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PEGASUS

A NEWSLETTER FOR THE CAUX ROUND TABLE FOR MORAL CAPITALISM NETWORK LOOKING AT BUSINESS ABOVE THE CLUTTER AND CONFETTI

Pegasus

Introduction

In 2001, when the Caux Round Table for Moral Capitalism was planning its Global Dialogue in London, John C. Whitehead, former Co-Chairman of Goldman Sachs and former U.S. Deputy Secretary of State, suggested we invite Raymond Baker to talk to us about a failure of global capitalism – the flight of money from poor countries and its welcome reception in money centers like London.

The issue Raymond then put before us was stark: more cash was leaving poor countries than international aid programs and private sector investment was bringing in. Under these conditions, there was no way economic growth in poor countries could be sufficient to raise living standards there to middle class levels of per capita GDP.

Raymond then wrote a book about this disfunction of global finance and founded a non-profit to do something to stop the outflows – Global Financial Integrity. Raymond and his colleagues have done unique and important work pointing to illicit money flows in the regular course of trade and development, outside of drugs and criminal activity. Shell corporations, secrecy accounts, jurisdictions which profit from giving cover to illicit money transfers and mis-invoicing of commercial transactions were all pointed out by Global Financial Integrity as detrimental to economic growth with justice around the world.

We have followed Raymond's work with respect and given him our full support. Due partly to his efforts, the United Nations finally produced a covenant against corruption, including provisions for the repatriation of money stolen from one country and for investment in another.

Rich Broderick, editor of Pegasus, has interviewed Raymond retrospectively to honor his contributions. Rich's report is included in this issue. Raymond presents us all with a time-honored gift – a role model of good citizenship which we can emulate. He shows that intellect, good faith, courage and dedication are necessary foundations for a moral society sustaining acceptable behaviors in business and government. As my grandfather might have said in the era where leadership was prized, "Never show the white feather."

Raymond's contributions bring to my mind lines from Kipling:

If you can dream—and not make dreams your master;

If you can think—and not make thoughts your aim;

If you can meet with Triumph and Disaster

And treat those two impostors just the same;

If you can bear to hear the truth you've spoken
   Twisted by knaves to make a trap for fools,
Or watch the things you gave your life to, broken,
   And stoop and build 'em up with worn-out tools:

…

If you can force your heart and nerve and sinew
   To serve your turn long after they are gone,
And so hold on when there is nothing in you
   Except the Will which says to them: 'Hold on!'

Such people count for much in any era we have known and will ever know.

Stephen B. Young

Global Executive Director

Caux Round Table for Moral Capitalism

Eyes on the Prize

Raymond Baker, author of a groundbreaking book on global corruption, is 83 – but still going strong

When Raymond Baker was living and managing a host of companies in Lagos, Nigeria, there was civil war for many of those years and an exhausted complacency most of the rest. Even though the country was resource rich and, at times, a "democracy," there was never enough for the thousands who moved to the capital to escape war, poverty and worse.

In the evening sometimes in the early 1970s, Baker liked to go with his wife to the edge of the small river that ran behind their house. There they would sometimes turn their attention to the two official looking buildings rising from the far side of water. One was the U.S. Embassy. The other, the Soviet. He realized, as he puts it, "that neither of these countries offers the answer to what was wrong" with a place like Nigeria.

Not that there were any shortages of "answers," none of which has turned out to be precisely (or even imprecisely) accurate. From Davos to the University of Chicago, from Tokyo to Russia, the cause of inordinate poverty in developing countries was all attributed to a single overriding cause: corrupt officials making off with billions every year. Why was the U.S. and Europe, Japan and China and every other advanced society not plagued by government corruption? Because in places like Nigeria and elsewhere, particularly in Africa and the Southern Hemisphere generally, sticky fingered members of government were diverting huge sums of money and depositing them in overseas banks where the identity of ownership was always unclear.

Well, yes, that was and certainly is part of the problem, but only a part and not even the biggest one. Starting from personal observation in Africa and then in the U.S. where he continued to struggle with the deadweight of lost revenues that plagued his and other businesses that did trading in the developing world, Baker pondered what the real reasons might be. And then it occurred to him. The real source of poverty in these places was what he originally called "Dirty Money" but has now upgraded the name to the more acceptable phrase "Illicit Financial Flows" of many different kinds, much of it affecting the manipulation of contracts and other records of cross border trade.

In his last years of private life, he was busy working with governments on issues of corruption. "I came to grips that what I was seeing around the world was not being addressed by financial experts," he recalls.

He received a grant from the MacArthur Foundation 1997, joined the Brookings Institute, and spent the next 10 years studying the subject; over time he got an idea on how to organize it as a combination of illegality, inequality, and distorted philosophy. What was going on in the world of dirty money was not something people thought was going wrong in the capitalist world, just the developing world. But, of course, there was. And he set about to establish why.

First and most important of all, the problem not only involved advanced capitalist countries. In fact, it could not continue without that involvement. Was there, is there, corruption on the part of officials in poorer nations? Yes, of course. But the bulk of the problem lay in the nexus of developing and advanced societies. While official corruption accounted for perhaps 20 or 30 percent of losses, the rest of it – from 7o to 80 percent – involved people in trade, banking, commercial accounting and more. But this was not truly the problem, was it? Could something that couldn't be dismissed as just a problem in "those countries" be cured by Western philosophies about business and government ethics?

The headquarters, if that is the word for it, of Global Financial Integrity (GFI) is on the near east side of Washington D.C., only a few blocks from the Capitol. This is one of the few parts of the city that seems to float between the pomp and circumstance of the federal government or the swank and upscale homes and watering holes of the K Street district and the dire poverty that dominates much of the rest of the Washington. It is an area of mostly modernist but undistinguished office buildings, restaurants and coffee houses pressing against each other cheek by jowl.

The office housing GFI occupies a corner of the 5th floor. It seems as though it should hold dozens of offices but in fact it's rather small inside: room for Baker's office, an other for his colleagues like his managing director, Tom Cardamone, and a staff of economists and policy experts, a secretarial enclave and a large flat counter, chest-high, that keeps visitors at bay until they are welcomed to the space.

When he left business, Baker spent several years working as a consultant with long stretches of time traveling the world, alone or with assistants, to interview everyone involved in trade in the third world. He realized that to be able to give a kind of scientific definition to the idea or ideas that caused so much pain and trouble in the developing world, he'd have to go back and make an in-depth analysis of the two philosophical positions that gave rise to capitalism in the late 18th and early 19th century. In particular, he focused his attention on the two intellectual giants who defined the primary foci of capitalism's vitality, strength and potential pitfalls. He studied Adam Smith and Jeremy Bentham. Smith, of course, was the author of a book on capitalism's moral core and limits – limits that have to be defined by what good capitalism achieves in the larger scheme of things. Bentham, on the other hand, identified utilitarianism as the core of capitalism's drive and beneficent direction in terms of the world at large.

GLOBAL FINANCIAL INTEGRITY

As part of his routine, he studied both men intensively, including commentaries on their work from other writers. He then leapfrogged both of them to evaluate other economists since Adams and Bentham's time. For this extremely meticulous man none for them seemed like more than minor economists until he reached John Rawls, the 20th Century America, and the first to offer what Baker considered an in depth reevaluation of utilitarianism.

"Utilitarianism and capitalism are in lock step as we understand them today," he explains. "Both are philosophies of maximization. For most people in capitalism the top priority is to maximize their work for themselves. Rawls came along and said, No, the goal is to promote justice not just personal worth."

Rawls proposed an experiment. Put people behind a veil of ignorance and ask them to design an ideal society. Would they come up with what we have now? Or would they propose a society in which opportunity is equal. Rawls argues that if a person of extraordinary talent comes up with an extraordinary proposal, it should be regarded as such but only to the degree that the idea promoted justice for all. This directly undercuts the basic principle of Bentham who argued that ultimately, all that matters is to pursue a path that maximizes output and distribution for the good of most but at the expense of others. It's not hard to see how Bentham's fundamental appeal would attract those who lay the groundwork not just for exploitative economic systems but also for the conquest of the "undeveloped world."

It was this insight, coupled with all the other nitty-gritty information he acquired during his time in business that led him to begin writing his first (and so far only book, though another is on the way) that was finally published in 2005 under the title Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System.

"Smith essentially laid the foundations for the free market system," Baker declares. "That was very exciting. But he was a moral philosopher first and took for granted that those who operated the system should be people who focused on both."

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Following publication of his book right in the middle of the darkness of Bush-Cheney years, Baker decided he better put down roots that would allow him to pursue his ideas free of restraint of places like the Brookings Institute. With a healthy sum of money from a wealthy backer and other sources, he established Global Financial Integrity and began to launch what now amounts to dozens of studies, reports, workshops and more.

In undertaking an analysis of a country's covert losses – not the ones that show up in gaps between a countries reported GNP and the reality of what is there, a task made somewhat easier by the fact that all the statistics are tended by the world's financial watchdogs -- Baker realized that there needed to be an actual accounting of how much money is slipping out through means other than official corruption.

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What he discovered is this kind of data is everywhere but is not taken into account of a country's losses. Here's how it works: there is data on all kinds of commercial and monetary transactions around the world. There are not government statistics but figures compiled from "ordinary" business transactions. So, for example, a company in say, Sweden, reports that it has received $100,000 for a shipment of ag equipment it made to, say, a company in South Africa. Meanwhile the company in South Africa reports that it spent $200,000 for that same equipment. How to account for the difference?

"We look at gaps in the data," Baker explains. "There are capital accounts and trade accounts. For a country, capital accounts are kept in balance of payments accounts and if they don't equate, there is an imbalance." That imbalance is put into "errors and admissions." These can arise through errors or theft of money from government accounts or from the timing of transactions or other technical details. "But if a country is running a consistent pattern of errors and admissions in one direction or another, that's 'a pretty good indication of corruption," he says.

"On the trade side we are looking at statistics for gaps," he says. To do that, Baker and his team use IMF and UN data. These are, he points out, not always consistent but will show similar trend. "With that kind of analysis we can tell a country where you are suffering problems, much of it the result of deliberate misinvoicing."

In making this case, he points out a persistent nuance, which is that "a lot of people, including economists, think this is all about tax evasion." But that is not entirely correct when it comes to developing countries. The first emphasis is to take soft money and transfer it into hard currency. The second is that its origins are secret, except to those involved in the transaction. The third motive is only then tax evasion.

"There are in fact three forms of illicit money," Baker declares. "There is commercial – essentially what you get with mis-invoicing – criminal and corrupt: only the last is theft by government officials."

As a guest scholar with the Brooking Institute after he left business, he spent a year conducting over 300 interviews around the world; the purpose of this was to come up with estimate of the cross-border flow of illicit money. The basis of the project was to get a handle on the size of corruption – and to allocate it according to its type.

Based on those hundreds of interviews, Baker estimates that about $20 to $40 of all misallocated money came about because of official "corruption" – finance minister sneaking a few million into untraceable back accounts, a vice president buying up thousands of acres of banana plantations.

The vast bulk of the money – an estimate backed by some 500 previous interviews with official in trade managing companies – was that the rest of the missing money, 60 to 80 percent, came about through various other schemes that were not officially or even unofficially tied to governments or government officials. So if the estimated take away from developing countries every year is anywhere from $500 billion to one trillion (and Baker clearly leans in favor of the second figure) than anywhere from $300 billion up to $700 billion per year comes from "private" corruption.

"My data indicated that about 40 percent of transactions by Latin American traders was misallocated by 6 percent and from Africa around 8 percent," he says. "Corruption on a commercial basis dwarfs corruption in government or on a criminal basis."

"We've done reports on a lot of countries," Baker argues. "We've built up a team of analysts to do this. Academics say no you have to rely on good data to make policy decisions. No, Baker says – you need orders of magnitude to allow you to make effective policy decisions".

In another study, this one on Brazil, all the data GFI relied on is public data. The same is true for studies of other countries in remote parts of the world. "The methodology of gap analysis has been around for about 50 years," Baker observes. "We were the first group to apply data to all developing countries, not just one. This is a problem everywhere but it takes only about three months to produce an analysis for a country." Meanwhile, money continues to flow illicitly out of developing countries and into bank accounts and other holdings in the richer world.

"We were the first organization to put on the table the proposal that it is illicit transfers out of poor countries, not corruption by officials that is the primary source of loss," he says. Given that this premise runs counter to the official point of view, its proposal has at times shocked officials. In 2010, for example, Baker and his colleagues made a presentation in

Addis Ababa in Ethiopia; participants were astounded by the conclusion that losses in the developing world stem more from commercial flow and not corrupt officials. Not long after he was asked to make another presentation at another conference that took place early on a Sunday morning; the estimate was that the turnout would be very small. Only room open was a giant conference hall. It turned out to be a good thing because the space ended up being overflowed. All this work gave way five years later with a report commissioned by AU/ECA Conference of Ministers of Finance, Planning and Economic Development in a document entitled "Track It, Stop It, Get It" prepared by the High Level Panel on Illicit Financial Flows from Africa, chaired by Thabo Mbeki, former president of South Africa, a panel on which Baker has served since its inception.

"We are dealing with something fundamental to capitalism. It is going to take as long to address this as it will take to address climate change," says Baker. "The situation is not that different from feudalism. How do you fight the idea that this kind of corruption is not helpful, it is counterproductive to building the world we want to – and can – live in. The capitalist system as it exists today cannot survive. We either change it or lose it."

The system that has facilitated this exponential growth in corruption took 50 years to nurture. Take tax havens, he says. In the 1950s, there were perhaps 4 or 5 of them. Now, there is 10 times that. "Every state in the U.S. allows you to establish entities whose owners are not identified. All of them have lawyers and accountants whose job is to shield the movement of money."

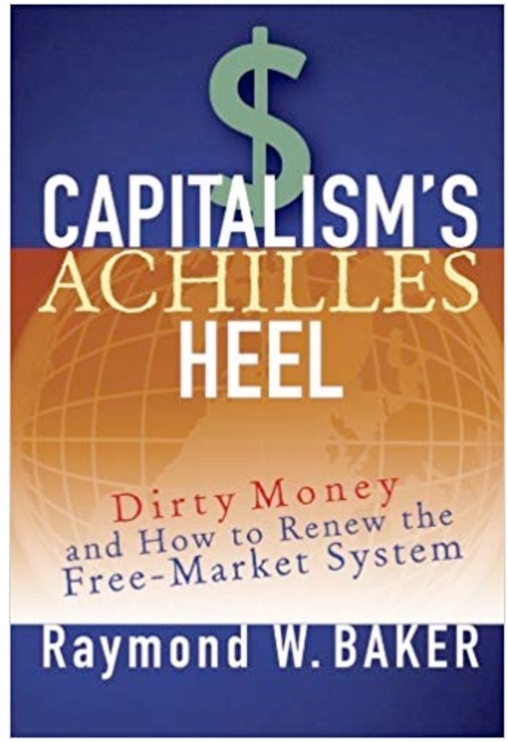
The result is a system that now has hundreds of billions moving about in a nearly unfathomable way. The amount of money that has accumulated in liquid financial assets is now estimated to be more than $80 trillion. A fair amount of that has moved through a shadow financial system.

"We're dealing with a situation where there are trillions floating through the world despite problems with unemployment and poverty," Baker points out.

The insanity extends even to accounts where interest rates are less than the rate of inflation so that the holders of these accounts are losing, often huge amounts – yet continue to put money into the account. Why? The answer is simple. The accounts hide illicit transfers. The more goes in to the principal, the more in the end can be transferred out. "There is now about $8 trillion in negative interest rate securities," says Baker. "The reason is the interest you earn is not important if you can continue to add to principal in the account; assets are going up even as you are 'losing' money."

A shadow financial system like this is possible because countries, especially wealthier countries, have methods to shift money into these enterprises and that so much of this is money is transferred out of poorer countries into richer ones.

Estimates vary, but coming out of poorer counties is about $500 billion to $1 trillion a year. That's just an estimated figure. In any case, even with the UN and other non-profit organizations spending money to "bail out" the poor countries, it is the poorer countries that are supporting us.



Baker's first (and to date only) book still causes unease among the higher ranks of officials of organizations mandated with identifying and proposing cures for the chronic poverty of undeveloped countries (hint: it's all their fault so why don't we focus on corrupt officials and ignore the rest?). Whether the term is "dirty money" – the phrase he uses copiously in Capitalism's Achilles Heel -- or the more genteel "illicit financial flows" which is the term he's using these days. In any case, his argument is one that has been making inroads and he doesn't plan to give up on it.

At 83, he has the physical presence of a man 20 years younger than that; and although his manner of speaking and overall demeanor calls to mind a partner in a corporate law term or perhaps professor at an elite college, they are married to a man who combines intellectual acumen with a stubborn goal of getting to the bottom of things. His latest project? Another book that he is, with the help of the same person, Jennifer Nordin, already beginning to sketch out. With less to explain and a certain amount of ground already taken, he expects it will do even more than Achilles.

"The theme is an expansion of the first book with particular emphasis on how illicit funds are undermining democracy," he explains. "It will not be exhaustive, but perhaps only 150 or so pages long.

"We covered a lot of this ground already," he says with a dry smile. "We'll dig even deeper than before, though perhaps there will be fewer skeptics this time!"

Looking Back on 2018

The Reality of Market Power

The Caux Round Table for Moral Capitalism's vision of a moral capitalism recognizes that, with moral persons and in a moral community, power generates a duty of care towards those who become subject to the power. Thus, market power is subject to this standard. Market power like all other forms of power is corrupting of our intentions. As Lord Acton said: “power corrupts and absolute power corrupts absolutely.”

But as Alexander Hamilton or James Madison argued in Federalist Paper #55 of 1788, written in support of the newly proposed federal constitution for the United States, “As there is a degree of depravity in mankind which requires a certain degree of circumspection and distrust, so there are other qualities in human nature which justify a certain portion of esteem and confidence.”

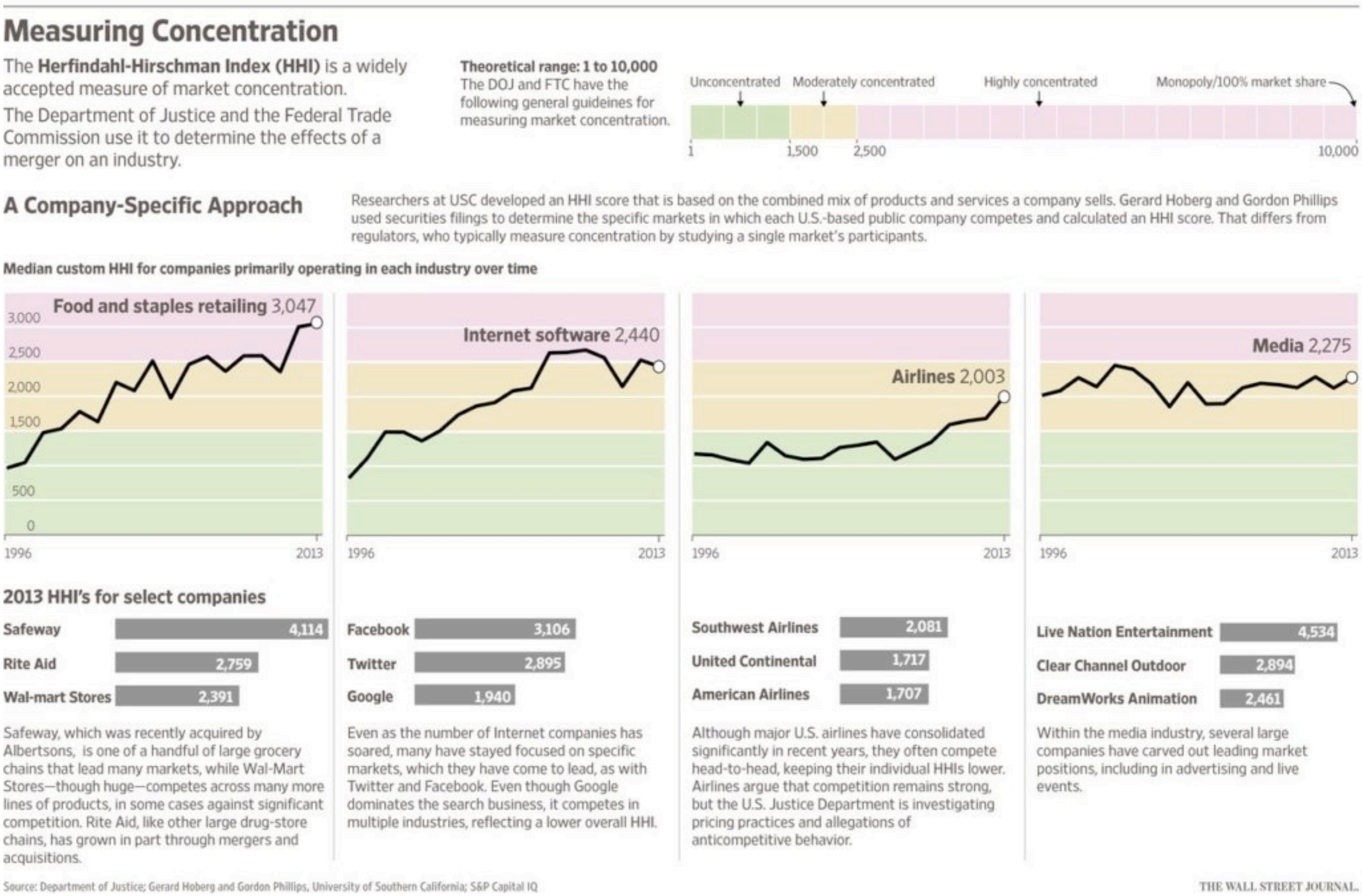
Where market power emerges, we must be diligent in analyzing how it is used by those who hold it. Are they to be esteemed or distrusted?

Do we need to insist more intently on the ethics of their intentions? Do we need to reduce the autonomy of their power with the checks and balances of market forces, including consumer sentiment, or with government regulation?

Those concerned for the quality of any capitalism should pay particular attention to concentrations of market power, as such power can distort prices and the allocation of goods and services among deserving claimants. Generally speaking, experience shows that market power tends to favor the rich and the powerful and discriminates against the poor and the weak.

As Thucydides reported the attitude of the Athenians towards the conquered people of Melos: “The strong do what they will; the weak what they must.” This is the ethic of Social Darwinism and a brute capitalism. In the economy it can become the ethic of market power.

Last year 2018 saw increases in market concentration.



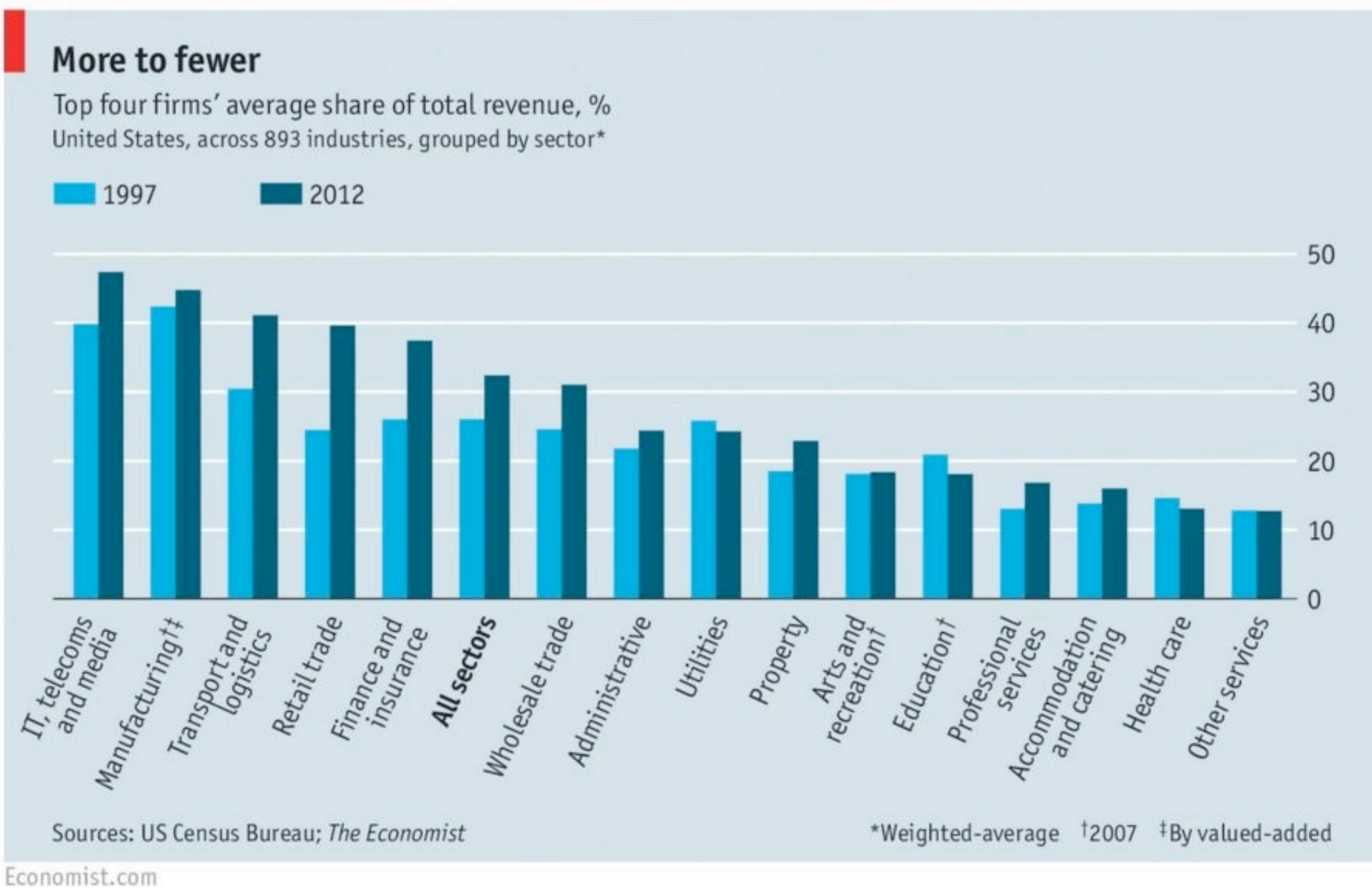
Amazon is starting to use its market dominance in data to restructure the American health care industry. It is selling software which allows users to pull data from patient medical records for information to sell to doctors and hospitals to improve treatments and cut costs. Amazon is looking at expanding sales of an app embedded in medical records which doctors can use to send links to products which their patients can buy. Thus new technology financed by Amazon's profits will replace hard written notes from doctors and patient use of pharmacies.

Amazon paid $1 billion to acquire an online pharmacy PillPac Inc. to integrate exploitation of patient data with sales of medicines and compete with traditional channels of distribution. It is doubtful that PillPac on its own would have market power to disrupt existing business models.

Apple is proposing to the American Department of Veterans Affairs that the health records of veterans be transferred to iPhones.

Mergers in 2018 added to market concentration. By Sept there had been $3.3 trillion in announced mergers globally.

Albertsons, a large grocery firm, acquired Rite Aid pharmacy in a move on Rite Aid's part to compete in a business increasingly threatened by Amazon, which has acquired Whole Foods markets.



AT&T's $85.4 billion acquisition of Time Warner Inc. was approved by a federal court. Microsoft bought potential competitor GitHub for $7.5 billion. GitHub provides a website for 28 million programmers and developers globally allowing them to exploit codes from other developers using the site.

United natural Foods acquired rival Supervalu for $1.3 billion.

Cisco bought Duo Security Inc. for $2.35 billion, adding to its cybersecurity product and service lines.

Canada's Barrick gold bought Randgold Resources for $18.3 billion, creating the world's largest miner of gold.

Michael Kors bought Versace for $2.2 billion.

IBM bought Red Hat for $33 billion to augment its cloud computing services.

PepsiCo bought SodaStream International to $3.2 billion to meet consumer demand for low-sugar, make-it-on-your-own drinks.

German company Bayer bought Monsanto for $62.5 billion adding to market concentration in the pesticide industry. Bayer had to sell $9 billion of assets to BASF to preserve competition.

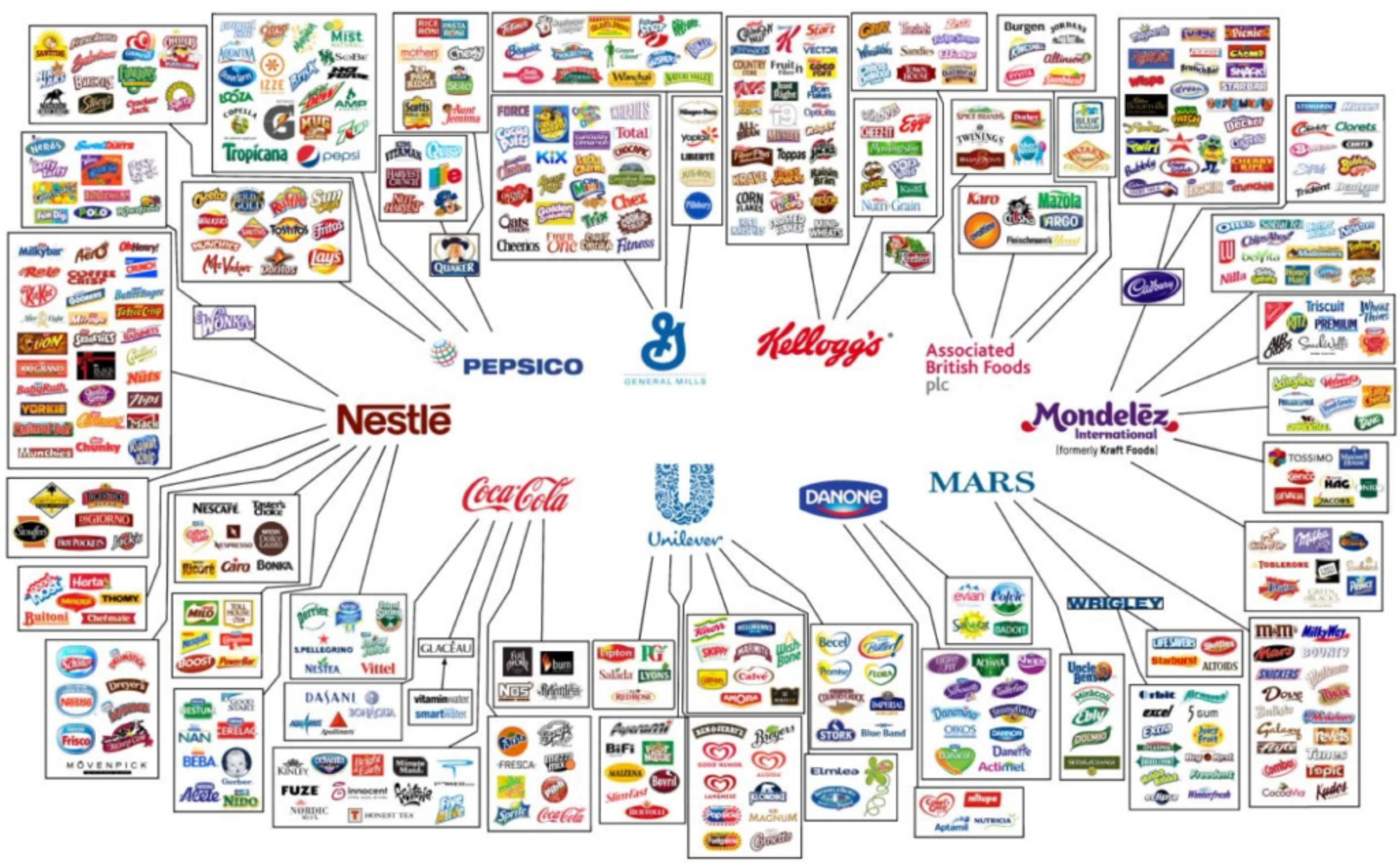
JAB acquired Pret A Manger for $2 billion to add to its collection of prepared food companies.

Marathon Petroleum bought Andeavor for $23.3 billion to form America's largest oil refiner.

T-Mobile US bought its competitor Sprint for $26 billion, combining the number 3 and 4 US carriers into one company, creating a web of redundant stores and cell towers.

Takeda Pharmaceutical bought Shire which makes drugs for rare diseases for $62 billion.

The July 2018 Economist published a short article pointing out that two thirds of American industries have become more concentrated and big firms are taking up larger and larger shares of revenues in their industries. The article pointed out that in the last 20 years, Britain has experienced $5 trillion of domestic mergers and acquisitions.



Concerns emerged about the market power of the dominant high tech firms. Amazon computing capacity demands huge upfront investments. The company has 254 million square feet of plant with dozens of data centers running acres of servers 24/7. The company has negotiated with local governments to pick up the costs of such facilities in order to have Amazon locate them in the community. New York City agreed to pay $1.5 billion for Amazon to locate a new office center in the city. Amazon gets others to pay the cost of the electricity it uses to run its servers in many locations. America's cloud business now consumes 25 of US electricity.

Amazon's web services now provide 73% of its operating income on about 11% of its total revenue.

Australia's anti-trust regulator called for measures to curb the power of Facebook and Alphabet (Google) in news and advertising. The regulator proposed that the big companies offer consumers more choices in search and browsing.

It was asked whether Facebook should be forced to sell Instagram and WhatsApp.

Google and Facebook take in 73% of US digital advertising expenditures, giving them cash flow to buy up emerging competitors.

Outro

The complexity or simplicity of a solution required more often than not reveals the complexity or simplicity of the problem at hand. Simple problems almost always have simple solutions. Complex problems almost always require complex solutions.

Problems that seem simple almost never are because simple problems are rare. That said, problems that are complex are sometimes, in fact, simple — but these are rare too.

Problems that have formed over a long time will, likely, not be solved quickly. And problems that come quickly may sometimes last a long time.

We humans wish for every problem to be easily identifiable and solved quickly, with the simplest solution possible. We, in general, hate complexity of choice and thus do all we can to narrow a choice as quickly as possible to a binary simplicity.

Good/Bad
Right/Wrong
Ethical/Corrupt

Because of this, we often look for the simplest possible solution to every problem no matter how complex. And because simple problems are rare, we sometimes assume a complex problem where a simple one exists.

This is why we need the Raymond Bakers of the world. Those who are bold enough to question long held assumptions. To test the theory. To do the math. Those who refuse to accept the easy answer and quick fix. Those who are willing to put that which we have concluded to account. Those willing to meet the problems we face with appropriately sized and fact-based solutions.

If we all are not so quick to assume simplicity in the face of complexity and vice/versa, if we could be a bit more OK with a wealth of possible options instead of dividing everything up into either/or, then we may find a way forward that benefits all stakeholders. Because by not doing so, we often take no action and, thus, solve nothing. And that is the real problem.

Patrick Rhone
Director of Technical and Internet Support
Caux Round Table for Moral Capitalism

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