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Global Financial Information, Compliance Incentives and Conflict Funding

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Interdiction of terrorist funds has become a priority for intergovernmental cooperation. Logically, this initiative should affect SDM financing as well as conflict funding more generally – particularly where incumbent states can outlaw such movements. However, multilateral and unilateral attempts to ensure timely reporting of transactions made by targeted individuals or groups, and to deny them access to the international financial system, have had limited success. This is mainly due to economic disincentives for the disclosure of the identity and purpose of transacting agents, particularly those using correspondent banking services, informal money transfer networks and offshore financial centres. Solutions should be based on positive incentives for disclosure, and could include trans-border withholding taxes on transactions with unregulated clients and the provision of affordable transfer systems for emigrants. But this in turn would require a clear and practicable definition of the 'right to self-determination' in terms of international jurisdiction.

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INTRODUCTION*

Since the attack of 11 September 2001 on the USA, the interdiction of terrorist funds has occupied the attention of international organisations and national governments throughout the world, and has been defined as a central element of the 'war on terror'. During the succeeding twelve months trans-border cooperation on the provision of financial information was strengthened, led by Washington and London in their double role as strategic security allies and regulators of the two major global financial centres. In this period, some 166 countries issued orders blocking the terrorist assets, but only US $112 million of funds were frozen.[1] However, closer examination reveals that it proved very difficult to ensure timely reporting of the financial transactions of targeted individuals or groups, or to deny them access to the international financial system.[2]

Logically, this initiative should affect SDM financing as well as conflict funding more generally – particularly where the inevitable attempts by incumbent states to outlaw such movements are supported by international organisations. A 'self-determination movement' (SDM) in this context is understood to be an organised movement to fundamentally change the nature of a nation state in order to permit those represented by the movement to gain greater autonomy. This change may take the form of either the creation of a separate geographical entity or the replacement of the existing state by a fundamentally different social order. The former case, of separation, is usually identified with a particular ethnic group that inhabits the region in question, a group that demands separation in order to escape repression by the incumbent state (itself often dominated by a distinct ethnic group, majority or minority). Clear examples of this are East Timor, Northern Ireland, Eritrea and the former Yugoslavia. The latter case of replacement, refers to much more than a change of government (albeit by violent means), but rather a change in the social 'constitution' – during much of the twentieth century this involved the construction of socialism (e.g. China, Cuba), but was then succeeded by movements to replace communism by capitalism (e.g. Poland, Rumania), and dictatorship and military rule by democracy (e.g. Philippines). There are of course cases of ethnic overthrows of whole states (e.g. South Africa, Zimbabwe) and the establishment of theocratic states (e.g. Iran, Afghanistan) has also become a significant phenomenon.

This definition of the SDM, therefore, implies a widespread support among the social group in question and fundamental change as the objective. It thus excludes violent actions by small groups of activists on the one hand (e.g. the Weathermen), and attempts to capture the state by military means in order to replace the leadership (e.g. Sierra Leone). Terrorism proper is understood to be violent actions by non-state groups against civilian targets for the purpose of achieving political ends: SDMs may or may not engage in terrorism in this strict sense. Indeed most SDMs try to avoid actions against civilians as this would reduce their support. Moreover, non-democratic states may (and often do) engage in illegal repression of civilians that is effectively a form of terrorism.

The incumbent state will logically oppose the attempt to overthrow its fundamental constitution or to separate part of its territory. This usually involves the use of armed force, to which the SDM may respond equally with armed actions. These actions are inevitably termed 'crimes' or 'terrorism' by the state, although of course other states may support the SDM, turning a blind eye to its the armed activities or even supporting them as 'freedom fighters'. Indeed it is very difficult if not impossible for an SDM to be sustained without the implicit or explicit support of another state – if only as a safe haven. In consequence, a key objective of the incumbent state and its allies is to define opposition SDMs as international terrorists.

The need for considerable and continuous funding, and the need to transfer these funds internationally, imposes an effective budget constraint on non-state conflict participants SDMs as well as terrorism proper – that can reduce the number and intensity of attacks as effectively as direct police action (Sandler et al., 1983). Second, there are considerable externalities to other states arising from the interdiction of international terrorism or the containment of SDMs in any one territory, while the costs are local, so that there are potential gains from international cooperation in this field and a temptation – particularly for small states – to engage in free-riding (Lee, 1988).

Within the limitations of publicly available information[3], this paper sets out to explore this issue from the viewpoint of the economics of financial regulation. The key issue is the geostrategic need for more information on the identity of transactors and the ability to freeze/expropriate assets and/or gain information on other related activities. However, the regulators' problem is that the large unregulated flows generated by broadly legal activities such as tax avoidance and migrant remittances provide cover for crime-related transactions (Johnson, 2001). To the extent that the loss of secrecy and increased reporting requirements involves a loss in efficiency of the market as a whole by increasing transactions costs, this must be set against the less tangible global welfare gain of increased security. The obvious parallel here is with the logic of the trade-off between efficiency and stability in financial markets which brings about the need for prudential regulation to prevent systemic risk, and thus the obligation to provide proprietary information to regulators in exchange for the licence to operate (Goodhart et al., 1998).

In economic theory, financial intermediaries undertake the task of monitoring the firms to whom they lend on behalf of the households who deposit funds with them (Diamond 1984). These intermediaries enjoy scale and learning economies in this activity, and possess privileged information about their debtors. In consequence they are in a unique position to provide accurate information on their clients to the regulatory authorities without undue cost. Further, financial intermediaries possess considerable information on their creditors, particularly when they provide a wide range of financial services and thus build up a picture of clients' assets and activities. Traditionally, therefore, financial intermediaries in OECD countries have worked closely with national law enforcement authorities in the detection of criminal activities – particularly the transfer of criminal proceeds and the evasion of tax obligations. However, over the last decade the competitive forces associated with financial globalisation have tended to undermine this altered this relationship: on the one hand, banks have increasingly moved away from direct lending towards the management of capital market assets, and so there is much less non-financial information available on borrowers; on the other hand, high net worth individuals regard secrecy as a key service, and in the absence of capital controls can move funds rapidly to another jurisdiction if this is not provided.

The demand for secrecy ranges from concealing assets from other family members or business associates, through tax evasion to laundering the proceeds of criminal activities. International law enforcement, however, require information about depositors and users of financial services. This information asymmetry is precisely the reverse of that analysed in the financial literature, where it is assumed that the lender has insufficient information to properly monitor the borrower (Hiller, 1997). Further, in the case of interdiction of cross-border terrorist funds, there is the additional complication that the origin of the funds can be fully legitimate (e.g. a scholarship fund) and their use also (e.g. hotel bills) until the attack takes place.

This paper is structured as follows. Attempts to detect and interdict illegal financial flows related to the funding of trans-border terrorism are built on existing systems of reporting the use of financial systems for illegal purposes. This foundation is examined in Section 2, which covers multilateral coordination on financial interdiction, the role of unregulated money transfer networks (MTNs) and the problem of offshore financial centres (OFCs). The limitations of this approach are shown to derive from the bias of economic incentives towards less rather than more disclosure. Section 3 examines the multilateral and unilateral attempts during the twelve months after the attack of September 2001 to strengthen regulatory controls on international banking and to regulate informal transfer systems. The effect of this effort on self-determination movements is examined in Section 4, from which it is clear that SDMs have merely been treated as terrorist organisations according to the definitions of incumbent states. Section 5 concludes that unless market incentives work with – rather than against – regulatory disclosure, there is little prospect of substantial progress in the interdiction of terrorist funds. A possible policy solution could combine trans-border withholding taxes on transactions with unregulated high-wealth clients, supported by the establishment of a bank-based system for low-cost money transfers by emigrants. However, this would require a clear concept of 'legitimate' SDMs unless they are all to be branded as terrorists by the incumbent state and thus prevented from raising or transferring funds internationally.

2. ANTECEDENTS FOR THE INTERDICTION OF FINANCIAL TRANSFERS

Money laundering and the international banking system

Mechanisms to interdict terrorist financing have been built upon the foundations of those already established for the prevention of financial crime including money laundering. Existing multi-lateral regulation bodies such as the Financial Action Task Force (FATF) of the G7, Interpol and the United Nations have long been involved in attempts to coordinate reactions to all forms of trans-border financial crime (Johnson, 2001). In the immediate aftermath of September 2001, it thus appeared that that the most effective way to counter this threat was to redirect and intensify the efforts of already existing multi-lateral monitoring and coordination bodies.

In the 'formal sector' of international banking, the weakest link appears to be the essentially self-regulated international network of correspondent banks. International correspondent banking exists in order that banks may provide a wide range of alternate services for their clients in territories where they have no established branches. This in turn makes these formal financial institutions vulnerable to unwitting collusion in money laundering activities. This problem is most evident when international correspondent banks engage partners domiciled in poorly regulated emerging market countries. These arrangements allow the transfer of both illegally and legally derived money from the unregulated into the regulated financial institutions, thus “allowing funds in through the backdoor of the regulated institutions to commence or continue the laundering process” (Johnson, 2001 p.130).

For banks, attempts to detect and interdict terrorist financing are dealt with through existing mechanisms to counter money laundering. However, while most money laundering funds derive from other criminal offences, such as the sale of illegal drugs, the source of terrorist funds are frequently legal. The banking sector is aware that any action which would be able to limit terrorist financing would require cooperation between banks, between governments and between banks and governments. This cooperation would take the form of information sharing and the creation of new mechanisms to track suspicious behaviour. A group of twelve leading international banks agreed to the ‘Wolfsberg Principles’ for self-regulation in October 2000.[4] These principles were established with assistance from Transparency International (an anti-corruption NGO), and focus on increased due diligence on the part of the banks. In particular, they are expected to be more aware of their customers and their actions. The ‘Wolfsberg Group’ extended their principles to meet the new concern of terrorist financing, increasing the due diligence expected from their members.

Various United Nations agencies were also previously involved in combating financial crime in general and terrorist funding in particular. Existing UN resolutions, such as the 1999 International Convention for the Suppression of the Financing of Terrorism, were used as a starting point for new action. The perception of new threats gave greater importance to the ratification of existing legislation. Additionally, the UN Security Council and General Assembly have adopted resolutions calling upon all nations to act to stop terrorism and its supporters in all ways. The most powerful of these resolutions, detailing measures to be taken to suppress the financing of terrorist acts is Security Council Resolution 1373. The UN called for increased cooperation from all member states to stop acts of terrorism and the means by which terrorist actions were supported.

Multilateral monitoring and policy proposing organizations such as the FATF were already concerned with financial crime, in particular money laundering. The FATF was founded in 1989 to coordinate policies against the misuse of the financial system by money laundering. [5] Now including 29 member states and several regional affiliated bodies, it monitors the actions of member states in implementing anti-money laundering policy and promoting such policies around the world. Its ‘Forty Recommendations’ delineate measures for law enforcement agencies, banks and governments. These recommendations are designed to be widely applied, providing flexibility for individual states to apply them in their own jurisdictions. The FATF recommendations are composed of several sections, including the criminalisation of laundering money from crime, the requirement of banks to know their clients, and reporting any suspicious transactions to their governments. The FATF not only contributes to monitoring but also provides a platform for information sharing among law enforcement and regulatory officials from member states and international organizations. At these annual meetings, member regulators discuss advances changes in money laundering and new ways to counteract it.

Informal financial systems

Multilateral bodies such as the FATF, although principally concerned with the integrity of the international banking system, have also expressed considerable concern about global money transfer networks (MTNs), particularly unregulated or 'informal' MTNs such as the *hawala* system. The regulatory problems they raise are complex, both because it is very difficult to trace the activities of these networks accurately, and because it is unclear how to regulate them even in principle. The apparent use of informal MTNs by terrorists has increased the pressure to bring them under regulatory control.[6]

All informal MTNs share a common set of operational characteristics, a "lack of records, customer identification or regulatory oversight, and the potential for misuse by criminals".[7] Those most commonly referred to are the Chinese *chit* or *chop* system of East and Southeast Asia, the *black market peso exchange* system of Latin America, and the *hawala* system, with its offshoot the *hundi* system in South Asia. Mirroring established migrant labour patterns, these networks provide unregulated (and thus cheaper) remittance services between developed and developing countries. Unregulated small-scale money transfer networks are also used to transfer funds between commercial parties both within and across national borders.[8] The final settlement between the associate hawaladars may be made through various mechanisms such as bank transfers, reciprocal remittances, manipulation of trade invoices, smuggling of gold or drugs, or through the physical movement of cash by trusted couriers. Informal MTNs are often held to be 'archaic' or 'underground' financial systems (Gilligan, 2001). However, such networks are better viewed as a structural response to information asymmetries in the financial services market place and a necessary feature of segmented financial systems (Nawaz et al., 2002). This explains why these networks thrive: they are used predominantly by those consumers, particularly the poor, who are not served by formal financial institutions because of cost and risk. Specifically, they provide a rapid, reliable and relatively cheap means for migrant workers to remit cash to poor and illiterate families.

Given that migrant remittances provide the 'base load' for such systems, informal MTNs have two further advantages over the formal financial system. First, they avoid the additional costs imposed by regulation of banks, for prudential as well as policing purposes. The introduction of international codes and standards by the G7 through the Financial Stability Forum, as well as increased consumer protection, has led to increased costs for banks which are passed on as transactions fees.[9] This makes the international transfer of relatively small sums highly unattractive to banks. Second, hawala networks circumvent the record keeping that formal banking involves. Thus they provide the highly valued 'financial' service of customer confidentiality similar to that offered by offshore financial centres – particularly for the transactions of wealthy individuals with highly regulated OECD countries. Although hawala networks rely on traditional forms of personal trust rather than written contracts, they also use formal banking systems and continually respond to the ongoing process of financial globalisation. For example, they are well suited to new e-commerce platforms and form a key element of international 'cyber-laundering' business along with activities such as gambling (Philippsohn, 2001).

Offshore financial centres

International capital mobility makes criminal and terrorist funds transfer easier, particularly since these transactions can be obscured by the quasi-legal flows related to tax evasion, which require a similar degree of secrecy. The role of the tax factor in determining business location gives rise to wasteful tax competition for investment, particularly between small developing countries with a small business sector of their own, for whom the positive externalities of such investment are a significant source of national income, but who do not bear the externalities involved in terms of tax loss to other countries (UNCTAD, 1995). The deregulation of cross-border capital flows also reduces or even eliminates the information about investors generated by licensing systems. Liberalisation also reduces the transactions cost of the use of off-shore financial centres (OFCs) to channel cross-border capital flows through the incorporation of offshore holding companies. The object here is not so much to attract foreign investment as such, but rather the administration of assets and tax revenue. The use of these schemes is detrimental to both the home and host country through reduced tax revenues and distorted investment inflows (OECD, 1998).

The number of double taxation agreements has thus increased rapidly in recent decades, and there are now some two thousand such treaties in existence. The principle of information exchange between national tax authorities has been intrinsic to such treaties since the last century; and was central to the draft tax convention prepared by the League of Nations in 1935 (IBFD, 1998). These treaties become ineffective if offshore centres are used as transfer pricing points as well as for tax avoidance (JTC, 1999). The OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters established in 1988 ensures that information on such holding is shared between OECD members – but not with non-members.

Extensive transfer pricing and tax-induced capital restructuring (e.g. intra-firm debt) take place despite the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines (Bartelsman and Beetsma, 2000). A significant problem associated with this issue is that of offshore financial centres. By allowing multinationals, through transfer pricing, to declare the majority of their profits in shell companies registered in OFCs, the tax revenues resulting from investment and production in (non-OFC) countries are lost to the hosts. The Financial Stability Forum (FSF, 2000) has addressed the issue of OFCs from the point of view of systemic instability in international capital markets. Those centres unable or unwilling to adhere to international supervisory standards of cooperation and transparency pose two serious problems. First, there are prudential concerns for the effective supervision of international financial intermediaries in order to forestall a bank collapse from putting the payments system in danger. Second, there are market integrity concerns relating to the effectiveness of international enforcement efforts in respect of illicit activity and abusive market behaviour.

There are thus substantial global welfare losses from OFCs to be set against the marginal benefits to small economies with no other legal source of high income other than perhaps tourism. These losses are composed of the loss of fiscal revenue to other jurisdictions where firms' and individuals' economic activities take place on the one hand, and the cover that tax evasion flows give to money laundering, narcotics funding – and now terrorist finance – on the other (UN, 1998). IMF research on the prudential issues raised suggests that "OFCs attract funds because they promise anonymity and the possibility of tax avoidance or evasion. A high level of bank secrecy is almost invariably used as a selling point by OFCs, some of which have been (and are) exploited also for activities related to money laundering" (Errico and Muslaem, 1999, p. 10).

The Financial Action Task Force (OECD 2000) initially defined some thirty-five jurisdictions as 'non-cooperative countries or territories' in key areas of transparency and information exchange required to meet international anti-money laundering standards for – a list which included the Bahamas, Cayman Islands, St. Kitts & Nevis, St Vincent & Grenadines, Dominica and Panama in the region as well as Israel, Lebanon, Liechtenstein, Philippines and Russia. Six, including Bermuda and the Caymans, rapidly made commitments to eliminate harmful practices by the end of 2005. In the wake of global anti-terrorist measures after September 2001, the remaining Caribbean states and UK dependencies (and the Channel Islands) in the region had signed by February 2002; embracing international standards for transparency, exchange of information and fair tax competition (FSF, 2000). It remained to be seen, however, how effective the information exchange is in practice, because this would mean that OFCs would lose most of their financial services income.

3. INTERVENTIONS IN THE INTERNATIONAL FINANCIAL SYSTEM DURING THE FIRST YEAR OF THE 'WAR ON TERRORISM'.

The Financial Action.Task Force

Most of the actions taken in the immediate aftermath of September 11 involved the restructuring of existing bodies to meet this new threat. In October 2001, the Financial Action Task Force expanded its mandate from narcotics-related money laundering to include terrorist financing. Its existing mandate apparently made it particularly suitable to prevent the misuses of world financial system by terrorists. Following this, the FATF issued a series of special recommendations to be adopted by member states. These recommendations drew upon the content of the 'Forty Recommendations' but were more closely concerned with terrorist funding. The seven parts of the new FATF guidelines include the criminalisation of terrorist funding and connected money laundering, followed by the seizing and confiscating of terrorist assets.[10] States should also increase cooperation, sharing information and assisting others in bringing financial criminals to justice. However, relatively little thought has apparently been given yet to implementation, with decisions instead being left up to individual member states for the time being. The FATF has yet to develop interpretations based on the experience of member states: effectively is still at the data gathering stage.

The FATF recommendations are intended to separate the legal and necessary actions of remittances and the donation of money to non-profit organizations on the one hand from the illegal acts of financial crime and support of terrorist activities on the other. Unlike more traditional money laundering, in which crime has already taken place before the money is transferred, the origins of terrorist financial support may be completely legal, until they enter terrorist financial channels. Informal channels such as hawala are used legally by many to transmit their remittances to their home countries, as well as providing a conduit for terrorist support. As a result, these transactions are both more difficult to track and risk impeding legal financial transfers. Since these transfers are by nature informal, there is no "paper trail" for investigators to follow. In an attempt to curtail an activity that seems unregulatable, the FATF recommendations suggest promoting alternative means for transferring money and increasing the number of documents kept on transactions. Additionally, wire transfer operators have been asked to keep additional records of transactions and to attach all information of sender and recipient at all points in the transaction.[11] At the same time, the recommendations call upon those who conduct any transactions – including large cash operations such as gambling - to 'know their customers' and to attach this identification material to the transfer. The lack of this information is seen as suspicious and is liable to be reported – but the effectiveness of this measure remains to be seen.

The FATF is a monitoring, coordinating multi-lateral organization, but its means are limited to cope with its new mandate. After the October 30 2001 statement of the Special Principles on Terrorism, the FATF released documents to help states identify suspicious activities. The first step in the FATF monitoring procedure involved a self-assessment questionnaire to all member states, to track their progress in implementing these new guidelines.[12] Subsequently non-member states were been invited to fill out this questionnaire also. This questionnaire is designed not only to determine if states have been implementing the guidelines but also to provide case studies for other states to follow in their policy design. Drawing upon the results of some of the questionnaires, the FATF produced guidance notes to help financial institutions do avoid becoming the unwitting conduit for terrorist funds.[13]

Other multilateral action

The G7 itself also took action to increase information sharing and cooperation in broader measures to fight financial crime. While the impetus for these actions is relatively new, it draws upon previous anti-money lending and anti-drug smuggling agreements. At the G8 meeting of May 13-4 2002, measures were taken to increase cooperation across borders, particularly in electronic communications and e-commerce, in an attempt to stop terrorists from abusing the system[14].

In November 2001, the wider G20 group of leading developed and developing countries adopted an action plan to increase cooperation among states and with international institutions to adopt measures necessary to limit international terrorist funding. According to this plan, all states would ratify the existing conventions and resolutions dealing with terrorist financing; collectively they would draw up lists of offending groups so that their assets could be frozen and information would be shared to make action possible.[15] Liaising with the FATF and other international actors, common standards limiting terrorist financing were to be implemented. Also, more developed countries promised financial support and assistance to those states that lacked the infrastructure to carry out these missions effectively. Aside from multi-lateral agreements from groups such as the G7, ASEAN and others, multi-lateral designations of terrorist suspects remain the most noticeable sign of this cooperation. The United States has used the medium of joint declarations of terrorists and terrorist-supporting groups to promote cooperation in this effort.[16]

Additionally US officials pointed to the willingness of other states to issue designations of terrorist supporting groups on their own and with US support.[17] These declarations and the negotiation required to agree upon them, formed a key part of this cooperation. However, the United States itself did not comply with the first item of the FATF recommendation list: to ratify the 1999 UN Convention on the Suppression of Terrorist Financing. Indeed, only seven OECD member states had ratified the convention (Austria, Canada, France, Iceland, the Netherlands, Spain and the United Kingdom) by mid-2002.[18] The European Union was quick to support the US led actions to stop the flow of funds that support terrorist activities and issued three separate lists of designated terrorist supporters whose assets should be blocked by end-2001. However, the legal and financial infrastructure appear to be inadequate to implement these decisions, and only the UK froze significant sums.[19]

Meanwhile, informal financial transactions systems such as hawala networks have been the subject of increased regulation and anti-money laundering declarations. While states such as the UAE have not banned hawala, it is important that they are seen to be participating in the international struggle against terrorism. In May 2002 at Abu Dhabi, representatives from regional banking and law enforcement agencies called for the application of the FATF regulations to the hawala industry, declaring that "the international community should continue to work individually and collectively to regulate the hawala system for legitimate commerce and to prevent its exploitation or misuse by criminals and others", and that to this end, they should "designate competent supervisors to monitor and enforce the application of the recommendations of the Financial Action Task Force to hawala dealers and other alternative remittance providers."[20] The proposals to regulate hawala stems from the positive aspects of this system and the fear that any attempt to eliminate informal channels would merely drive more transactions underground. In May 2002, the Central Bank of the UAE announced that hawala operators in the UAE would be licensed and regulated.[21] Pakistan has launched a scheme to convince its nationals to avoid unofficial channels, including novel incentives such as baggage allowances and preferential treatment at airports.[22]

The campaign to interdict terrorist financing seems to demonstrate the value of intergovernmental cooperation. However, many measures taken recently are commitments rather than action. While it is too soon to determine how successful the adopted measures have been, success seems limited mainly to unilateral action *within* the United States and the United Kingdom. To ensure the wholehearted participation of other member countries of the OECD, and of leading emerging market countries, would require that they have a more effective share in decision making by international bodies. To the extent that that the proposal for fiscal compliance incentives discussed below were to be implemented, this would also provide a stronger economic motive for governments of small or poor countries to participate more effectively in the suppression of terrorism.

Unilateral Intervention

The US response to terrorist financing was probably the swiftest and most wide ranging. The October 2001 the Patriot Act includes several amendments to the bank secrecy act and new anti-money laundering measures.[23] Within the Patriot Act, Title III is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. The Financial Crimes Section of the Department of the Treasury is the government agency responsible for determining policy on terrorist financing. The American Banking Association (ABA) has cooperated with this agency to introduce new practices to reduce money laundering. In February 2002, the ABA announced new procedures to reduce the threat of terrorists misusing the US banking structures, including new checks for the opening of bank accounts.[24] However, the ABA has also challenged certain aspects of the Patriot Act, claiming that new provisions for cooperation between the government and the banks might impinge upon existing agreements of ongoing information sharing.[25] They fear that the creation of new channels might circumvent older ones and even make information sharing more difficult, and that the time restrictions on reporting are unrealistic.

The US Treasury has devoted substantial resources to waging the financial war on terrorism. The initial step was to identify the terrorists and terror-supporting groups and to freeze their assets. The next was the regulation of charities to ensure that money intended for legitimate purposes was not used to support terrorism. US officials leading the fight against terrorist financing thus announced a second phase of attack: informal money transfer systems including hawala and charitable donations. The Secretary of the Treasury announced: " We are driving the terrorists out of the modern financial infrastructure and into less efficient transfer methods, which are more difficult, slower and more easily intercepted by law enforcement."[26] The designation of Islamic charities abroad as supporting terrorists and blocking of their resources has also been a US-led initiative, and include the Saudi decision to require charities to report to the foreign ministry about charities abroad, more regulation and increased transparency of charities in Pakistan and greater government supervision of charities in Egypt.[27]

The British government has a substantial history of anti-money laundering and anti-terrorist financing actions, but a new terrorist finance team was set up in November 2001, bringing together different interested agencies.[28] The British Government had begun to take actions against terrorist financing since 1992, but after September 11, the assets of 100 organizations and over 200 individuals were frozen. New anti-terrorist legislation increased the powers of the police to monitor and seize assets of those suspected to be engaged in terrorist activities and increased the requirements of banks to report suspicious activities.[29] According to its own progress report in April 2002, the UK was already compliant with most of the FATF recommendations and was seeking to pass legislation that would satisfy the remaining recommendations. The banks and financial services industry has also taken the initiative to introduce stricter controls over anti-money laundering system. In July 2002, the major UK banks announced that they would identify suspicious accounts established since 1994, before international regulations require.[30]

It would seem therefore, that unilateral intervention has been more effective than multilateral action. On the one hand, as New York and London are the only truly global financial centres, to deny their use to terrorist groups is a major achievement. On the other hand, most of the rest of the world – non-OECD countries and offshore-centres in particular – are thereby excluded and arguably become more difficult to monitor.

4. IMPACT OF TERRORIST INTERDICTION ON THE FUNDING OF SELF DETERMINATION MOVEMENTS

The inclusion of SDMs in the interdiction of terrorist funds

The impact of the global attempts to curtail terrorist financing and its effect on SDMs is not entirely clear. Many SDMs were placed on a variety of terrorist financing lists compiled by the US, the EU and the UN – although not consistently. Moreover, it is impossible to discern how much effect these indictments have had on self-determination groups and their ability to gain funding. There fact that these initiatives have not had much success against al Qaeda does not necessarily imply less impact on SDMs, because the latter by virtue of their extent and territorial base are easier to detect and thus interdict.

The global war against terrorism has resulted in a blurring of the definition between terrorism and self-determination as many countries have sought to brand their domestic and international opposition in acceptable terms. Since the United States seeks the assistance of allies to stop the flows of money that enable terrorism, it has expanded the scope of thee mission, which was initially limited closely to al Qaeda and its actions. In all, 208 countries and jurisdictions expressed support for the financial aspect war on terror. Of these, 166 have issued orders freezing assets of terrorist organizations – usually including their domestic armed opposition if one exists. [31] The global war on terror is to some extent based on inter-state reciprocity, that is, the US seeks the assistance of other states in its fight against al Qaeda and a possible intervention in Iraq. In turn it is willing to support the anti-terrorist actions of other states.

Initially, the placing of names on the "list" thus concerned al Qaeda and very closely associated groups and individuals. However, then war on terror was expanded: US Undersecretary Gurulé insisted in a congressional hearing that "the president's mandate has been to go after all terrorist groups, not simply Al Qaeda and the Taliban. Our priority has been Al Qaeda, but we have focused as well on other terrorist groups, such as ETA and the IRA."[32] The US willingness to expand the number of enemies can be seen as a side payment to allies or those whom it sought as allies. As long as those allies were willing to participate in blocking resources and sharing of information, the US was willing to add the names of unrelated groups. In the process many groups connected to a wide variety of SDMs were added to the list.

The US and its European allies had different responses to international terrorist groups. US attempts to use extraterritorial powers to stop terrorist financing have made the FATF and the EU impose stricter policies on the freezing of assets and financial sanctions.[33] Initially, the global war on terrorist financing was mainly US-led with little allied involvement. As of April 2002, the US had listed 165 names of groups and individuals out of a total of 192, while Spain had added 21 groups, and the UK, six groups.[34] EU member states were very unwilling to extend the blocking of assets to non-al Qaeda groups – that is. SDMs. EU rules on interdicting terrorist financing require that groups in question be placed on the United Nations list of terrorist organizations, a law that the US has asked its European allies to change.[35]

The interdiction of terrorist financing has clearly had substantial effect on financing of SDMs even though these effects might not have been as focussed on international terrorism as was desired. The US Treasury has announced that terrorist fund-raising is now less efficient.[36] However, these groups still find sources of funds to support their actions. In general, indicted groups have been forced to turn to other, often more illegal sources of funding. Thus, instead of appealing to political supporters, they become more involved in other illegal activities such as drug trafficking and smuggling. Seizure of their assets makes them turn increasingly to other ways of transporting their assets. Thus instead of using banks or even informal means of transferring money, they are increasingly using diamonds and gold to finance their activities. By being driven more underground, it becomes even more difficult for finances to be checked.

The US maintains 4 different list detailing terrorist sponsors. Firstly, the list of states that sponsor terrorist acts. Next, the list of foreign terrorist organizations, which lists 29 of these organizations. While the assets of these groups are frozen and members are likely to be refused entry into the US, the assets of supporters may not be seized.[37] Two new lists, created after September 11, extend the powers of the previous act. The terrorist-financing list consists of a list of groups, individuals and companies involved in conducting and supporting terrorist activities. The assets of any group or individual on this list are to be frozen but immigration restrictions are under the rubric of another list, the Terrorist exclusion list. This list forms a part of the PATRIOT Act and includes suspected terrorist organizations and groups, whose members could be expelled or forbidden from entering the United States.[38]

Six SDMs

Paramilitary groups in Northern Ireland were not initially part of the focus of the financial war on terror, even though some of the terrorist groups were previously banned in the US. On October 31, 2001, the US banned the Real IRA[39]; and on December 31, 2001, five Unionist and republican groups were added to the US financial sanctions against terrorist groups. These included Continuity IRA (CIRA), Loyalist Volunteer Force (LVF), Orange Volunteers, Red Hand Defenders (RHD) and the Ulster Defence Association (a.k.a. Ulster Freedom Fighters).[40] Paramilitary groups such as the IRA, Real IRA, UVF, and UDA are increasingly involved in organized crime to fund their activities. These crimes provide a growing bulk of their resources. A House of Commons committee reported that the IRA and the Real IRA are involved in such activity. In particular, up to 80% of the involvement of the Real IRA on the British mainland is organized crime, rather than terrorist activities per se.[41] In its 2002 threat assessment, the UK government claimed significant progress in disrupting terrorist activity in Northern Ireland. This progress, the disruption of 42 out of 79 criminal groups, took the form of arresting members of these groups and successful prosecution[42]. However, the connection between terrorist groups and other organized crime is concerning. It is possible that illegal activities such as drug dealing, money laundering, and fuel smuggling are being undertaken by larger groups. Nearly half of all organized crime groups are connected with or controlled by paramilitary organizations.[43] Organized crime provides much of the funding for this groups and there are increasing connections between these groups both within Northern Ireland and around the world.

Initially, the LTTE in Sri Lanka were not a part of the US-led global war on terrorism, so they were not included on the new terrorist financing list and not part of the primary focus.[44] The LTTE[45] were listed on October 31 2001. The Tamil Tigers are believed to get a substantial amount of their funding from the Tamil diaspora; in particular, Tamil charities in Canada have been cited for their funding of such activity. The Sri Lankan Government believed that the Tamil population in Canada was the largest source of funds for the self-determination movement.[46] While the LTTE had been banned in the US from 1997, they were only added to the terrorist list by Canada in November 2001. This freezing of assets may be part of the reason why negotiations were finally progressing in the summer of 2002.

In Burma/Myanmar, the ruling junta used the excuse of terrorism to continue to repress the opposition. They used the rhetoric of the global war on terror to continue to sideline the opposition. With the US emphasis on the war on terrorism, less attention has been paid to the issues of drug production and smuggling.[47] The government remains on the FATF list of non-cooperative countries and territories, which includes states that have refused to comply adequately with the FATF efforts to stop money laundering. [48] But since Myanmar is a member of ASEAN and had accepted the ASEAN joint statement on measures to counteract terrorism, it is likely to play a somewhat larger role in the global fight against terrorist financing, but likely using these actions to its own benefit. The United Wa State Army, has been funded by exports of methamphetamine and heroin.[49]

The Turkish Government has also used the framework of international terrorism to continue to limit the funding of the Kurdish self-determination movements. Turkey was one of the few states to have had a specific anti-terrorism law prior to September 2001.[50] At the same time, as a part of its EU candidacy, Turkey has changed its laws, eliminating the ban on Kurdish language and protecting the human rights of Kurds. Some Kurdish self determination groups were already considered to be terrorist groups prior to September 11 and they were some of the first non-al Qaeda groups to be included on the US terrorism list. The PKK earned some of its funding from taxation of drug shipments and the protection of drug traffickers.[51] In October 2001, Dev sol and the PKK were added to the list.[52] Both of these groups had been listed in previous US reports on global terrorism. Additionally, the Eastern Turkistan Islamic Movement (ETIM or ETIP) was added to the US list of terrorist groups on September 3, 2002.[53] In 2002, the PKK changed its name to KADEK and announced that it would reform into a politically oriented group. However, it retained the same leadership and the US government continued to see it as a threat to security and American interests.[54] Thus in December, the US government added three names to the listing of the PKK, the result of cooperation with the Turkish government in other aspects of the war on terrorism and a potential intervention in Iraq. [55]

The Colombian FARC was added to the EU terrorism list in June of 2002, conversely the FARC has been listed as a terrorist organization by the US for many years.
The ELN and the FARC were listed on listed October 31 2001.[56] These SDMs are involved in the protection of drug growers at least and probably production and trafficking as well, so international illegal activity provides the bulk of their funding. The US has given substantial military aid to the Bogota government because in "Colombia the drug traffickers, the terrorist groups and the illegal self defense groups, some of which are terrorist organizations themselves, all carry out the most extreme attacks on society. The two major insurgency groups, the FARC and the National Liberation Army or the ELN have divided the territory and they are carrying out acts of violence against the citizens and public officials. Likewise the paramilitary

members have raised funds through extortion or by protecting laboratory operations in Northern and Central Colombia."[57] The attempts at interdiction of terrorist financing and drug trafficking in Columbia originated in 1995 when an Executive Order imposed sanctions on specific narcotics traffickers. Since then this has affected "over 575 businesses and individuals including 10 drug cartel leaders, 230 businesses, and 335 other individuals. Four of the most notorious Colombian drug cartel leaders were identified in the Executive Order itself…Consequences of sanctions against Colombian drug cartels have been swift, clear and compelling….In May of 2001, more than 60 of these SDNT companies with an estimated annual aggregate income of more than $230 million have been liquidated, or were in the process of liquidation."[58]

There is little evidence to link the SDM of East Timor to "international terrorism", but this is also due to timing since East Timor was already independent prior to the great push against terrorist financing. Other self-determination movements in Indonesia, in particular Islamic groups have been connected to the global war on terror. However, the increased security risk has led to greater concern from Indonesia and Australia, a tendency exacerbated by the 2002 attack in Bali. Australia and Indonesia plan to co-host an international conference on terrorist financing. Indeed, the fight against terrorist financing has been a way for many countries to resume closer ties with Indonesia, after they were broken after the conflict in East Timor. In the summer of 2002, for instance, the US agreed to give Indonesia $50 million to support their fight against terrorism.[59]

In sum, most of the significant SDMs currently active have become subject to the new offensive against international terrorism and by strengthened international police action virtue of their involvement with narcotics. There are some signs that this pressure has been successful in forcing peace negotiations. However, whether lack of access to legitimate (e.g. diaspora) sources of support has forced a reliance on narcotics traffic is a serious issue for the future. It should not be forgotten that SDMs previously considered as 'freedom fighters' supported by the US and Europe such as the Mujadeen in Afghanistan, the Khmer Rouge in Cambodia and the Contras in Nicaragua were actively encouraged to finance themselves in this way.

5. CREATING ECONOMIC INCENTIVES FOR COMPLIANCE

The evidence presented above demonstrates that systemic features of the international financial system make limiting conflict finances very difficult. The reliance on existing international financial monitoring arrangements seemed logical, but failed to learn from the lessons of past failure. Above all, the proposed interventions failed to create positive economic incentives for compliance in order to counteract the existing disincentives for disclosure experienced by financial intermediaries and regulatory jurisdictions. Moreover, even within highly regulated institutional structures, the nature of bank secrecy makes the tracking of transactions difficult. With the growth of the Internet and the increasing impersonalisation of the banking industry, banks find it more difficult to detect suspicious transactions. For many offshore banking companies, their very comparative advantage is in high secrecy and minimal records. As a result, cooperation faces obstacles from all sides. Indeed, governments are often unwilling to share information with banks, expecting instead that banks will act as a conduit for information to the government.

By definition, attempts to exercise some form of regulatory control over hawala systems imply that these informal networks will become either increasingly formalised or they will cease to exist. Either way, any curtailment of the operations of informal MTNs is likely to have negative collateral impacts, and in particular upon marginalised users of these networks who have little or no access to formal financial services. It would not be desirable to close down these systems – even if it were possible - because they help the poor and the small enterprises that provide the bulk of employment. There are two logically preferable solutions: to oblige the formal banking system to provide these services at low cost to migrants; or to extend existing micro-credit systems – which reach these clients at the local level in developing countries – to the international level by recognising them as correspondent banks.

In sum, there is no strong economic incentive for financial intermediaries to comply in reporting dubious transactions as the probability of conviction is low and fines small. There are strong incentives for non-compliance as the sums of money involved are large and costs of monitoring are substantial- especially is high-wealth clients value secrecy highly. It is thus necessary to internalise the externalities caused by non-compliant institutions and jurisdictions, and make it unprofitable for them to handle these transactions – or at least to make it so expensive that the resources available to criminals and terrorists are significantly reduced thereby.

A logical solution to this problem could be to shift from the present 'blacklist' system such as that administered by the US Office of Foreign Assets Control to an equivalent 'whitelist' system based on persons or firms registered for tax purposes (and thus monitored) in OECD countries and qualified emerging markets. Transactions with compliant jurisdictions (that is, one sharing full information with OECD member countries) made by persons or firms not properly registered for tax purposes would then be subject to a substantial withholding tax.[60] This would create a strong incentive against dealing with unregulated agents. This would have three strong positive effects: first, it would make handling unregistered funds unprofitable – or at worst cost criminals a great deal to transact, reducing their liquidity and eroding their assets. Second, the process of levying the tax would provide a steady information flow on the pattern of payments not now available. Third it would mean effective closure of tax havens and a large increase in fiscal resources for both developed countries (to balance increased security expenditure) and developing countries to reduce social disparities. The European Community proposal for the taxation of cross-border interest payments, the 'withholding tax directive', is a precedent that shows that a measure of this nature is politically and administratively feasible (EC, 1998).

The concern of OECD members to coordinate measures against tax evasion, avoidance and competition between themselves – and the resultant pressure on offshore centres – has until now been based mainly on concern for their own tax bases. To extend such cooperative measures towards the main emerging markets would be a logical and technically feasible step, particularly since there are strong economic arguments for imposing withholding taxes in order to short-term financial flows (Zee 1998). On more general grounds, the leading scholar of international tax economics argues that the time has come for the establishment of a 'world tax organisation' that would not impose or collect taxes, but rather support national authorities by exercising surveillance on tax systems worldwide; resolving disputes on tax competition and developing codes of conduct for tax administration (Tanzi, 1996). Supporting the interdiction of criminal and terrorist funds would be a powerful additional justification for an overdue international reform.

However, this would leave SDMS in an anomalous position. Clearly incumbent states (and some other regional or international powers) have a vested interest in declaring internal opposition illegal, particularly when armed conflict is involved. If this is automatically ratified internationally, then oppressive regimes are reinforced and genuine self-determination becomes virtually impossible – despite being enshrined in the UN Charter. Some procedure is probably needed for 'recognising' SDMs in the way that belligerents are recognised in the international law relating to war. There is some precedent for this approach in cases such as the admission of the PLO to observer status at the UN. Until this issue is resolved, self-determination movements will continue to be drawn into international criminal activity.

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Endnotes

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3 These limitations illuminate the implicit contradiction inherent in this process: intelligence work is generally conducted in secret, but to restrict terrorist financing the authorities have to inform the public because interdiction is implemented through the market. While almost all states have accepted this responsibility, they lack the resources or the interest for substantial implementation. Thus, the greatest amount of information can be found on the US Treasury's Financial Crimes website, followed by the UK Treasury. Conversely, other countries, including other members of the G7 such as France, appear much less involved in dissemination.

4 More details about the Wolfsberg Group can be found on http://www.wolfsberg-principles.com.

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[60] At, say, 25 percent of the gross transaction – which is the retention tax levied presently within the EU for fees paid to non-residents.