fully implementing the 5th Anti-Money Laundering Directive (5AMLD) adopted by the European Parliament this year, this includes:
  - ❖ Following the example of the United Kingdom and other countries and make beneficial ownership register publicly available. This will allow the public and civil society to use its capacity and expertise to help the government investigate possible money laundering and tax dodging.
  - ❖ Increasing the budget, ensuring adequate staffing and strengthening the central oversight of Financial Intelligence Unit (FIU) over more than one hundred of anti-money laundering oversight bodies. Strengthening the FIU, the main governmental body responsible for examining money laundering activities is key in order to effectively process suspicious transaction reports from banks.
- ❖ Expanding the statistics currently disclosed by all anti-money laundering oversight bodies, including information on their core activities.
- ❖ Publish details on sanctions imposed by the Banking Oversight Agency (BaFin), especially with regards to high-profile investigations. This will enable international comparisons, comprehensive risk assessments and promotion of best practices.
- ❖ Ensuring that the data in the public company register is comprehensive and of a good quality. This will allow civil society to use its capacity and expertise to help the government investigate possible money laundering and tax dodging.

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