How to identify norms, laws and regulations that facilitate illicit financial flows and related financial crimes

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How to identify norms, laws, and regulations that facilitate illicit financial flows and related financial crimes

Abstract

ABSTRACT

Purpose: Illicit financial flows are targeted by the United Nations' (UN) Sustainable Development Goals (SDGs). However, these illicit flows are not entirely understood. Furthermore, they can benefit from economic norms, laws, and regulations that lack mechanisms to detect and penalize them. This paper investigates whether a recent test, the embezzler test, can be used to identify regulatory architectures that facilitate illicit financial flows and related financial crimes.

Design/methodology/approach: To develop a more advanced version of the embezzler test in terms of definitions and practical implementation methodology.

Findings: In this test, the definition of embezzlement can be understood to be the occurrence of illicit financial flows crossing the boundaries of organizations and/or countries. This is a multi-stage test, which intentionally simulates illicit financial flows to observe how well equipped is the regulatory architecture to deal with other financial offences that are related with these flows, such as theft, money laundering, fraud, corruption, market manipulation, and tax evasion.

Originality: This is the first explicit test that has been presented to identify norms, laws, and regulations that facilitate illicit financial flows and related financial crimes.

Research implications: Future research can employ the version of this test to stress test a large range of economic norms, laws, and regulations.

Practical/Social implications: This test's new version can assist achieve the UN SDGs' illicit financial flow reduction target. Furthermore, it can be used to study both existing and proposed norms, laws, and regulation.

Keywords: embezzler test; illicit financial flow; Sustainable Development Goals (SDGs); secondary offence.

1- Introduction

Recently published, the embezzler test aims to address a difficult problem in the fight against financial crime, namely, the existence of norms, laws and regulations that can benefit criminals (Cardao-Pito, 2022). It is unlikely (but not impossible) that lawmakers have deliberately created normative blind spots to facilitate financial crime. Nevertheless, there are deficient normative architectures that are not well equipped with detection and sanction mechanisms against financial wrongdoing. Consequently, these normative architectures can thus assist the perpetuation of financial crime. The question that the embezzler test addresses is how can we identify these defective economic norms, laws, and regulations? The suggested solution involves simulating hypothetical criminals who intentionally wish to commit financial crimes.

In fact, the use of defective regulatory architectures to identify financial wrongdoing can become a fruitless endeavour, for when these architectures lack detection and penalty mechanisms, financial crime is intangible in the sense that it cannot be identified with precision (Cardao-Pito, 2021 a). The embezzler test turns this traditional procedure around. Rather than using norms, laws, and regulations to identify financial crimes, the test enquires whether hypothetical criminals could employ these rules to carry out financial crimes without being caught. That is to say, simulated offences are employed to test the robustness and preparedness of compliance mechanisms.

The first version of the embezzler test only contained a generic description, which does not advance much into the details of implementation. It was suggested that this test could be used to investigate weak spots in normative architectures regarding embezzlement and other financial crimes. However, it was not entirely described how the embezzlement in the test could be connected to those other financial crimes.

This paper contributes with a more advanced version of the embezzler test. Accordingly, this test simulates a hypothetical intentional offence, namely, embezzlement, which is understood to be the illicit diversion of funds and other resources from/to an organization. To put it in another way, this test simulates illicit financial flows from/to an organization. The aim, however, is to identify weak spots regarding the other financial crimes that are potentially related with these illicit financial flows. Examples of these secondary offences are fraud, theft, money laundering, tax evasion, corruption, and other financial crimes. When norms, laws, and regulations lack means of detecting and sanctioning illicit financial flows, they likewise facilitate other financial crimes which are substantiated by these illicit financial flows.

An additional contribution from this paper is that is proves that the embezzler test is relevant to address serious criminal difficulties related with illicit financial flows, which are now inscribed in the United Nations' Sustainable Development Goals, namely, in SDG-16 [Peace, Justice, and Strong Institutions] (UN, 2023 a b). Indeed, the 16.4 target explicitly aims to:

"*16.4. By 2030, significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organized crime"* (UN, 2023 a b)

These illicit flows can also be linked to other SDGs, such as SDG-10 [Reduced Inequalities] or SDG-1 [No Poverty]. Financial crimes are empirical phenomena through which illegal wealth is accumulated, inequality increases, and political turmoil grows (Bak, 2020; Cobham et al., 2017; Gilsinan et al., 2020; Hendriyetty, and Grewal 2017; Kukutschka et al., 2019; Neu et al., 2013).

Illicit financial flows have most frequently been studied in the perspective of international cross-border flows (Chowla and Falcao 2016; Agbor, 2023; Forstater, 2018; Bak, 2020; Brandt, 2022; Solomon, 2019; Cobham and Janský, 2017; UN and OECD, 2016; World Bank, 2016; Spanjers and Solomon 2017; UN 2015; UN and OECD, 2016; World Bank, 2016; Mugarura, 2015; Brandt, 2022). Nevertheless, we choose to develop and examine a related concept, namely, illicit financial flows which cross the boundaries of organizations. Although organization boundary crossing illicit flows can often be linked to international illicit financial flows, they do not necessarily coincide.

Defective normative architectures are a hindrance in the fight against illicit financial flows that cross the boundaries of organizations and/or countries. Likewise, they are a hindrance in the fight against other financial crimes that rely on, or are related with these illicit flows. Lamentably, various decades of deregulation advocated by mainstream economic theory may have seriously depleted compliance mechanisms' ability to detect and penalize illicit financial flows. The embezzler test can be helpful to inspect regulatory fragilities that have resulted from deregulatory processes.

The remainder of the paper is organized as follows. The next section explains how deregulation of economic normative architectures may have depleted juridical mechanisms' ability to detect and penalize illicit financial flows and connectable financial crimes. The third section presents a more developed version of the embezzler test, in terms of definitions and practical implementation methodology. The fourth section discusses these contributions and provides concluding remarks. It notices that while laws, norms and regulation are not the only reason for the occurrence of undetectable financial crimes, normative architectures are a substantial part of the problem that is necessary to address. The new version of the embezzler test can help address this difficult problematic by introducing a new procedure to identify defective normative architectures. However, the embezzler test cannot, just by itself, modify these normative architectures. Such a change requires political will and power.

2. Deregulation and illicit financial flows

2.1 Deregulation and its consequences for financial crime

Much of economics operates under a self-regulating market myth, which supposes that markets could solve most, if not all of our human necessities through monetary intermediation (Gray & Fennell, 1996; Polanyi 1944, 2001; Cardao-Pito, 2021 b, p. 12 Haruna & Bakar, 2021 a). The elimination of taxes and regulations advocated by mainstream economics theory matches this mythology. Evidently only a naive view could consider that all taxes are just, and that all regulations are adequate. They are not. Nonetheless, mainstream economic theory advocates a “perfect market fallacy” (Cardao-Pito, 2021 a, p. 510), which argues (without evidence) that markets are not “perfect” as predicted by the theory, due to real-world imperfections, such as taxes, regulations, and trading costs. These so-called “imperfections" need to be eliminated. The fallacy is to claim that it is not the theory that fails to explain the world, but rather that it is the world that fails to adapt to the theory.

Many governments have aligned themselves with mainstream economic theory’s proposals for reducing taxes and deregulating over the last decades. These initiatives were especially directed towards the obligations of the wealthy and corporations (Ganghof, 2006; Gabor, 2012; Andrew et al., 2022; Haruna & Bakar, 2021 b; Hope and Limberg, 2021, 2022; Horwitz, 1986; Piketty 2014; Angelopoulos et al., 2007; Gemmell et al., 2014; Huber et al., 2019). The consequences of reducing taxes are more tangible than those of deregulation. The alleged tax-reduction trickle-down effect of increasing economic growth and unemployment failed to clearly materialize (Angelopoulos et al., 2007; Gemmell et al., 2014; Hope and Limberg, 2022; Huber et al., 2019). Conversely, tax cuts have empirically increased economic inequality, as is to be expected (Hope and Limberg, 2022; Andrew et al., 2022; Huber et al., 2019; Piketty 2014).

Although deregulation can consist in eliminating existing normative dispositions, it has other more frequent forms. One of those is to revamp existing normative architectures with permissive norms, laws, and regulations. Another is by depleting mechanisms for government intervention and judicial control, which in turn inhibit governments' capacity to function effectively (Derthick, and Quirk 2001; Hancher and Moran, 1989; Horwitz, 1986; Rider, 2009; Buren, 2019). Accordingly, deregulation may create norms, laws, and regulations that lack mechanisms to identify and sanction financial criminals.

Snider (2000, p. 170) identifies a strange occurrence, which is quite verifiable in the last decades: corporate crime shows a tendency to disappear, not because of better detection and penalty, but rather by modifications been made to existing regulations that have "*legitimized virtually every acquisitive, profit generating act of the private sector, and challenged every policy that impeded this agenda*". These regulatory modifications are based on knowledge claims from powerful elites, which are better understood when related with economic interests.

In this way, financial crime is reduced through the elimination of the instruments in place to detect and punish financial criminals. In past research, however, the effects of deregulation have been more difficult to identify than those of tax reduction. The consequences of deregulation might not be all that well-known, because, as hypothesized by Snider (2000, p. 170), deregulation legitimizes every acquisitive profit-generating act of the private sector and challenges every policy that impedes it.

Given that there have been deregulatory processes whereby mechanisms for detection and sanctioning of financial crime are eliminated, it becomes very difficult to use norms, laws, and regulations to find evidence of financial wrongdoing being committed. After all, crime depends on the law, and the law may have been dismantled from within. Addressing this difficulty, the embezzler test contributes with a formulation to identify how financial criminals can benefit from deregulation processes.

2.2. Deregulation and illicit financial flows

Various studies have addressed the phenomena of illicit financial flows, which are now beset in the United Nations' Sustainable Development Goals (Number 16 [Peace, Justice, and Strong Institutions]) (Chowla and Falcao 2016; Forstater, 2018; Bak, 2020; Brandt, 2022; Solomon, 2019; Cobham and Janský, 2017; UN and OECD, 2016; World Bank, 2016; UN, 2023 a b; Spanjers and Solomon 2017; UN 2015). As noted above, illicit financial flows can also be related with other SDGs, such as SDG-10 [Reduced Inequalities] and SDG-1 [No Poverty]. Nevertheless, it is quite difficult to identify illicit financial flows that are perpetuated, because of defective regulatory architectures and their consequences.

For instance, in a report published by Transparency International, Bak (2020) notes that while links between inequality and illicit financial flows seem evident, very few studies explicitly conceptualize these links or measure their correlations. Likewise, it is possible to hypothesize that illicit financial flows may undermine institutions, cause lower levels of public service provision, and exclude the poorest and most marginalized groups from benefitting from economic growth and development. However, the anonymity and secrecy of illicit financial flows makes it quite difficult to track them down (Agbor, 2023; Bak, 2020; UN 2015; Solomon, 2019, UN and OECD, 2016; World Bank, 2016; Brandt, 2022).

Furthermore, we do not completely understand how these flows are generated and operated. Although they have often been studied in the context of international flows and from the perspective of outflows (Forstater, 2018; Bak, 2020; Brandt, 2022; Solomon, 2019; Cobham and Janský, 2017; Mugarura, 2015; UN and OECD, 2016; World Bank, 2016), illicit financial flows can also be domestic and entail inflows (Agbor, 2023; Bak, 2020; Solomon, 2019; Spanjers and Solomon 2017; Cobham and Janský, 2017). Apart from crossing countries' borders, illicit financial flows can also cross organizations' boundaries whereby resources' property status is shifted.

Although illicit financial flows may be difficult to track down, we can demonstrate many of their material consequences in illicit profiting, criminal property, and unexplained wealth (Alexander, 2015; Naylor, 2003; Wronka and Rider 2023; McIntyre et al., 2022; Tellechea, 2008; Kleemans, 2015). However, normative architectures can be poorly equipped or even defective in dealing with illicit flows and their consequences. Through the embezzler test, nonetheless, hypothetical illicit financial flows can be simulated to detect norms, laws, and regulations that are poorly equipped to deal with these flows and the crimes related with them.

3- Developing the mechanics of the embezzler test

3.1 Defining embezzlement through illicit financial flows in the embezzler test

The embezzler test was created to detect weak spots in normative architectures. It aims to verify whether norms, laws, and regulations are capable of coping with financial wrongdoing (Cardao-Pito, 2022). The objective of the test is to confirm "*whether the standard, norm, or regulation can be used by one or more hypothetical embezzlers to divert funds or other resources from, or to an organization, without being subject to detection and applicable sanctions*." (Cardao-Pito, 2022, p. 881)".

An initial definition is naturally the effort to introduce a new concept into knowledge. In the initial version, however, no clear guidance was available regarding what is understood by embezzlement, nor how this financial crime could be related with other financial crimes such as fraud, money laundering, corruption, or tax evasion. In this new paper, we suggest that this test's concept of embezzlement can be explicitly related with illicit financial flows crossing the boundaries of organizations (and eventually countries). That is to say, embezzlement can be understood to be the illicit diversion of funds and other resources from/to an organization, or, in other words, the implementation of illicit outflows and inflows connected with organizations.

This definition might not exactly coincide with the legal definition of embezzlement, which varies from country to country. However, relating the embezzler test with illicit financial flows offers a simple, rigorous, and practical solution for this test's implementation. The current procedure is to use norms, laws, and regulations to detect illicit flows, however, in practice, these flows have often eluded auditors and courts. On the contrary, the embezzlement test turns this procedure around, as it is underpinned by the hypothesis that illicit flows can be facilitated by defective normative architectures.

Furthermore, it can be confirmed that illicit financial flows are the foundation of several other significant financial crimes. As described in Figure 1 and the next Sub Section, the embezzler test is a multi-step test, which simulates the illicit diversion of funds and other resources to test other secondary offences that rely and/or are linked with illicit financial flows. When norms, laws and regulation lack the means to detect and sanction illicit flows related with organizations, in effect they also enable the occurrence of other undetectable financial crimes that rely and/or are linked with these illicit financial flows.

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3.2 Secondary offences that are also testable through the embezzler test

By simulating intentionally illicit organizational flows, the embezzler test enables the ability to inspect regulatory architectures' robustness towards other financial crimes that rely and/or are related with illicit financial flows. This subsection identifies several examples. Owing to the limit of words, we cannot expand the conceptual analysis regarding these secondary offences, nevertheless there have been some interesting debates in these areas in the literature (e.g., Gilligan, 2015; Gottschalk, 2010; Palmer, 2018; Sutherland, 1983; Rider, 2015; Tupman, 2015; Ünvan, 2020, just to mention a few). The references below provide further guidance for readers who wish to know more about these debates.

Several economic crimes are relatively easy to associate with illicit financial flows, among them being theft (Alexander, 2015; Dittenhofer, 1995; Gottschalk, 2010; Tupman, 2015), corruption (Gottschalk, 2010; Palmer, 2018; Castro, Phillips, and Ansari 2020; Svensson, 2005; Lino et al., 2022; Konovalova, Tuck and Pérez, 2022; Tupman, 2015; Zyglidopoulos, 2016), and money laundering (Bryant, 2015; Chong and Lopez-De-Silanes, 2015; Gilmour, 2023; Gottschalk, 2010; Tupman, 2015; Konovalova, Tuck and Pérez, 2022; Teichmann, 2017; Walker, 1999). All these crimes require the existence of illicit financial flows.

Fraud, which often precedes illicit financial flows, can also be included in the examination. Previous research has been proficient in studying fraudulent financial reporting (e.g., Cooper, Dacin, and Palmer 2013; Gullkvist and Jokipii, 2013; Johnson, Grazioh, and Jamal, 1993; Maulidi and Ansell, 2020; Kassem, 2021; Navarrete, & Gallego, 2022; Palmer, 2018; Morales, Gendron, and Guénin-Paracini, 2014; Ratzinger-Sakel & Tiedemann, 2022; Saluja et al., 2021). Similarly, many studies address the concept of the fraud triangle, comprising three conditions for fraud, namely: motive/pressure, opportunity, and rationalization, as well as several possible other conditions for fraud (Cheliatsidou et al., 2023; Homer, 2020; Kagias et al., 2022; Maulidi and Ansell, 2020; Morales, Gendron, and Guénin-Paracini, 2014; Saluja et al., 2021). Nevertheless, it seems safe to say that only rarely is financial statement fraud the desired end-result of its perpetrators. Rather, it is a means to achieve the joint objectives of enabling illicit flows of resources and financially benefiting certain persons.

Likewise, market manipulation (Cumming; 2020; Putnins, 2012, 2020) is a financial crime which is associable with both fraud and illicit financial flows. For instance, stock market prices are well known to react to firms' profit announcements, and thus financial statement fraud that results in better- or worse-than-expected profits can help manipulate stock prices with the aim of generating illicit flows, such as illicit premiums and bonuses linked to share prices or the sale of shares at inflated or deflated values (e.g., for purposes of selling or acquisition).

The inclusion of tax evasion in the embezzler test's remit might be less consensual, nevertheless, we opt to include this activity among the secondary offences examined. Tax evasion is frequently distinguished from tax avoidance. According to the definition of HM Treasury (2015, 5; Musselli and Bonanomi, 2020), tax evasion occurs when people or businesses intentionally fail to declare, account for, and pay the taxes that are due. Tax evasion occurs when the perpetrators underreport income, over-report expenses, or simply fail to pay taxes due. Conversely, tax avoidance represents bending the rules of the tax system to gain a tax advantage that lawmakers may not have intended (HM Treasury 2015, 5; Hearson, 2014; Musselli and Bonanomi, 2020; European Commission, 2012; 2015; 2017; Ylönen and Laine 2015). The distinction between evasion and avoidance can be blurred in some firms' aggressive tax planning (idem). In this paper we just focus on tax evasion, for reasons of space. However future research could inquire whether tax avoidance should also be included in the embezzler test's remit.

Numerous studies have considered tax evasion when discussing illicit financial flows (see, for instance, Chowla and Falcao 2016; Forstater, 2018; Bak, 2020; Brandt, 2022; Hearson, 2014; Solomon, 2019; Cobham and Janský, 2017; UN and OECD, 2016; World Bank, 2016; Spanjers and Solomon 2017; UN 2015; UN and OECD, 2016; Konovalova et al., 2022; World Bank, 2016; Brandt, 2022). However, when the UN's SDG-16 [Peace, Justice and Strong Institutions] integrated the target of significantly reducing (international) illicit financial flows, a well-funded lobbying effort attempted to persuade the UN to exclude multinational tax evasion from the definition of illicit financial flow.

Consequently, the heads of several NGOs that work in this area felt the obligation to write to the UN to denounce these lobbying efforts. Among them were the Tax Justice Network (TJN), the Global Alliance for Tax Justice (GATJ), and the Independent Commission for Reform of International Corporate Taxation (ICRICT) (Alemayehu and Cobham, 2017; Ocampo, 2017; Turner, 2017; Forstater, 2018).

We support the opinion of these NGOs that tax avoidance should be kept within the concept of illicit financial flows. There are at least two routes by which tax avoidance can be associated with illicit financial flows, namely: i) the shifting of profit/resource to tax havens, and ii) the erosion of tax obligations (e.g., Alm et al., 2022; Álvarez-Martínez et al., 2022; Hearson, 2014; Ginevra, 2017; Temouri et al., 2022; Ahrens and Bothner, 2020; Mayer and Gendron, 2022; Forstater, 2018; Peng, 2016; Ylönen and Laine 2015).

The use of tax havens obviously entails illicit financial flows. Although perhaps less directly recognisable, base erosion likewise represents illicit flows. As suggested by Chowla and Falcao's (2016) review, an illicit flow is related with at least one of three illicit dimensions, namely: the source of resources, the transfer of funds, and the application of funds. When an organization engages in tax evasion, it obtains and can apply resources that it was not entitled to, thereby appropriating resources that rightly belong to the state. Tax evasion undermines legitimate flows of taxes and diverts those resources to the control of the organization that engaged in such evasion. Accordingly, we are of the opinion that tax evasion is a secondary offence that is also directly related with illicit financial flows.

Tax evasion can thus be examined by the embezzler test, together with other secondary offences that are related with illicit financial flows, such as theft, money laundering, corruption, fraud, and market manipulation. The embezzler test simulates intentionally illicit financial flows that cross organizations' boundaries in order to test how normative architectures are equipped to deal with other secondary offences that are related with illicit flows.

4- Discussion and concluding remarks

The reduction of illicit financial flows targeted by the United Nations' Sustainable Development Goals can be assisted by the embezzler test. This test examines how norms, laws, and regulations are equipped to cope with illicit flows crossing the boundaries of organizations and countries, as well as other financial offences that rely and/or are related with these illicit flows. Accordingly, this test can be employed to identify defective normative architectures in this regard. In addition, this test can be used to exhibit the consequences of many decades of deregulation advocated by mainstream economics. Revamping existing normative architectures with permissive norms, laws, and regulations, and inhibiting governments' capacity to function effectively may have indirectly benefited many financial criminals.

Nevertheless, defective laws, norms and regulations are just one of several motives for financial criminals not to be prosecuted and found guilty by courts. Gilsinan et al. (2015) investigated three major financial crises (post-1929, 1990, and post-2007) to attempt to understand why some financial crises do not result in extensive prosecution, as the evidence of financial wrongdoing appears to be abundant. These authors found that the number of laws and regulations available in the prosecutorial toolkit was indeed an important factor. The embezzler test can contribute to this factor, albeit other important factors exist, such as: the prosecutor's level of risk tolerance (the 'probable win test'); the potential economic impact of a successful conviction; the desired outcome, which ranging from new regulatory structures through the desire to attribute blame, the will to find a scapegoat, or the drive to implement financial penalties that bolster the government's bottom line.

Furthermore, even the best designed economic laws, norms, and regulations require the existence of police forces to implement and control the respective law enforcement. Such police forces need to be well managed, equipped, and staffed to increase the probability of achieving success in carrying out their mission. Governments need to invest in these forces if they are serious about finding and punishing financial criminals, especially so in these times of rapid and significant technological transformation (Gilmour, 2021; Young & Phillips, 2022). Laws, norms, and regulations represent only a part of the financial crime conundrum, and it should not be overlooked that modifying defective normative architectures requires political will and power if it is to be achieved.

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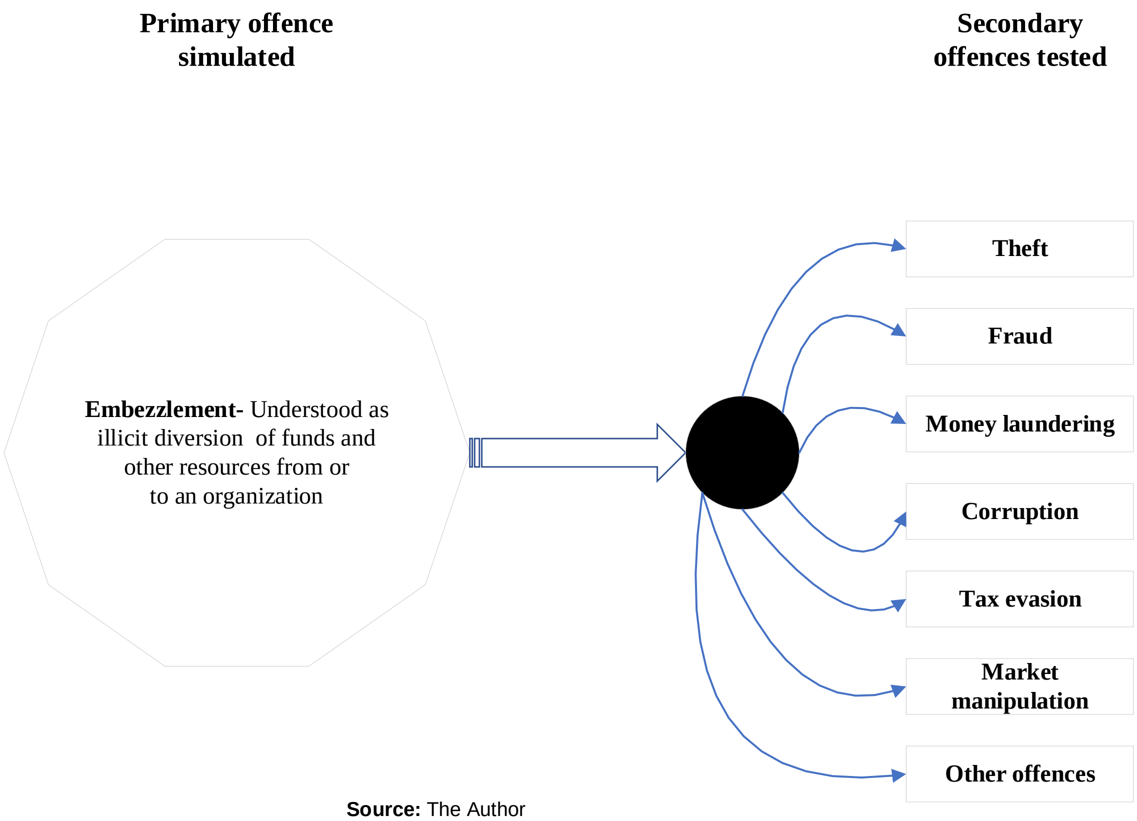
Figure 1 – The Mechanics of the embezzler test: This test simulates the intention to illicitly divert funds and other resources from or to an organization to test financial crimes that rely on and/or are related with illicit financial flows**.**



Source: The Author