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Appropriate Measures to Use Money Laundering Prevention as an Antidote to Tax Evasion

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Money laundering, which is closely linked with tax evasion and informal trade, is facilitated by the poorly regulated financial institutions of "mafia nations." These nations make billions of dollars by laundering money and giving safe haven to drug dealers and corrupt politicians, allowing them to transfer money globally. Money laundering prevention policies require financial institutions to periodically update their customer's personal information. Furthermore, they attempt to match tax and transaction reports collected from banks and non-

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banks around the world to detect tax evasion. This research explains how efficient policies for preventing money laundering can help reduce tax evasion.

I. Introduction

We live in an increasingly globalized economy, which is characterized by innovation and technology, market integration and the emergence of new economies. The opening of borders for free trade has introduced a new way of making business. As the world financial systems become more interrelated, the movement of capital between countries is becoming more constant, intensive and instantaneous. Electronic transactions have made trade, finance and large investments easier, facilitating the development of international business (da Costa, 2001). Nonetheless, the harnessing the tremendous potential of these new changes involves important changes, especially in the financial sector.

For example, integration and technology facilitates the evasion of taxes by companies, the laundering of profits obtained from crime, and corruption (Agarwal and Agarwal, 2004). As the later is a constant variable in our society, it makes it very difficult to prevent money laundering and fight tax evasion indexes. Moreover, it is important to consider that even when efforts to combat money laundering and tax evasion are being increased, corruption is not receding. This adversely affects the effectiveness of any prevention policy and program.

This research explains how efficient policies for preventing money laundering can help reduce tax evasion.

The increasing amounts of corruption is revealed by the following figures which show the corruption levels in different countries and regions, as calculated using the International Transparency (the only worldwide non-governmental organization dedicated to combating corruption) methodology. The figures reflect the perception of the corruption level according to entrepreneurs, academics, and analysts. The values range from 0 (highly corrupt) to 10 (highly clean).

The remainder of the paper is organized as follows. Section II provides an overview of the main issues discussed in this paper: corruption, tax evasion, and money laundering. Section III discusses the current money laundering legislation in the Unites States of America and in Mexico. Section IV analysis how this legislation can potentially be used to combat tax evasion and money laundering. Section V concludes.

II. An Overview of Corruption, Tax Evasion and Money Laundering

II.1 Corruption

Corruption strongly hinders economic development. It erodes confidence in public institutions. It distorts decisions on macroeconomic, monetary and financial policy, which adversely affects public revenues, and discourages private investment. Moreover, it distorts public sector expenditure, damaging the government credibility by eroding confidence from both, tax payers and private investors. Thus, it is evident that corruption obstructs the mission of our finance ministers – economic growth and development. However, unfortunately, they have not been traditionally considered as part of the front line to combat corruption.

Shleifer and Vishny (1993) show that weak governments that do not control their agencies experience very high corruption levels, and that the illegality of corruption and the need for secrecy make it much more distortionary and costly than its sister activity, taxation. These results may explain why, in some less developed countries, corruption is so high and so costly to development (see also Shleifer and Vishny, 1999). Glaeser, Scheinkman and Shleifer (2003) shows that in many countries, the operation of legal, political and regulatory institutions is subverted by the wealthy and the politically powerful for their own benefit. This subversion takes the form of corruption, intimidation, and other forms of influence. They illustrate the model they construct with historical evidence from Gilded Age United States and the transition economies of the 1990s. They also present some cross-country evidence consistent with the basic prediction of the model (see also, Shleifer, 2004).

Goel and Nelson (2005) use an index of corruption, to examine the determinants of corruption for a large sample of countries. Specifically, they investigate whether economic freedom or political freedom serves as a deterrent to corrupt activity. Does greater economic freedom or greater political freedom yield a more "clean" society? They conclude that greater economic freedom seems to matter more in this regard. The authors Examine different components of economic freedom and find that not all these components are equally effective in reducing corruption. For example, monetary policy seems to have a stronger influence on the level of corrupt activity in a country than fiscal policy.[1]

Corruption is actually instigated by the recent proliferation of non-transparent financial procedures, excess regulations, as well as poorly trained or low-paid public officials. Furthermore, the lack of competition in the financial sector along with corruption, adversely affect the distribution of private capital, facilitating the emergence of money laundering and fiscal evasion; this makes the financial system more vulnerable.

Thus, this research intends to explain how efficient policies for preventing money laundering can help reduce tax evasion.

For instance, among the Latin American and Caribbean countries, Chile ranks as the least corrupt country in the region, while Mexico stands in 64th place. At the same time, the region of Latin American and Caribbean nations is the second most corrupt in the world.

II.2 Tax Evasion

Tax or fiscal evasion refers to the elimination or diminution of a tax amount produced within a country by those who are legally obliged to pay it, and who achieve this goal by means of fraudulent activities or with the omission and violation of legal provisions. For a country to meet the collective public needs and its institutional, social, and political aims, it needs financial resources. These resources are obtained through exercising its tax power originating from its own sovereignty, from the usufruct of the state's goods, and through indebtedness from public credit. Therefore, from the point of view of revenue from taxes, the absence of this revenue source causes significant fund insufficiency in state coffers which support the basic functions of the state. Hence, tax evasion constitutes a phenomenon that, besides eroding the government revenues, deteriorates the social and economic structure of the country, causing an inefficient resource allocation system and hurting the government's legitimacy (see, for example, Slemrod, 1998, and Slemrod and Yitzhaki, 2002).

Slemrod (2004) offers an economics perspective on tax evasion and abusive avoidance done by corporations. The paper reviews what is known about the extent and nature of corporate tax noncompliance and the resources devoted to enforcement. It then addresses the supply side of aggressive corporate tax planning--the industrial organization of the tax shelter industry--as well as the demand for corporate tax evasion and abusive avoidance, focusing on how the standard approach to tax evasion needs to be modified when applied to public corporations. It then discusses the implications of a supply-and-demand approach for the analysis of the incidence and efficiency cost of corporate income taxation, and the very justification for a separate tax on corporation income. The paper also addresses policy proposals aimed at increased disclosure of corporate tax activities to both the IRS and to the public.

The obvious way of reducing tax evasion would be to improve supervision of tax authorities over institutions and companies, both formal and informal, which generate wealth in a country. This supervision must be strict, respecting the principles of tax equality and equity.

The significance of tax evasion is illustrated by the recent estimate by the Servicio de Administracion Tributaria (SAT, Tax Administration Service, which is a decentralized organization in charge of collecting the country's federal taxes) that tax evasion in Mexico was equal to almost 4% of the country's GDP in 2004, with evasion in Value Added Taxes and Income Tax each amounting to 2% of GDP. Consequently, if tax evasion were eliminated tax revenues would increase to about 16% of GDP.

Tax evasion is significant in Mexico due to the following weaknesses within the Mexican tax framework:

1. rates differentiated from VAT with easy arbitrage
2. special regimes
3. unnecessary complexity in Income tax calculation

Therefore, tax evasion cannot be reduced through a single policy. Multiple short and long term actions would be required, with the most effective ones being the reduction and simplification of administration, and the increase of information about current and potential tax payers.

In Mexico, for instance, the collection from VAT is only 3.5% of GDP, which is much lower than the average of 6.6% in OECD countries and 5.5% in Latin America. Additionally, according to international sources, the informal economy indicator for Mexico ranges 30% to 50%. Thus, if the informal trade percentage were to be applied to the 8 million tax payers in SHCP 's (Ministry of Finance) database, the active tax payers' SAT database would swell to, at least, 10, 400, 000.

This significant statistic shows that the Mexican economy would gain tremendously if the economic resources from the shadow economy were invested or saved in national financial institutions (see in this regard, Choi and Thum, 2005) Thus, it is imperative that the tax authorities in Latin America use the anti-money laundering information generated by the financial sector to stop tax evaders.

II.3 Money Laundering

Money Laundering is defined as the process by which the existence of an illegal source or use of income derived from illegal activities is hidden so as to make that income seem legitimate. It is estimated that total money laundering amounts to nearly 2% to 5% of the world Gross Domestic Product.[1]

Agarwal and Agarwal (2004) study the extensive money laundering in the banking sector, claiming that electronic transfers greatly facilitated and magnified the scale of international money laundering through banks. They conclude that the international scale of money laundering needs to be assessed by the IMF and World Bank through a more comprehensive and integrated approach. Da Costa (2001) addresses the issue of how small and medium-sized companies can use the Internet as a tool for reaching new markets and for improving service in the markets where they are players already. He discusses the growing worldwide importance of small companies and provides background on the information industry and the Internet economy across national borders. Da Costa (2001) presents a vision of a future in which small companies will have a much larger share of economic activity worldwide, and where business and consumers will organize themselves into virtual communities. Although he does not specifically address the issue of money laundering, it seems that the increased use of the internet greatly facilitate such illegal activities.

De Boyrie and Zdanowicz (2005) study the impact of Switzerland's money laundering law on the movement of money through false invoicing in international trade between the US and Switzerland during the period 1995-2000. The study supports the view that individuals and companies will find substitute techniques and channels to launder money when central banking authorities enact legislation that only focuses on financial institutions.

Levi (2002) examines the definitions of "money laundering' and the role its regulation plays in dealing with drug markets. He claims that prevention of laundering would reduce incentives to become major criminals, as he discusses the laundering techniques used with drug money. He also confirms the impact of anti-laundering efforts on enforcement resources, organized crime markets, and drug consumption.

Masciandaro (2005) theoretically discusses and empirically tests the relationships between specific country features, policymaker choices, toward tax financial regulation and national non co-operative attitude with respect to the international effort to combat money-laundering phenomena. Schneider (2004) examines how the financial proceeds of organized criminal activity are laundered through the Canadian real estate market. He believes that real estate can be used as a monetary laundering vehicle as a host of mechanisms commonly used with real estate transactions can frustrate efforts to unearth the criminal source of funds, such as nominees, fake mortgages, solicitor-client privilege, and legal trust accounts.

Swamy (2000) presents detailed case studies of money laundering in Russia (focusing on capital flight) and in Nigeria (focusing on the collapse of the London-based Johnson Matthey Bank) and proves that the exercise of preparing conventional financial statements year after year by accountants for companies/organizations is a theoretical exercise in futility. She, subsequently, comes out with a new approach to financial statements analysis to fit into real business life situations.

Money laundering has severe adverse economic consequences for a country such as: variations in monetary demand and interest rates, exchange rate volatility. Moreover, tax collection is adversely affected and public resources are misallocated as registration information is forged, confidence in financial markets is eroded and the design of public policies is distorted. Moreover, since money laundering has become an international problem, organizations such as the UN and OECD have initiated important efforts to combat it.

For instance, the Grupo de Accion Financiera (GAFI, Financial Action Task Force) was established by the G-7 Summit held in Paris in July 1989, with the aim of assessing the measures taken to combat money laundering. In 1990, 40 recommendations for combating money laundering were issued, and so far, 9 special recommendations have been issued for combating terrorism funding (Huizinga, 2002).

Mexico is one the 33 GAFI members, starting as an observer in 1999 and acquiring full status as a member in 2000.

The 40 recommendations from GAFI are divided into 4 categories:

1. Measures that must be taken by legal systems.
2. Measures that must be taken by financial institutions and non-financial professions and activities to prevent asset laundering and terrorism funding.
3. Institutional measures in bodies assigned to combating asset laundering and terrorism funding.
4. International co-operation.

Similarly, the Grupo de Accion Financiera Internacional (International Financial Action) works with various governments to develop policies to combat money laundering and terrorism funding at a national and international scale. Also, a group of major banks of the world has approved a set of guidelines against money laundering, known as Wolfsberg's Principles, to be applied by the international private banks. These new guidelines were jointly announced on October 30, 2000 by 11 banks.

Additionally, there are also some guidelines issued by the Basel committee, formed in 1975 by the presidents of the central banks of the participating ten countries, to increase co-operation between banking supervision authorities. These nations include Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Sweden, Switzerland, the United Kingdom.

In April 1997, the committee published Principios Basicos para la Supervision Bancaria Efectiva (Basic Principles for Effective banking Supervision), a document outlining 25 principles which need to be implemented by banking and public authorities in all the countries in order to achieve an effective supervision society. The Basel committee members and the 16 banking supervising agencies that participated in producing this document have already implemented these suggestions. In January 2001, the Basel Committee on Banking Supervision also issued a report establishing a program about customer knowledge, the best defense a bank can have against launderers and other financial crimes.

Taking into account the abovementioned definitions and concepts, we can claim that in general, tax evasion involves hiding or disguising legally earned money in order to prevent it from being transferred to the Treasury. That is, legal money is made illegal. On the other hand, money laundering consists of generating revenue illegally and hiding or disguising them in such way that they seem to be legitimate. That is, illegal money is made legal.

Although both concepts have opposite effects on the legitimacy of money, it has been suggested that efficient policies for preventing money laundering can help reduce tax evasion. Nonetheless, it is important to first discuss the policies implemented by some countries such as the United States and Mexico to combat money laundering.

III. Money Laundering Legislation in the United States and in Mexico

III.1 Money Laundering Legislation in the United States

In 1986, the United State enacted Title 19, U.S. Code Sec. 1956, making it the first country to pass legislation recognizing money laundering as a crime. Since the law applies to much more than just drug trafficking cash proceeds and carries heavy penalties, it is extensively used by federal prosecutors.

The Figure 1 is a brief description of how this powerful law works and how it relates money laundering and tax evasion.

The events of September 11, 2001 renewed attention towards money laundering activities around the world. The USA, in particular, has reinforced its policies to combat money laundering. They have made important modifications to the Bank Secrecy Act (BSA) and the Money Laundering Laws (MLL) through the Patriot Act, making it world's most advanced legislation in preventing money laundering. The force and international scope of this act makes it the most powerful law since the times of Franklin D. Roosevelt.

The chief aims of these measures were:

1. Regulating the money transmitters.
2. Requiring the compliance of some standards by non-financial trade or business, including jewelry sellers, real estate agencies, and car, plane and vessel dealers.

3. Detecting suspicious operations.
4. Establishing the minimum guidelines for programs against money laundering.
5. Detecting the source and/or ownership of the funds coming from illegal activities.
6. Legally preventing, detecting and processing international money laundering practices, as well as terrorism funding.
7. Regulating both, financial sector and non-economic enterprises, which are susceptible to money laundering.

The US law has an extraterritorial reach if the offense is committed by a U.S. citizen or by a non-U.S. citizen who conducts at least part of the offense in the U.S. and if the transaction involves more than $10,000. In addition to its heavy criminal penalties of up to 20 years in prison and $500,000 in fines, the law permits civil penalty lawsuits by the government for the value of the funds or property involved in the transaction.

III.2 Money Laundering Legislation in Mexico

By the decree published in the Official Gazette (DOF, for its acronym in Spanish) on December 28, 1989, article 115 BIS to the Fiscal Code of the Federation was added. In it, they have typified the behavior of money laundering as a tax nature crime. This was applied from 1989 to 1996. On November 17, 1995 modifications were made to the Credit Institution Act, the Exchange Act, General Act on Organizations and Auxiliary Credit Activities, General Act on Insurance Mutualist Institutions and Corporations, and the Federal Act on Guarantor Institutions. These modifications had the aim of enabling the SHCP to dictate general provisions for preventing and detecting acts or operations with resources, rights or goods that proceeds or represent the product of a likely crime.

The article 400 BIS from the Criminal Code was later modified (through a Decree published in the DOF on May 13, 1996) in order to define the crime which involves carrying out operations with illegal origin resources. This type of crime was formerly considered in article 115 BIS from the Fiscal Code of the Federation. Furthermore, article 180 from the Criminal Code and its modification establish the information or document requirements in relation to the financial system, formulated by the PGR (Attorney General of the Republic) or any other judiciary authority. These policies would be implemented through the National Banks Commission (CNBV) and Insurance Commission (CNSF), as may be the case.

In the same decree, article 194 from the Federal Code of Criminal Procedures was modified in order to establish money laundering as a serious crime. This is provisioned in article 400 BIS of the Criminal Code. This qualification does not give the defendant the right, during previous investigation or during the process, to be provisionally free under parole. Moreover, Article 9 requires that when Federation Attorney investigates activities of members from organized crime related to the crime of operations made with illegal origin resources (money laundering), they do so in co-ordination with the SHCP (Ministry of Finance). Furthermore, in order to prevent any activity related to articles 139 and 400 BIS from the Federal Criminal Code, a decree was released on January 28, 2004 in the Official Gazette of the Federation regarding the punishments applied to money laundering and terrorism. This decree modifies and adds several provisions for several institutions belonging to the financial sector.

On May 14, 2004 SHCP released the General Provisions applicable to the following Acts:

- Ley de Instituciones de Credito (Credit Institutions Act)
- Ley de Ahorro y Credito Popular (Popular Credit and Saving Act)
- Ley de los Sistemas de Ahorro para el Retiro (Saving System for Retirement Act)
- Ley Federal de Instituciones de Fianzas (Federal Act on Guarantor Instituions)
- Ley General de Instituciones y Sociedades Mutualists de Seguros (General Act on Insurance Mutualist Institutions and Corporations)
- Ley del Mercado de Valores (Exchange Act)
- Ley de Sociedades de Inversion (Investment Corporations Act)
- Ley General de Organizaciones y Actividades Auxiliares del Credito (General Act on Credit Auxiliary Organizations and Activities

This would allow all the financial institutions included in the previous acts to strengthen their measures and procedures for detecting funds from illegal activities that could be introduced into the financial system.

The main aspects established by the federal government are the following:

- Financial institutions are compelled to aim to prevent and detect acts regarding money laundering.
- Informing the authorities about any activity or link established with customers classified as high-risk. This includes politically exposed people.
- Establishing a policy for knowing and identifying the customer.
- Creating a Communication and Control Committee that would analyze every internal procedure.
- Appointing a Compliance Official, who will be in charge in assessing the correct functioning of internal procedures.
- Training the staff of the institution for detecting and preventing illegal origin resources.
- Systematize the procedures for identifying fragmented operations that are higher than the limits established for each institution.

Civil punishments for violating General Provisions amount to almost 100,000 days of S.M.G.V. (4.5 million pesos, approximately) and the criminal ones range from five to fifteen years of imprisonment and from 1,000 to 5,000 days of fine (SMGV).

IV. Combating tax evasion through money laundering prevention policies

There are substantial similarities between the techniques used in tax evasion and those used in money laundering. The use of artificial arrangements and offshore financial centers are common to both, money laundering and tax evasion. Therefore, various regulatory systems have been designed to facilitate the information between tax and anti-money laundering authorities at the national level. Among OECD countries, for instance, there are information sharing procedures between tax and anti-money laundering authorities.

In May 1998, the G7 Finance Ministers encouraged international actions to enhance the capacity of anti-money laundering systems to deal more effectively with tax related crimes, as well as to deal with the provision of money laundering information to tax authorities in order to support the investigation of tax related crimes such as tax evasion. Thus, we can assert that combating tax evasion involves simplifying processes and making information more timely and reliable. Information for money laundering prevention, by law, has to provide the authorities of financial intelligence with the financial agents in Mexico. This information would therefore, help fiscal authorities to combat tax evasion.

The next few subtopics discuss some fundamental points that are part of a review or an audit regarding money laundering prevention and then go on to elaborate how this information could be used by fiscal authorities in order to reduce tax evasion indexes.

IV.1 Customer Knowledge and identification.

Customer knowledge is the core of any effective anti-money laundering program. It is important to differentiate between customer identification, which simply consists of requesting information or documentation accrediting the identity of anybody who intends to make any financial operation. Customer knowledge, similarly, consists of conducting a deeper analysis of the background, occupation and transactional behavior of the customer, with the aim of identifying possible unusual or suspicious operations.

With respect to customer identification, Mexican authorities require that financial institutions request their customer's personal information before engaging in any financial operations.

For instance, for individual customers would be required to submit important information such as business activity or field, occupation, CURP (Unique key for Population Registration) and RFC (Federal Tax payers' record). Customers are also required to submit a personal ID, CURP document and Fiscal Identification Card to the financial institutions.

Similarly, Mexican corporations also have to mention their trade field, date of establishment and their RFC. These corporations are also required to submit a testimony or a certify copy of the by-laws registered in the Public Registry of Trade, Fiscal Identification Card and a document verifying their permanent address.

Foreigners wishing to open deal with financial institutions have submit a copy of their passport and a legalized copy with apostille of the document verifying their legal existence. Correspondingly, federal, state and municipality public entities and agencies integrating the financial system have to submit their RFC and a testimony (or a certified copy) of the instrument containing the powers of the legal representatives.

This type of information would be really useful for a tax audit, since the authority would have the updated and accurate information from some national or foreign economic agent, either an individual or a corporation. However, customer identification is not enough to prevent money laundering. In a review regarding prevention of operations with illegal origin resources, it is verified that financial institutions conduct deeper analysis of the background of their customers as it is essential to know the background, occupation and transactional pattern of those who try to carry out operations with outstanding amounts.

Firstly, it is necessary to establish that one of chief constituent of customer knowledge is information about the origin of the funds with which they operate. However, this is a cumbersome process involving in-depth analysis of the activities carried out by customers, regular submission of documentation and operation monitoring. A useful variable employed by financial institutions for monitoring their customer transactional behavior is "Preferential Product" – products that are preferred by customers to carry out their operations. Thus, when these preferential products are analyzed in financial institutions, abnormalities can be detected in the customer transactional pattern, thereby identifying unusual or suspicious operations.

An example of such an analysis is shown in the table below. The analysis involves determining what products are the most widely used by customers of a financial institution. This information could therefore, facilitate the detection of a potential tax payer who is in the informal sector, but who has transactions amounting to thousands of dollars throughout the financial sector of a country.

Thus, this analysis of 'preferential treatment' can help fiscal authorities to detect tax evasion, since tax payers that evade paying taxes generally make financial transactions without informing the fiscal authority about the profit generated by them.

In this sense, knowing the customer entails much more than just having identification documents. The money laundering prevention acts compel financial institutions to record the origin of the funds and the characteristic of the operations of their customers. This information allows the fiscal authority to know if a tax payer is having making multi-million dollar financial transactions while their financial statements are non-existent.

With the possibilities of forging information and documentation in underdeveloped markets, customer knowledge requires transcending a simple identification, making it necessary to monitor customer's transactions in order to be able to detect unusual or suspicious operations. This information is highly useful for tax authorities in planning or leading tax audits.

For instance, some of the variables that financial institutions should analyze during the process of acquiring customer knowledge including considering the purchase volume per type of client and the sales volume per type of client. For the analysis of purchase volume per type of client, corporate individuals account for 45.76% of the volume, banks 27.22%, money exchange houses 14.61%, individuals 4.94%, brokerage houses 3.64%, foreigners 3.29% and the intermediaries, AE individuals making up the remaining 0.55%. Similarly, for sales volume per type of client, corporate individuals make up 48.07%, banks 24.71%, money exchange houses 15.18%, individuals 4.64%, brokerage houses 3.62%, foreigners 3.26%, with the intermediaries and AE individuals making up the remaining 0.51%.

With the information obtained from Figures 2 and 3, financial institutions can determine what sector of what type of customers stand out due the scale of their operating volume. This information would be highly useful for tax authorities, since they might be able to compare it against their tax databases and determine if there is connection. If no connection is established, tax authorities would have a reliable indicator to carry out a more accurate and thorough fiscal supervision. This would allow them to detect if even a tax-paying customer is reporting profits lower than the real amount, and thus evading the correct tax payment to the Treasury.

For instance, many tax payers, individuals and corporations, estimate the amount of tax they are going to pay as part of their fiscal planning at the beginning of the year. Consequently, they manipulate their accounts so that they only have to pay the 'target' amount of taxes. They for loopholes in the Fiscal Law so that if they have higher than estimated profits, they can invest in increasing business assets instead of reporting an increase in business profits to the tax authorities. Thus, the Federal Fiscal Audit of a country must gather financial intelligence to prevent tax evasion. Nonetheless, having financial information needs to be current in order to effectively combat money laundering and tax evasion. Therefore, once policies and procedures of customer identification and knowledge are established, it is essential that such information is updated periodically. For instance, the Mexican Law regarding money laundering prevention requires financial institutions to update information about customers, especially when significant changes are detected in the usual transactional behavior or whenever authorities raise doubts over the authenticity of such information or documents.

This information can help the fiscal authorities to detect the real address of a tax payer, since generally; evasive tax payers (mainly corporations) use fictitious addresses to simulate the real field and location of business. This is done to deceive tax regulators so that once a company address is not found it is deleted from the tax payers' database. This process is facilitated by the fact that the people who verify the fiscal address who are hired by the SHCP are temporary employees and do not earn more than the minimum salary. Therefore, they are easily bribed, as they enter false information into the SHCP databases in exchange for an economic remuneration. This sets a vicious circle in motion as tax evasion becomes worse. When there are no strict fiscal regulations, the authorities themselves cannot trigger the administrative execution procedure required for a tax audit.

IV.2 Operation prevention, identification, analysis and report.

According to FATF's 13th recommendation, if a financial institution suspects or has reasonable grounds to suspect that a customer's fund are coming from a criminal activity, it should be required (by law or regulation) to report its suspicions promptly to the financial intelligence unit (FIU). The purpose of the abovementioned regulation is to report known or suspected violations of law or suspicious activity observed by financial institutions. In many instances, these reports have been instrumental in enabling law enforcement to initiate or supplement major money laundering investigations and other criminal cases. Information provided in these reports also allows authorities to identify emerging trends and patterns associated with financial crimes. These trends and patterns are vital to law enforcement agencies and provide valuable feedback to financial institutions. The information generated from the suspicious or unusual activity report filings plays an important role in identifying potential illegal activities and assists law enforcement in detecting and preventing the flow of illegal funds through the financial systems.

In Mexico, the laws in force require that financial institutions issue reports to the competent authorities about the operations that could be considered as 'relevant' or 'unusual'. Relevant must be understood as an operation carried out for an amount equal or higher than the equivalent in national currency of 10,000 USD (3,000 USD for exchange centers) daily per customer, in any of the monetary instruments specified in the law. An 'unusual' activity is any activity, behavior or conduct that does not match with the background or activity known or stated by the customer (and for which the customer has no reasonable justification), or with his usual pattern of transactional behavior, in terms of the amount, frequency, type or nature of the operation in question.

Information concentrated in the unusual or suspicious operation reports can also be obtained by a fiscal authority as they record relevant information about individuals or corporations who are carrying out operations with large amounts or transactions that are beyond their usual transactional pattern. This behavior should be known by fiscal authorities in order to determine if tax payments correspond to the transactional activity or behavior of the reported subjects, thereby allowing the detection of possible tax evaders.

IV.3 Record and preservation of customer information and transactions

Financial institutions must keep necessary records about national and international transactions (chronological, alphabetical, etc.) with the aim of generating and auditable trace of the customer documentation and his transactions. This would allow them to respond efficiently to the requirements from the competent judiciary or administrative authorities as it would be possible to rebuild a certain transaction whenever necessary. According to the international and legal standards, banks and other financial institutions are required to preserve, for at least five years, documents accrediting the execution of operations and the identity of the people who may have executed them, or who may have had business relations with the institutions.

The Mexican legislation requires that personal information and documentation about customers, as well as their respective transactions, are kept for a period no shorter than 10 years from the last transaction made. Information and documentation preservation periods match those required by fiscal authorities, thereby providing sufficient physical evidence in the case that it is required to start a trial against any tax payer.

IV.4 Information requests by authorities

The SHCP has the authority to require financial institutions to make modifications to their policies of customer identification and knowledge, and the criteria, measures and procedures that they have made according to what is foreseen in the Law. The SHCP by means of the Corresponding Commissions and the Tax Administration Service (SAT), in the exercise of the supervision faculties conferred by the law, would supervise financial institutions (including its offices, branches, agencies, affiliates and establishment, both in the national territory and abroad). Under the regulations established in the law, these institutions would be required to provide the SHCP with all the information or documentation necessary for developing its faculties at any given moment. Therefore, cases in which subjects under obligation submit incomplete or incorrect information (or when the electronic media do not comply with the specifications indicated by the SHCP), the subjects could face punishments or sanctions for non-compliance. Financial institutions would also submit the following documents and information to the SHCP:

- Official name of the financial institution
- Owner's name or in its case, of the main stockholders.
- Address of their offices, establishments or branches where operations are made.
- Name of administrators or factors.
- Copy of the Fiscal Identification Card.

This information should be updated at least once a year in the sequence determined by the SHCP.

The core of this section refers to the fact that the SHCP, along with the subsidiary Financial Intelligence Unit (UIF) and the Tax Administration Service, and the body in charge of conducting fiscal reviews and audits should be able to share information about the current and potential tax payers. This would allow the internal transfer of information about the customers of the financial institutions and the current tax payers, into the SHCP database.

IV.5 Proper technological media for preventing, detecting and reporting operations with illegal origin resources

One of the fundamental aspects that an effective money laundering program must have is that financial institutions must implement the proper technological systems that can help them detect operations with illegal origin resources. The automatic procedure of the information that produces alert indicators or red lights is essential for money laundering prevention, since financial institutions may have a supporting tool that allows them to get information about customers and their operations, making records, filing information, monitoring their customers' transactions an dmaking reports. Currently, authorities require that financial institutions issue reports on the operations of those customers who carry out unusual or suspicious transactions, as well as of those who operate with relevant or large amounts, electronically. In Mexico, financial institutions must do this through the official format or "layout" issued by the Mexican Financial Intelligence Unit (UIF).

The information in the power of the competent authorities when receiving such reports can be highly useful for fiscal authorities, since these reports concentrate the information of customers who are operating suspiciously or unusually, or who are making transactions for large amounts. This could be an important alert signal for fiscal authorities; as such information might be compared with the tax databases, with the aim of determining if, apart from that, there are no irregular aspects or omissions as for tax payment. The official layout contains information such as: personal information of who is making the operation address, the kind of operation that was done, the monetary instrument used, account number, the operation date, a brief description of the operation, among others.

IV.6 Risk Analysis of customers

International recommendations suggest that any money laundering prevention program must be made based on the risk level that the institution is facing as the institutions face the possibility that their customers may carry out acts or operations that could assist in money laundering crime. Thus, an important international recommendation is that financial institutions must periodically verify the lists issued by organizations such as the OFAC, CIA, FBI and PGR before making frequent operations and/or of significant amounts with a current or potential customer. This is done in order to know his background, identify risks and prevent making operations with people linked to criminal organizations. Moreover, in order to determine the risk level more accurately, it is essential to verify the list of non-cooperating countries and territories issued by the Financial Action Task Force (FATF) with the aim of identifying such customers coming from territories considered as high risks, as well as from those territories considered as fiscal paradises.

The Mexican legislation, for instance, requires institutions to classify customers according to risk degree, high risk and low risk. The institutions can choose to establish further intermediate risks levels. It is also recommended that financial institutions make a money-laundering potential risk matrix which includes key variables that help to profile their customers. All potential and current customers must be filtered through this matrix before making any operation. Such a risk level analysis of people operating through the different financial institutions can be really useful for fiscal authorities as it allows the authorities to make all the audits necessary to determine if the customers identified as high risk are paying the correct amount of taxes (as determined by their activity, business field, geographic location, and type of operations made). Therefore, risk collections would make the detection of tax evaders more efficient.

IV.7 Audits

Within the GAFI recommendations, it is suggested that financial institutions develop programs to combat asset laundering and terrorism funding. This would involve setting up an audit function to test the correct implementation of policies and procedures regarding prevention, detection and reporting on operations with illegal origin resources. This type of audits may include a section in which fiscal aspects shall be verified, in order to determine if the tax payments are being made correctly.

Auditing is one of the chief methods of detecting tax evasion. Therefore, it is imperative to identify impacts that audits may have on the tax payers' payment availability. Similarly, it is possible to estimate the current probability of a person, individual or corporation, being audited. It is necessary that tax authorities consider the way in which audits are conducted. The auditing process must be highly focused and must be accompanied with random reviews as this influences the tax payer's perception of the probability of him being detected. Thus, when the probability of being audited is low, the tax payer is more likely to evade taxes. On the other hand, anti-money laundering programs, through the risk analysis conducted by financial institutions, would be able to identify those tax payers who need to be audited. Thus, it serves as an effective measure to combat tax evasion.

IV.8 Frequency and amount of operations

When reviews or audits are conducted, some of the information requested is the daily record of operations corresponding to a specific period as part of the program to combat money laundering. These records include purchase and sales-related information, number of operations, transfers and profits derived from services rendered by the financial institution. This information can be really helpful for fiscal authorities as they can use it to determine the transactional pattern of a financial institution, its input and output flows and the profits for which they must be paying the corresponding taxes.

V. Conclusion

A country must combat money laundering, terrorism and tax evasion to facilitate economic growth and development. Tax evasion may occur for several reasons:

1. Overly confusing and complicated tax legislation.
2. Certain territories have informal trade tendencies and, therefore, carry out most of their transactions in cash. This makes it easier to hide the actual trace of the number of transactions made and the amounts involved.
3. Inefficient and obsolete revision and enforcement mechanisms.
4. Lack of information regarding the taxpayer's fiscal address and whether any given

A high money laundering index in a territory is an indicator of the lack of appropriate controls set forth by the judicial authorities. Crimes such as drug dealing, child prostitution, organ trafficking, corruption, fraud, piracy and bootlegging, smuggling, extortion, public fund diversion are committed with the intention of usufructing the revenue derived from them. As a result, money laundering prevention provides a non-judicial way of combating crimes which affect society in general.

Terrorism and money laundering are chiefly combated through the establishment and management of databases containing detailed information about persons and businesses. These databases include knowing the financial management of accounts, providers and customers, as well as the transfers through financial enterprises. This information is gathered by legal means and may be used by fiscal authorities to cross financial information with tax declaration databases, opening up the possibility of correctly addressing fiscal audits. This solves fundamental problems such as the lack of updated and reliable information of businesses or persons which avoid making their federal contributions.

Money laundering is like water as it follows the path of least resistance. Therefore, it is essential that all countries are committed to combat organized crime, financial and non-financial, and establish effective policies to prevent money laundering.

Furthermore, tax audits play an important role in decreasing the incidence of tax evasion, as they take into consideration that if the probability of being audited is low, businesses are more likely to underreport their income or exaggerate their tax deductions, using transfer pricing methods to evade taxes. Additionally, if the probability of competent authorities auditing a given person or business is latent in the areas of tax evasion and money laundering, tax evasion indexes are bound to decrease. Thus, every institution should be required to have an external auditor report specialized in money laundering prevention as the financial and fiscal authorities of a given country usually do not possess enough resources.

Moreover, due to budget constraints, the government cannot greatly increase expenditure on the implementation of an anti-money laundering program.

The report should at least include a review of the next few aspects:

1. Money laundering prevention policies and procedures.
2. Know you customer (KYC) policies.
3. Mechanisms to send transaction reports to the authorities.
4. Customer Risk Classification.
5. Appropriate systems to prevent, detect, and report transactions with proceedings of illicit origin.
6. Anti-money laundering training programs and their implementation.

Finally, it is important that authorities promote the sharing of information between governmental entities as this would allow authorities to detect potential tax evaders who are not yet part of a taxable base but (based on the monitoring of their activities) should be declaring and paying the appropriate taxes. Therefore, the more information is gathered about taxpayers and their transactional behavior, the more precise and effective the supervision of the taxable base will be.

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Notes

1. The benefit in having a shadow economy is illustrated in the work of Choi and Thum (2005) who study the mutual relationships among corruption, the shadow economy, and the unofficial economy. In a model of self-selection with heterogeneous entrepreneurs, they show that the entrepreneurs' option to flee to the underground economy constrains a corrupt official's ability to introduce distortions to the economy for private gains. The unofficial economy thus mitigates government-induced distortions and, as a result, leads to enhanced economic activities in the official sector. In this sense, the presence of the unofficial sector acts as a complement to the official economy instead of as a substitute

2. The issue of money laundering in the economics literature is quite vast. Some web resources include:

1. "Banking in Cyprus: Anti-Money Laundering Measures," at http://www.centralbank.gov.cy/nqcontent.cfm?a_id=35
2. "Cyber-payments and Money Laundering: Problems and Promise," at http://www.rand.org/publications/MR/MR965/MR965.pdf/
3. "Drug Trafficking and Money Laundering," at http://www.foreignpolicy-infocus.org/briefs/vol3/v3n16lau.html
4. "Drug Trafficking and Money Laundering in Panama," at http://www.usdoj.gov/dea/pubs/cngrtest/ct061300.htm
5. "Fact Sheet: International Money Laundering and Asset Forfeiture," at http://www.whitehousedrugpolicy.gov/publications/international/factsht/
6. "Financial Flows and Drug Trafficking in The Amazon Basin," at http://www.unesco.org/most/ds22eng.htm
7. "The Global Fight against Money Laundering," at http://www.ustreas.gov/fincen/border.html
8. "International Money Laundering," at http://www.usdoj.gov/dea/pubs/cngrtest/ct062300.htm
9. "Money Laundering by Drug Trafficking Organizations," at http://www.usdoj.gov/dea/pubs/cngrtest/ct960228.htm
10. "Money Laundering: A Banker's Guide to Avoiding Problems," at http://www.occ.treas.gov/moneylaundering2002.pdf
11. "On the Issue of the United States, Russia, and Money Laundering," at http://www.csis.org/hill/ts990921deborch.pdf
12. "U.S. Law Enforcement Response to Money Laundering Activities in Mexico," at http://www.usdoj.gov/dea/pubs/cngrtest/ct960906.htm

Figure 1

Error!

Title 18, USC Sec. 1956 (a) (1)