



CORRUPTION AS STATECRAFT

Using Corrupt Practices as Foreign Policy Tools

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Author: Dr Karolina MacLachlan

Research provided by:

Nikolai Topalov
Transparency International Anti-Corruption Center, Armenia
Transparency International Bosnia & Herzegovina

Editors: Katherine Dixon, Leah Wawro, Deirdre Mahony

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CORRUPTION AND FOREIGN POLICY: THE BIG PICTURE

Corruption is frequently described as a ‘cancer’: a malign force which undermines societal development and security, but one that is amorphous and devoid of deliberate intent. In many contexts, this is an accurate depiction; in others, it does not tell the whole story. This is especially the case where corruption is used, consciously and intentionally, as an instrument of statecraft, to help achieve foreign policy goals.

Corruption can enable elites in one country to hold whole political classes in other countries to ransom, exert illegitimate influence over another state, sow insecurity and instability, and undermine government institutions. This kind of corruption is not aimed at economic benefit: rather, it often relies on a willingness to forgo economic gains in favour of influence, favourable political outcomes, and an ability to spread political norms and practices.

‘Corruption with intent’ is difficult to diagnose, analyse and prove, especially as it can be intertwined with complex, opaque corruption and criminal networks, both in the state employing corruption and in the target state. In states where governing elites have extensive links to organised crime, criminal networks can be harnessed by the state to exercise influence, thereby turning corruption into a weapon. This is the case especially where the distinction between public and private is blurred.

The ‘Azerbaijani Laundromat’, a money-laundering scheme that transferred a total of \$2.9 billion USD from Azerbaijani companies and government departments through four UK-based shell companies, financed both private enrichment and foreign policy schemes aimed at improving the country’s international reputation.¹ Azerbaijani officials appear to have used funds passed through the ‘Laundromat’ to bribe members of the Parliamentary Assembly of the Council of Europe in order to water down official criticism of Azerbaijan’s human rights record. At the same time, top officials used it as a slush fund to pay for luxury goods and services. Individual corruption and state-sponsored schemes both benefitted from the fund, and corrupt practices accompanied the use of legal services such as lobbying and PR activities to achieve the aims of both individuals and the state.

An additional challenge is that in their most dangerous and durable form, ‘corruption with intent’ schemes are built on political and economic dependence, usually in key sectors. Russia’s attempts to shape the domestic and foreign policy decisions of Ukraine over the last two decades,

for example, apparently utilised corrupt schemes in the energy sector, strengthening and eventually leveraging corrupt networks in Ukraine to help achieve foreign policy goals.

...Russia over the last decade or so has used another foreign policy weapon. It uses corruption as a tool of coercion to keep Ukraine vulnerable and dependent. So pursue those reforms to root out corruption. It’s not just about good governance. It’s about self-preservation. It’s about your very national security.²

Joe Biden, Former US Vice President
Kiyv, January 2017

The use of corruption as a foreign policy tool robs countries of opportunities to pursue development, democratic reforms, and security. It repurposes state institutions into networks that extract resources and divert public wealth into private pockets. It can be used to strengthen authoritarian governments and weaken those which promote democratic norms, from electoral reforms to robust human rights provisions.

When corrupt practices are intertwined with trade in a crucial resource such as energy, disentangling the relevant networks and enabling factors is extremely challenging. Even a robust anti-corruption effort will only have limited effects if the underlying strategic dependence of the weaker state is not addressed.

These schemes also pose significant problems in mature democracies. The links between corruption and insecurity have been recognised in the US, with calls for Congress to take action to block financial flows which can not only undermine allies, but also influence the US political system.³ The Australian national security apparatus is also sufficiently concerned – especially after the cross-party donations by China-born businessman Huang Xiangmo, linked to attempts to influence the main parties’ stance on the South China Sea - to have introduced significant legislative changes to defend against foreign interference.⁴

Yet much more effort is needed to safeguard democratic

institutions. In the EU, some financial institutions, PR and real estate companies use legal loopholes and act as professional enablers that facilitate corrupt transactions and can, in turn, further the interests of malign actors.⁵ The ‘Azerbaijani Laundromat’ case suggests that major financial institutions had failed to follow up on suspicions of money laundering or to comply with beneficial ownership regulations, allowing large amounts of money to flow through financial systems with no record of who controlled it or who benefitted.

Authoritarian, kleptocratic elites from across the globe use these financial channels – the scale of which was revealed in the Panama Papers – not only to hide and legitimise wealth, but also to export their way of doing business. Unless countered, practices ranging from the illegal (bribery and tax evasion) to the unethical (such as tax avoidance through offshore banking) will weaken institutions and laws across multiple states in which corrupt networks operate.⁶ Ultimately, the use of corruption to undermine national and international institutions, such as the Council of Europe, threatens the democratic norms upon which many societies, especially European, are based.

[T]he lack of transparency, the practice of hiding the names of beneficiaries, the use of off-shore nameplate companies, and the secretive nature of Gazprom’s contracts with its clients all bode ill for the EU.⁷

Roman Kupchinsky,
Director of Radio Liberty in Ukraine, 2009

Finally, corruption could become a tool of hybrid warfare, alongside disinformation and cyber-attacks. Electoral campaign contributions could be traded for political influence or promises of decisions favourable to individuals. Former Lithuanian President Rolandas Paksas, for example, was accused of having received campaign financing from individuals suspected to be linked to Russian organised crime, in exchange for granting them Lithuanian citizenship and for divulging classified information on investigations into their business dealings.⁸ While Paksas was eventually cleared of the charges of divulging state secrets to his campaign contributors,⁹ similar schemes could be employed to undermine institutions managing crucial infrastructure or those responsible for deterring aggression and providing security.

The first step toward counteracting the malign influence of corruption deployed as an element of the foreign policy arsenal is to understand and appreciate the way it operates. The second is to understand the corrupt

networks in states on both sides of the issue, and to minimise the strategic dependence that can underpin these schemes.

- ‘Corruption with intent’ needs to be approached as a **systemic issue**: a problem based not merely on the actions of individuals, but facilitated by intricate, often transnational, networks and professional institutions, which requires a systemic approach in order to challenge it.
- The use of corruption as a foreign policy tool is frequently underpinned by **strategic dependence**: a pressure point, such as energy exports, crucial infrastructure investments or debt, which makes it difficult for individuals to counteract a corrupt system and which means that anti-corruption reforms are, in and of themselves, frequently insufficient.
- Countries seeking to counteract these schemes will also need to look closer to home, identifying their own corrupt networks and vulnerabilities and **insulating their own political and defence institutions** from malign influences. When attempting to assist others, they will need to carefully balance conditionality and support to incentivise change.
- Countries whose lax regulations enable illicit financial flows need to **limit the activity of professional enablers**, from financial channels to safe havens for stolen money. While the international community has made significant progress through adopting anti-money laundering regulations, their implementation requires long-term commitment supported by sufficient resources. Equally, EU, OECD and NATO states still need to strengthen – and most importantly, enforce – conflict of interest regulations, and to maintain a degree of transparency and accountability that would make these regulations meaningful and allow scrutiny. The link between corrupt practices and strategic dependence also suggests that key sectors such as **energy and defence and security** could be at a greater risk of interference. A sector-based approach, founded on a thorough risk analysis, would help prevent corrupt practices being deployed to control states’ decisions.
- Finally, democratic countries need to help strengthen the rules-based international order by **supporting change agents in emerging powers**: those who aim to build inclusive, legitimate governments interested in bettering the lot of the populations. This includes protecting independent journalists and civil society organisations, which have hitherto played key roles in exposing corruption networks and their significance.

EXPORTING CORRUPTION

The corruption playbook can be used, most simply, to buy influence within political systems. Concerns about influencing individuals through electoral contributions, for example, led to Lithuanian President Rolandas Paksas being impeached in 2004 for alleged contacts with Russian intelligence services and with a businessman suspected of links to organised crime. Paksas was reported to have granted Lithuanian citizenship to businessman Yuri Borisov, who contributed \$400,000 USD to his political campaign. Alongside preferential access to the President, Borisov reportedly received classified information on investigations into his businesses – a charge Paksas has denied and was eventually cleared of.¹⁰

But while corrupt individuals can be a potential source of influence for a foreign state, it's the combination of strategic dependence, competing international priorities and corruption which creates serious vulnerabilities. The following cases suggest that it is the strategic dependence of emerging democracies on more powerful states which enables not only corrupt influence over individuals, but also the creation of more durable corrupt schemes of influence.

The case of Ukraine

In the aftermath of Ukraine's 2004 Orange Revolution, one issue dominated the Ukrainian agenda: gas imports. At the time, 60% of Ukraine's domestic demand was met by discount-price imports through Russia's Gazprom, and the country was serving as a conduit for 25% of the EU's gas supply also coming from Russia. Under these circumstances, securing long-term access to gas was a critical issue of national security.¹¹

However, the shift in Kyiv from the pro-Russian Kuchma to the more European-oriented Yushchenko administration prompted a change in Moscow. Citing the need to ensure fair market pricing and pointing to Ukraine's payment arrears (which Ukraine disputed), Gazprom proposed a steep hike in price, from \$50 USD per cubic metre of gas to \$230 USD per cubic metre. On the one hand, this increase would bring Ukraine's fees in line with those paid by Gazprom's European customers; on the other, that market rate would not reflect a discount that Ukraine could be eligible for due to its role in transporting Russian gas to European markets.¹² While many analysts supported the move to market prices in the Russia-Ukraine gas trade – combined with improved energy efficiency in Ukraine and greater transparency in the sector – the timing of the demand was judged to have been political and aimed at weakening the new Ukrainian government. In the short

term, Ukraine was unable to meet Gazprom's demands.¹³

Oleh Rybachuk, the newly appointed Chief of Staff to President Yushchenko, found himself at the centre of negotiations with Russia. His main memory of that period, he told us in an interview, was one of bewilderment.¹⁴ The Russia-Ukraine gas trade (as well as transactions between Ukraine and Turkmenistan, another significant gas supplier) did not operate directly between the countries' two state-owned enterprises, Russia's Gazprom and Ukraine's Naftogaz, as might have been expected. Instead, the contract and the transactions were facilitated by RosUkrEnergo (RUE), an intermediary company.¹⁵ RUE, despite its role in managing the flow of a crucial resource, was a puzzle: registered in Switzerland, the company was 50% owned by Gazprom and 50% by a consortium of Ukrainian businessmen whose shares were held through CentraGas Holding AG, an Austrian company and a subsidiary of Raiffeisen Investment.¹⁶ The names of the ultimate Ukrainian beneficiaries were not known. Even a 2005 investigation by Ukraine's Security Service (SBU) failed to identify RUE's owners (it was shut down the same year and the SBU later denied it had ever taken place).¹⁷ To add to the confusion, RosUkrEnergo was reportedly buying gas from Gazprom at prices lower than Gazprom itself had initially paid for the gas.¹⁸

The secrecy behind RUE made it difficult for Rybachuk to work out what was happening and why the gas deal was structured in this particular way. He consulted Ukrainian businessmen and politicians, but reportedly to no avail. 'They were telling me nothing', he later said. The only message he received was that it was imperative that he signed a new Russia-Ukraine gas deal. Leading oligarchs primed Rybachuk for the role he was meant to play, advising him to cooperate and make a deal. 'The scheme must work', he heard repeatedly, and making it work was Rybachuk's 'historic chance'. To help him make a good impression at the Kremlin, where he was sent to consult Dmitri Medvedev, Vladimir Putin's Chief of Staff and the head of Gazprom's supervisory board, these oligarchs reportedly offered Rybachuk the use of a private jet which he declined.¹⁹

Rybachuk's meetings at the Kremlin resulted, he told us, in a concrete offer: \$2 billion USD a year, funnelled through the gas intermediary, for Yushchenko to use as he pleased, including for political campaigns. Rybachuk, seeing a danger to Ukraine's independence, says he advised the President not to sign the deal. But in January 2006, the gas crisis was resolved with an agreement giving RosUkrEnergo a leading role in the Russia-Ukraine

gas trade. According to Rybachuk, President Yushchenko had already agreed to a deal through one of RUE's mysterious owners – businessman Dmytro Firtash, who had connections to Yushenko's brother.²⁰ Firtash himself confirmed, in a conversation with the US Ambassador to Ukraine, that he visited Yushchenko at his country residence and consulted closely on the deal during the gas crisis.²¹

Ukraine, gas and RUE

According to this deal, RUE would become the sole supplier of gas to Ukraine and would itself procure Turkmen, Kazakh, Uzbek and Russian gas, with up to 41 billion cubic metres (bcm) per year coming from the Central Asian republics and up to 17 bcm from Russia. While Turkmen gas cost around \$55 per thousand cubic meters (mcm), Russian gas was priced at \$230 USD per mcm. In the first half of 2006, RUE would sell Ukraine a 'cocktail' of the different types of gas at a constant price of \$95 per mcm; the price would be renegotiated later on. It was subsequently revealed that one element of the agreement saw transit prices for Russian gas through Ukraine fixed for the next five years.²²

RosUkrEnergo (RUE) and Dmytro Firtash: the story so far

Dmytro Firtash, a Ukrainian businessman currently residing in Austria, has long been connected to Ukraine's gas industry and its relations with Russia. Aside from RUE, he controlled EuralTransGas, which acted as an intermediary between Gazprom and Naftogaz prior to RUE's creation, and ran chemical businesses which had received preferential treatments from the Russian-owned Gazprombank.²³

Mr Firtash's ability to secure lucrative deals, usually with the participation of Russian state-owned companies, has received significant coverage, as have his reported links to Semion Mogilevich, an organised crime boss on the FBI's most-wanted list. The oligarch has admitted – to the Financial Times and to the US Ambassador to Ukraine – that he did know Mr Mogilevich, but has insisted either that they had not done business together,²⁴ or that, although Mr Mogilevich's 'approval' was needed for him to get into business in the lawless post-communist period, this did not amount to a crime.²⁵

Dmytro Firtash has acknowledged that his business activities may have been secretive, but insisted that he had always operated legally and that EuralTransGas won its contract for supplying gas to Ukraine because it was able to offer competitive terms. RUE, Mr Firtash has said, was established to take over the contract after Gazprom requested a stake in the business.²⁶ In a conversation with the US Ambassador to Ukraine, Mr Firtash stated that his good relations with Central Asian leaders enabled him to secure business deals in the energy field.²⁷

Mr Firtash's connection to RUE was only revealed in 2006 by Russia's Izvestia newspaper, which

reported that 45% of RUE was owned by Dmytro Firtash, an Ukrainian businessman with long-standing ties to the opaque Ukrainian gas business, and 5% by Ivan Fursin, a member of Viktor Yanukovich's Party of Regions. While it's unclear how the paper managed to procure this information, The Moscow Times and the New York Times claimed that it was based on a PriceWaterhouseCoopers audit of RUE, which identified the beneficial owners of the company.²⁸ In 2009-2010, Mr Firtash represented RUE – now disbanded – during an arbitration suit at the Stockholm-based Chamber of Commerce, in a dispute with the Ukrainian government following RUE's ouster from the gas trade.

The FBI investigated Mr Firtash twice. The 2006 investigation, which reportedly looked into RUE, did not result in any charges. The second investigation yielded charges of corruption, accusing Mr Firtash of paying \$18.5 million USD of bribes in exchange for permission to extract titanium in India. Mr Firtash was arrested in 2014 in Austria, although an Austrian court later rejected the US extradition request, agreeing with Mr Firtash's lawyers that it was politically motivated by the situation in Ukraine. An appeals court allowed the extradition in 2017, only for the process to be derailed by a Spanish extradition warrant. At the time of writing, the Spanish extradition warrant had been denied and the US request has been put on hold pending review.²⁹ Mr Firtash has denied all the charges, dismissing them as politically motivated, and declared his wish to prove his innocence and 'have his life back'.³⁰

5 Corruption as Statecraft: Using Corrupt Practices as Foreign Policy Tools

To Rybachuk, the recurrent energy deals between Russia and Ukraine, particularly through RosUkrEnergo, have provided a way for the Russian leadership to use and enhance Ukrainian corruption schemes to secure the loyalty of the Ukrainian leadership.³¹ The company certainly had significant sums at its disposal to facilitate this; one estimate pegged profits received by RUE's shareholders in 2005-7 at about 2.5 billion CHF³² and another, by Raiffeisen Bank, reported RUE's 2005 profit as \$500 million USD, of which 50% went to the company's Ukrainian beneficial owners.³³ RUE was also able to take advantage of lax European regulations allowing secrecy of corporate ownership and transactions, enabling it to distribute money under the radar. Given its income and the secrecy surrounding it, former US Ambassador to Ukraine William Taylor referred to RUE as a 'cash cow and a serious source of corruption and political patronage.'³⁴

By the time Yushenko came to power, 'the scheme' was already well-entrenched. During Rybachuk's time in the Ukrainian parliament (2002-2005), MPs' questions about Russian-Ukrainian energy issues were dismissed. 'When you are in government, you will deal with this,' Rybachuk heard.³⁵ By 2005, although the Orange Revolution had ousted many of the former corrupt elite, the established networks backed by Russian interests set about recruiting the new guard. The very real threat of withholding gas supplies was a strong enough incentive to make it difficult for newcomers to resist and still survive politically.

I said to Yushchenko, 'Now I know how they corrupt the whole country.'³⁶

Oleh Rybachuk

Russian President Vladimir Putin denied Russian participation in 'the scheme', declaring in 2006 that Gazprom and the Kremlin did not know who was behind RUE on the Ukrainian side and claiming that the intermediary company was a Ukrainian initiative to which Russia had acquiesced. In 2009, the President denied he had ever met Dmytro Firtash. But, as several analysts point out, it is questionable that the Russian state would have agreed to support a highly lucrative deal without knowing who benefitted from it, especially as RUE's board of directors included a former chief of Gazprom's legal department and a former head of the EuralTransGas Moscow office.³⁷ Former Ukrainian President Viktor Yushenko had the opposite view: RUE, he said, was part of a long chain of commercial entities facilitating the transmission of Russian gas to Ukraine, set up by Russia and to which Ukraine had no official connection.³⁸

In 2008, when Prime Minister Yulia Tymoshenko committed to curbing the clout of the energy intermediaries like RosUkrEnergo, the challenge that she faced was significant. US officials in Ukraine, for example,

were sceptical that Tymoshenko's commitments could be fulfilled, given the leverage that Russia had through Gazprom and Ukrainian debt, and concern that RUE would simply be replaced by another intermediary.³⁹ US embassy cables released through WikiLeaks painted a picture of RosUkrEnergo as a money-maker for the 'iron triangle' of corrupt businessmen, corrupt politicians, and organised crime,⁴⁰ firmly settled in Ukrainian political landscape.

In 2009, the Tymoshenko government negotiated a 7-year direct agreement between Naftogaz and Gazprom for gas imports, effectively ending RUE's role in the Russia-Ukraine energy deals. But a year later, both Yushenko and Tymoshenko lost power to Viktor Yanukovich, a pro-Russian politician generously supported by none other than Dmytro Firtash, one of RUE's beneficial owners. According to a Ukrainian parliamentarian, Firtash effectively represented Russian interests in Ukraine, making sure that pro-Russian politicians were at the helm of the country.⁴¹ Dmytro Firtash himself has strenuously denied these accusations, presenting himself as a Ukrainian patriot and criticising Prime Minister Tymoshenko for alleged involvement in corruption and according Russian interests priority over Ukrainian ones.⁴²

The 2009 gas deal Tymoshenko signed with Gazprom came in for a great deal of criticism. The short-term gains from the deal – security of supply and a first-year price discount, which secured deliveries of gas to Ukraine at \$230 USD per thousand of cubic metres in 2009 – did not, critics said, make up for the long-term problems. By signing the contract, Ukraine agreed to pay gas prices that were 10% higher than those offered to Germany, and did not manage to secure a favourable fee for transit of European gas.⁴³ Following Yanukovich's victory, Tymoshenko was tried and sentenced to 7 years in prison for her role in the Russia-Ukraine gas deal, which the new government described as illegal.⁴⁴ After her release in 2014, she instituted a civil case against Dmytro Firtash in a US court, alleging, among other issues, that he used RUE proceeds (laundered through US companies) to bribe Ukrainian officials into trying and imprisoning her. The US court dismissed the case, arguing that Tymoshenko failed to establish a link between the defendant's actions and harm to her.⁴⁵

Even after RUE was disbanded, Russia's influence over Ukrainian politics was visible, and still underpinned by Ukraine's dependence on Russian gas. After the 2009 contract was finalised, the price of gas for Ukraine routinely reached \$450 USD per thousand cubic meters, much higher than the market price level. It was reduced, however, by \$100 USD per cubic metre after President Yanukovich and Dmitry Medvedev signed the so-called 'Kharkiv Agreements' in 2010, extending Russia's Black Sea fleet's presence in Crimea by 25 years: a portion of the rent Russia paid for the Sevastopol base was used to

offset the bill Ukraine paid for gas. What Dmitry Medvedev himself called a 'direct and unambiguous link' between the gas and defence deals shaped Ukraine's strategic situation in the run-up to the 2014 revolution in Maidan.⁴⁶

It is important to note that throughout this saga economic profit was never the primary motivation for Gazprom, which was prepared to subsidise gas sales to Ukraine, so long as this served a larger political purpose. Controlled by Russian political elites, Gazprom has proven to be a useful instrument of both personal enrichment and foreign policy. Once President Putin's closest allies were appointed to Gazprom's board, the company's profitability declined sharply as its investment decisions shifted away from the company's stated core business. One 2011 estimate concluded that up to 70% of Gazprom's capital investments were not related to gas and could not be accurately assessed due to lack of transparency. Another assessment suggested that in 2011 alone, the total amount of loss due to waste and corruption in Gazprom may have reached \$40 billion USD, compared to \$44.7 billion USD in profits.⁴⁷ Time and again, Gazprom made decisions that were not in the financial interests of the company, but which enabled it to funnel wealth to individuals. Aleksey Navalny, a Russian opposition activist, found Gazprom (among other state enterprises) making unexplained financial transfers and deals through which inflated contract payments were rerouted to questionable intermediaries, decreasing the company's profitability.⁴⁸ This suggests that the end goal of corruption can be more complicated than straightforward monetary gain, and that financial considerations can be subjected to larger political issues.

The case of Armenia

Armenia's vulnerabilities similarly stem from a combination of strategic dependence, competing international priorities, and corruption risks. Armenia has long been dependent on Russia for two strategic commodities: energy and arms. Since 1997, Armenia's gas has been supplied by ArmRusGazprom, a joint venture between Gazprom and Armenia's state-owned enterprise, Armgasprom. Over time, Armgasprom has transferred its holdings and assets to Gazprom. In return, Gazprom was to develop Armenia's gas network. The result was a de facto monopoly over Armenian gas supplies and numerous allegations of corruption.⁴⁹ This relationship and the dependence on Russian gas have generated controversy and no shortage of corruption allegations.

In 2013, ArmRusGazprom became a formal subsidiary of Gazprom as the latter acquired the last 20% of its shares at zero cost. This was billed as a way to pay off debts accumulated through receiving gas at a 'preferential' price over the previous period. Despite numerous demands from the parliamentary opposition and civil society, no detailed calculation regarding the debt accumulation was provided. Gazprom was also guaranteed an effective monopoly not only on the supply of gas to Armenia until 2043, but also on exporting electricity through Armenia to customers in Georgia and Iran.⁵⁰

These changes coincided with a shift in Armenia's political trajectory away from European integration and toward greater cooperation with the Eurasian Economic Union. Three former government ministers – of Economy, Energy and Finance – claimed that had Armenia acted otherwise, Gazprom would have significantly increased the gas tariff.⁵¹ In other words, it is conceivable that the gas tariff might have been exploited in order to prevent Armenia from taking the European association path.

Just as in the Ukrainian case, Armenia's strategic dependence on Russia, that was deepened by Gazprom's acquisition of ArmRusGazprom, was compounded by evidence of links between Russian and Armenian institutions and politicians. In September 2016, Karen Karapetyan – previously First Vice-President of Gazprombank (not a Gazprom subsidiary, although Gazprom does hold a minority stake in it) in Moscow in 2011-2016 – was appointed prime minister of Armenia. Immediately after Karapetyan's appointment, Gazprom Armenia (currently 100% owned by Gazprom) agreed to reduce the gas tariff for final consumers by about 10%, seemingly without an economic justification or any evidence of a material change in factors affecting the pricing. The agreement also allows Gazprom to return to higher tariffs at a later time, and to request compensation for income not received due to temporary lower tariffs, creating a powerful lever of potential influence.⁵²

The case of Republika Srpska (RS)

Republika Srpska, one of the constituent parts of Bosnia and Herzegovina, has endured a long battle over the ownership and management of its iron ore mining sector. Since 2011, the RS government has been attempting to sell the Ljubija Mines in Prijedor, currently co-owned by ArcelorMittal Holdings AG and the RS government, to the Israeli Investment Group Balkan LLC (IIG-Balkan).⁵³ The deal has been repeatedly blocked by the RS Parliament, which needs to approve the sale of companies considered strategically important,⁵⁴ with a number of questions raised regarding transparency, international influence over a key sector, and relations between the public and private sectors.

Bosnian investigative journalists have noted that IIG, registered in the Dominican Republic and directed by Russian businessman Evgenij Zotov, is in turn owned by three other companies whose registered owners are close political allies of the RS President, Milorad Dodik. Zotov himself is something of an enigma, with close links to the Israeli political scene, but no apparent experience in the mining industry. The coverage in Bosnia, though, has stressed that the RS attempts to sell the mines to IIG-Balkan have corresponded with a notable rise in nationalist and pro-Russian sentiments in the Dodik government, and raised questions about Zotov's identity, expertise, and links to Russian, Israeli, and Bosnian political players.⁵⁵ At the time of writing, the RS government has removed the Ljubija mines from the list of strategically important companies and is planning to post the company on the Banja Luka stock exchange, where its shares could be freely bought and sold.⁵⁶

Looking further afield

After crises in Ukraine and other Eastern Partnership countries, much European attention has been on Russia and its influence in Europe and Central Asia. Decision makers, however, should not lose sight of risks further afield. One contender for the use of corruption as statecraft is China, where the system of authoritarian capitalism creates significant opportunities for turning economic power into political leverage. The extent to which China is actively deploying this kind of strategy is difficult to determine; what is clear, however, is that the aims of some of China's policies are directed towards transforming the international political, economic and security order.

The Belt and Road Initiative (BRI) – a planned network of overland corridors and maritime shipping lanes announced in 2013 – is now the lynchpin of China's global strategy. More than 70 countries have signed up, and China has announced an investment pot estimated at about \$1 trillion USD, about 8 times the size of the post-World War II Marshall Plan.⁵⁷ The BRI involves cooperation on major permanent infrastructure (especially ports and roads), the strengthening of cultural ties, and is accompanied by an expansion in China's security reach, from Chinese private security companies employed to safeguard projects in fragile states to possible Chinese military bases.⁵⁸

Critics of the BRI argue that Chinese investments come with strings, and can result in political and economic dependence. Loans financing BRI projects are often opaque and granted with conditions requiring recipients to hire Chinese companies – often state-owned – to do the work, rather than conduct an open call for tenders.⁵⁹ The focus on large-scale infrastructure investments also exposes the BRI to possible corruption: large, long-lasting projects, where bribes and kickbacks are relatively easy to hide, have long been associated with corruption.⁶⁰ In Bangladesh, the state-owned China Harbor construction company was banned from future projects following alleged attempts to bribe officials; its parent company was debarred from World Bank contracts for 8 years, between 2009 and 2017, due to corruption allegations.⁶¹ And then there is Malaysia, where Chinese companies are suspected of funnelling RM30 billion to former Prime Minister Najib, so that he could bail out state investment funds accused of stealing over \$3.5 billion USD from 1MDB, Malaysia's development fund. Leaked documents seemed to indicate that Najib colluded with the state-backed contractor China Communications Construction Company – previously debarred by the World Bank due to corruption – to put up the cost of the double-track East Coast Rail Project (ECRP) from RM30 billion to RM60 billion, with the surplus diverted to companies related to the former PM.⁶² Although the Chinese authorities denied that any bailout occurred or that China attached political conditions to its loans and investments, the current

Malaysian government cancelled two large infrastructure projects funded with Chinese loans, pointing to bloated costs and a lack of economic viability.⁶³

Concerns about the cost and economic viability of Chinese-financed projects have surfaced elsewhere too. BRI loans are granted at commercial interest rates and have already resulted in unsustainable levels of debt for a number of countries. From Montenegro to Kyrgyzstan and Pakistan, Chinese investment in major projects constituting significant percentages of GDP (about 20% in Pakistan's case) is likely to be a major repayment burden.⁶⁴ Much like dependence on oil and gas, a debt burden could be a source of long-term political and economic leverage, one that could influence countries' national and international choices.

Sri Lanka's investment in a new Hambantota port is perhaps one of the best illustrations of these risks. The port's construction, financed through loans from China and carried out by China Harbor, came with political and financial support from China Harbor to Sri Lanka's former president, Mahinda Rajapaksa, who approved the initiative despite analyses arguing that there was little need for it.⁶⁵ Since its opening in 2010, the port has struggled to attract ships, which have preferred the existing port in Colombo, Sri Lanka's capital. Unable to pay back the loans, in December 2017 Sri Lanka loaned the port and 15,000 acres around it to China for 99 years.⁶⁶

The agreement with the Sri Lankan government bans foreign governments from using the port for military purposes, unless the Colombo administration grants an explicit approval. Analysts worry that debt pressures could render Sri Lankan governments vulnerable to military requests, especially as Chinese submarines had already entered the port in 2014.⁶⁷

China could conceivably bring together all facets of its collective power in service of its foreign policy objectives, even if that is at the expense of the interests of the wider Chinese population or the health of the country's economy. The BRI investments – some of which are now delayed, have been abandoned, and have generated debt that China might not see repaid – are unlikely to benefit China economically. Rather, they offer a way to establish political influence over countries seen as geopolitically strategic.⁶⁸

This should matter to all of us: this new wave of Chinese investment could leave a lasting impact on the way the world is governed both domestically and internationally. Chinese influence in debt-ridden countries could not only dampen development, but also question the legitimacy of governments that had lost their freedom of manoeuvre due to heavy debt burdens and strategic dependence.

WHAT MAKES STATES VULNERABLE?

While it is often tempting to see corruption as a series of acts carried out by individuals, the story is often more complicated. The most resilient corruption networks are frequently based on a combination of enabling factors, from strategic dependence to secrecy that can offer inducements for individual actions and provide ways to hide wrongdoing.

Corruption and strategic dependence

Had Viktor Yuschenko attempted to resist Gazprom, gas in Ukraine would likely have been cut off in the midst of a severe winter, with consequences perhaps too serious for any government to consider. Ukraine's dependence on Russian gas underpinned a corrupt system and gave it resilience. RosUkrEnerg – and other companies like it – were able to corrupt Ukrainian politicians partly because they exploited a very real need for an indispensable resource.

Energy is not the only sector at risk. Defence and security institutions, with significant budgets, strategic importance, and higher levels of secrecy, are a particularly fertile ground for corruption and dependence. In Ukraine, Ukroboronprom – the large, state-owned arms producer, and sole importer and exporter of weapons – has been plagued by accusations of corruption and diversion through fraudulent procurement schemes. It has also long been unable to provide the Ukrainian armed forces with the equipment they need, while its intricate bureaucracy has slowed down the delivery of security assistance to the country's armed forces.⁶⁹

The 'Azerbaijani Laundromat' also exemplifies some of the risks affecting defence and security institutions. While the majority of 'Laundromat' resources came from opaque companies linked to the regime of President Ilham Aliyev, OCCRP reports that \$9 million USD was contributed directly by Azerbaijani defence and security institutions and another \$29 million USD came from Russian state-owned arms export company, Rosoboronexport.⁷⁰ The Rosoboronexport payments were reportedly funnelled to Metastar LLP, one of the core Laundromat companies, and through it to Velasco International Ltd, a company linked to the Eyyubov family.⁷¹ Attempts to explain the goal and rationale behind state sectors' participation in a corruption and money laundering scheme have been met with a wall of silence,⁷² while the overall secrecy surrounding defence and security institutions in Russia and Azerbaijan has made it impossible for external

stakeholders to investigate these expenses. Both the Azerbaijani government and the Russian Foreign Ministry denied the OCCRP allegations, with the latter referring to alleged Rosoboronexport payments as 'fake news.'⁷³

Infrastructure investments, especially if they come with high debt burdens, low transparency, and commitments to hire companies without tender or on preferential conditions, can also be the bedrock of dependency. As countries' and decision makers' options become ever narrower due to a debt burden or an investment whose costs keep ballooning, choices that can threaten national and international security might be the only ones available. The temptation to pursue grand investments without proper attention to their feasibility and cost can tether countries, in the long term, to foreign policy and security choices they might not otherwise wish to make.

Secrecy and anonymity

A combination of strategic dependence and weak governance create the underlying vulnerability that enables the use of corruption as statecraft. But these schemes would not work without a key enabling factor, namely the opacity of company beneficiaries and financial flows. In the case of Ukraine, a company's ability to issue bearer shares – anonymous shares whose holder is entitled to company dividends and to shareholder rights, but whose name and connection with the company is not made known – enabled financial benefits to come to beneficiaries whose identities could be kept secret. This practice, combined with the frequent substitution of nominees for actual beneficial owners, has allowed financial flows to remain under the radar.

In the case of the RosUkrEnerg scheme, it was Swiss regulations, for example, which allowed the issuance of bearer shares. At the time, Swiss authorities imposed no obligation for a company to register its shareholders or to track movements of shares between different owners. The anonymity tied to bearer shares enabled RUE to pass on profits to anonymous shareholders while keeping them hidden not only from public scrutiny, but – in some cases – from other shareholders as well. The existence of bearer shares and the secrecy surrounding them meant that company shareholders would not necessarily know who other shareholders were, or who had controlling interests in the company.⁷⁴

RosUkrEnerg's position as an intermediary between Gazprom and Naftogaz and its registration in a jurisdiction

which shielded shareholder identities reportedly facilitated significant wealth diversion. With the ability to generate significant income and keep records of shareholders internal rather than public, RUE could have been used as a tool both of bribery and political pressure.⁷⁵

The bearer share conundrum

Interviews with multiple reliable sources in Ukraine indicated that while RosUkrEnergo issued registered shares when it was established, it later converted, through a decision of the majority of shareholders, some of those shares into anonymous bearer shares. This conversion should have been reported to the commercial registry in the canton of Zug, where the company was registered. The Zug records, however, only note RosUkrEnergo issuing named shares; there is no record of the conversion. Correspondence with registry representatives indicates that while the company was obliged to report the change, there would have been no verification of whether it actually did so. Ukrainian interviewees have suggested that while the conversion was recorded in internal company documentation, it was never reported to the authorities.

Without access to RosUkrEnergo's internal company records, it is not possible to conclusively resolve the discrepancy. However, this is a further indication of the necessity for robust enforcement systems, where company-based obligations are complemented by checks and sanctions helping to enforce the flow of information.⁷⁶

Bearer shares are just one example of the mechanisms through which the identities of company owners, controllers and beneficiaries can be shielded. The 'Azerbaijani Laundromat' and the Panama Papers scandal have shed light upon the continuing opportunities to hide beneficiaries through layers of trusts, companies, nominees and intermediaries – all mechanisms that enable the corrupt to hide their ill-gotten gains through European financial systems. Conversely, transparency and easy ways to identify beneficial owners of companies and other legal entities help prevent money laundering, illicit financial flows, and large-scale bribery.⁷⁷ Without this ability to identify the individuals who ultimately benefit from particular financial transactions, authorities (or the public, for that matter) are unable to assess whether the entities conducting these transactions contribute to the entrenchment of corrupt networks and help spirit national resources away to safe havens where kleptocrats can benefit from them, thereby destroying whole countries' opportunities for development and security.

VULNERABILITY AT THE HEART OF EUROPE

While it would be tempting to imagine that ‘corruption as statecraft’ principally threatens emerging democracies, this would be a mistake. Opaque networks of companies also have the potential to corrupt and undermine established European institutions.

The Parliamentary Assembly of the Council of Europe (PACE), for example, found itself at the receiving end of Azerbaijan’s attempts to improve its international reputation. The Aliyev regime, keen to shore up its position at home and enhance its standing abroad, designed a charm offensive involving organising Formula 1 races and visits to Baku for European opinion-formers.⁷⁸ But the charm offensive had a darker side. Using money from a slush fund, Azerbaijani officials reportedly bribed members of the Parliamentary Assembly of the Council of Europe to secure more favourable reporting on human rights and democratic issues in the country, and to neglect the more egregious human rights breaches such as the imprisonment of journalists and political opponents.

The slush fund enabling the influence operation functioned between 2012 and 2014, with around 2.5 billion euros flowing from at least five different sources. About half came from Baktelekom MMC, a shell company linked to the Aliyev family; \$169 million USD from Faberlex LP and \$109 million USD from Jetfield Networks Ltd., two offshore companies connected to another regime official. \$29 million USD reportedly came from Rosoboronexport, Russia’s state-owned arms trade company, and \$9 million USD from the Azerbaijani defence and security ministries. The money was transferred to four shell companies registered in the UK, two of which hid behind a figurehead beneficial owner, a Baku taxi driver. All four companies held accounts at the Estonian branch of the Danske Bank, which processed all their payments, seemingly without raising red flags.⁷⁹

What came to be known as the Azerbaijani Laundromat had two purposes: paying for luxury goods for Azerbaijani officials in Europe and financing the state’s reputation-laundering initiatives.⁸⁰ According to reporting by the Organised Crime and Corruption Reporting Project (OCCRP) and the European Stability Initiative, Azerbaijani PACE member Elkhan Suleymanov orchestrated a scheme which funnelled payments to three other PACE members. This included Luca Volonte, a prominent Italian MP and former chair of a centre-right grouping in PACE, who received a total of \$2.64 million USD in 19 payments, and Christian Lintner, a German MP who led an election observation mission to Azerbaijan and who was paid a total of \$1.1 million USD.⁸¹ Lintner publicly praised the

2013 presidential election, described as flawed by most observers, while Volonte stands accused of building a coalition to reject a 2013 report criticising the Azerbaijani regime’s human rights record.⁸² At the time of writing Volonte, acquitted by an Italian court of money laundering charges, was awaiting judgment on corruption charges in Italy – charges which he has denied.⁸³ An independent investigation launched by PACE noted that Volonte and the Azerbaijani stakeholders engaged in ‘activities of a corruptive nature’ and breached the PACE code of conduct. Luca Volonte explained payments received from Azerbaijani stakeholders as remuneration for a long-term consultancy contract, but could not account for the payments being made through UK shell companies.⁸⁴

The scandal exposed gaps in the PACE ethics regulations and their enforcement. These gaps – from lax policies regulating conflicts of interest to a lack of investigations into alleged breaches – undermined the body’s credibility and effectiveness. Despite clear indications that the behaviour of some of its members was questionable, PACE failed to either investigate the allegations or sanction the perpetrators, and only launched a reform of its ethics system after the scandal had garnered considerable media attention.⁸⁵ In April 2018, PACE published the results of an independent investigation into the corruption allegations. The report stressed the need for more transparency in PACE appointments, a more robust policy on receiving gifts and preventing conflicts of interest, a strengthened ethical code, and a process to investigate and sanction ethical violations.⁸⁶

There are similar concerns about conflict of interest regulations for MEPs. The current parliamentary Code of Conduct imposes an obligation on MEPs to report outside income and activities, but the quality of data provided does not yet allow for meaningful monitoring of potential conflicts of interest or MEPs’ vulnerability to outside influences. Many MEPs provide vague descriptions for their external activities, describing them as ‘freelancing’ or ‘consultancy.’ It is therefore impossible to identify the exact source of their outside income. Income is also reported in broad gross categories per month rather than in concrete amounts. The most commonly used category is €1,000–€5000; high earners grossing more than €10,000 threshold must indicate their income rounded (up or down) to the nearest €10,000.⁸⁷ There is clearly a significant risk: the European Parliament could be exposed to the same vulnerabilities that affected the Parliamentary Assembly of the Council of Europe.

European countries, including EU members, accession candidate countries, and partners, have also been

developing political and economic links with China, which have affected key sectors. In 2017, Germany, France, and the United Kingdom refused to sign a proposed trade agreement at the Belt and Road Forum, concerned about limited transparency requirements in tendering contracts and a lack of social and environmental standards.⁸⁸ But several EU states, including Hungary, Greece, Slovenia and Portugal, have joined the initiative.⁸⁹ China has invested in many of Europe's important ports, including Antwerp and Rotterdam, and has rejuvenated others, including the port of Piraeus in Greece.⁹⁰ In Hungary, China has promised to build a modern, high-speed connection to replace an old, obsolete train system between Budapest and Belgrade.⁹¹ The railroad – which experts worry will not be economically viable – will cost close to US\$3.6 billion, with 85% financed by loans from China. The Hungarian government has provided no official justification for the project, making it a state secret instead. The European Commission expressed concerns about the project itself as well as the potential corruption risks, especially the possibility that competition laws and public procurement procedures may have been sidestepped.⁹²

These kinds of loans are also seen as an opportunity in Western Balkan states. China has strongly promoted its '16+1' initiative, with annual meetings between China, 11 EU Member States and five Balkan countries. The Chinese government has proposed investments of up to 12.2 billion euros in Eastern European countries and provided low-interest loans with few conditions attached.⁹³ Several of these agreements have been designed with limited public accountability and local oversight, leading to suspicions of illicit payments and the undermining of governance.⁹⁴ While not EU members, a number of these states are in initial negotiations to join the EU block by 2025, raising questions and concerns about EU-wide standards of integrity and transparency in public contracting and expenditures.⁹⁵

For instance, China has given a 1 billion euro loan to the government of Montenegro to build a 165-km motorway linking the port of Bar to Montenegro's neighbour Serbia.⁹⁶ Initial feasibility studies for a similar project, conducted in 2006 and 2012, cautioned against it, citing a lack of economic viability. Yet, a new feasibility study by economics professors from the University of Montenegro, paid for by the state-funded Export-Import Bank of China, reportedly found that the highway was viable. The study has never been made public.⁹⁷ Additionally, the loan has drastically increased Montenegro's debt, which has risen from 62.5% of GDP in 2017 to almost 80% of GDP in 2018, while only a portion of the highway is currently under construction.⁹⁸

The European Bank for Reconstruction and Development (EBRD) has raised concerns about the features of the '16+1' engagement, including the burden placed on governments by large debt obligations and indications

that 'Chinese companies serve as proxies for the Chinese state.'⁹⁹ While infrastructure investment should not be neglected in the Western Balkans, it should also not come at the expense of transparency, accountability and high standards of commercial competition.¹⁰⁰ The imbalance of power that these contracts create – both through the burden of debt and through the corruption risks inherent in non-transparent tenders – can threaten EU unity and deepen divisions on the bloc's fundamental principles. In 2016, Greece and Hungary fought against including a direct reference to China in an EU statement addressing an International Court of Justice (ICJ) ruling striking down China's claims in the South China Sea.¹⁰¹ A year later, Hungary blocked an EU statement at the UN Human Rights Council regarding China's human rights record and the torture of journalists; this was the first time the EU had failed to make a statement.¹⁰² Both Greece and Hungary benefit from loans and investments as part of the Belt and Road Initiative.

Last but not least, Europe faces the same risks as emerging democracies from multi-layered company structures involving subsidiaries in numerous jurisdictions. Gazprom's Swiss-registered subsidiaries, for example, include Gazprom Schweiz AG, a subsidiary of Gazprom Germania, which imports and exports Central Asian gas to and from Europe and is an issuer of bearer shares.¹⁰³ While a company's motivation in selecting a particular jurisdiction may not necessarily be driven by a desire for secrecy (tax policy, economic stability, and other considerations are frequently decisive), a jurisdiction's permissiveness toward secretive legal entities should not be overlooked.

COUNTERING CORRUPTION AS A FOREIGN POLICY TOOL: STATE OF PLAY

In recent years, awareness of the problems that secrecy poses has increased. Recent scandals – including the Panama Papers – have pushed European states toward greater transparency in corporate beneficial ownership, making it obligatory for companies to identify their beneficial owners. But systems of influence and corruption are resilient and it is largely down to individual countries to notice and tackle the vulnerabilities that can lead to corruption being used as a tool of statecraft, from strategic dependence and debt vulnerability to excessive secrecy and the ability of other countries to exert influence on their policy makers.

Tackling strategic dependence

In Ukraine, the Orange Revolution prompted not only a political change, but also greater commitment to tackling widespread, deeply entrenched corruption. The three pillars which made the RUE scheme possible – Ukrainian dependence on Russian gas, European laws allowing near-perfect anonymity for company beneficial owners and intermediaries, and either tacit acquiescence or active participation of Ukrainian elites – are being eroded through anti-money laundering regulations and increasing corporate transparency. But despite progress on legislation and greater scrutiny of political leaders, it remains to be seen whether European and Ukrainian leaders can sever the ties of dependence which have been established over the course of many years and sustained through very different political administrations.

Starting in 2014, Ukraine has made efforts to diversify its gas supply, and has achieved some success in reducing direct imports from Gazprom. Following another gas dispute in 2014, starting with a threat of a price hike and culminating in Gazprom's decision to cease deliveries (ostensibly over an unpaid bill which Ukraine has disputed), by 2015 Ukraine was purchasing 53% of its gas from the EU rather than from Russia. At least some of that gas, however, was 'reverse' Russian gas, originating from Gazprom supplies and resold by EU countries.¹⁰⁴ The Ukrainian government has also attempted to recover costs from Gazprom (for what it saw as unfair pricing) by instigating legal proceedings between Gazprom and Naftogaz at the Arbitration Institute of the Stockholm Chamber of Commerce. In March 2018, the Chamber ordered Gazprom to pay \$4.63 billion to Naftogaz as

compensation for transit fees and business lost since 2014. The Chamber also ordered Naftogaz to pay Gazprom back to past gas supplies; the overall result was a net payment of \$2.56 billion USD from Gazprom to Naftogaz. Three months later, however, Gazprom filed an appeal with the Swedish Court of Appeals, claiming outside interference. The court suspended the enforcement of the previous ruling, but repealed that decision and gave a green light to enforcement in September 2018.¹⁰⁵

While Ukraine has managed to diversify its supply of gas, it has developed other areas of strategic dependence on Russia which bring new risks. For example, analysts worry that the procurement of liquefied petroleum gas (LPG) and diesel fuel shows characteristics close to the RUE arrangement.

The share of Russian diesel in the Ukrainian market began to grow in 2016, after a pipeline transporting fuel from Russia through Belarus was reactivated. The pipeline, previously the property of the Ukrainian treasury, was transferred to Rosneft, a Russian energy company owned partially (50%) by the state, in 2015. Subsequently, it was sold to another Swiss-registered company, International Trading Partners AG. According to oil industry insiders, this company's ultimate beneficial owner appears to be Viktor Medvedchuk, a pro-Russian Ukrainian politician currently responsible for negotiations on the release of Ukrainians held in Russian prisons, and a relative of Vladimir Putin.¹⁰⁶

The pipeline is currently operated by another Swiss company – Proton Energy Group SA – whose subsidiary, Swiss-based Glusco Energy SA, recently bought 141 gas stations in Ukraine. The deal was approved by the Ukrainian Anti-Monopoly Committee, despite having been previously rejected.¹⁰⁷ Glusco and Proton Energy are in turn owned by Israeli businessman Nisan Moiseyev, who, according to Ukrainian investigative journalists, has close links to Viktor Medvedchuk. While both Medvedchuk and Moiseyev deny that a business relationship exists, investigative journalists consider one observation telling: after the imposition of an overall ban on direct air connections between Ukraine and Russia, Medvedchuk reportedly remains the only person who can fly, on a private jet, between Moscow and Kiyv, and has been accompanied, on at least one of these flights, by Moiseyev.¹⁰⁸

The advent of Ukraine's strategic dependence on Russian diesel and LPG has been coupled with concerns that its anti-corruption reforms are faltering due to entrenched corrupt networks and a lack of political will. Despite the swell of public anti-corruption activism and the initial moves toward integrity, comprehensive reform and the dismantling of corrupt networks has proved challenging.¹⁰⁹ The networks' resilience, the difficulties reformers face, and the emerging areas of strategic dependence could yet prove a pathway for the reappearance of corruption as a foreign policy tool. Other countries – notably Armenia – will likely need to tackle very similar issues.

More broadly, many emerging democracies, whether in Eastern Europe or Asia, are fragile; institutions are weak, and in some cases societies are divided by significant rifts, whether ethnic, linguistic or religious. This all renders the prospects for reform rather bleak. At the same time these conditions can be a significant source of domestic instability. Elite corruption on a grand scale robs entire populations of economic development, and repurposes institutions of state into networks extracting resources and diverting public wealth into private pockets. And there is considerable evidence that this in turn creates significant public frustration, divides societies, and can precipitate violent responses.

Ultimately, the failure to strengthen resilience will have broader consequences well beyond individual states. The use of corruption as statecraft by authoritarian systems which are able to fully integrate economic and political power, alongside elite corruption in many emerging powers, will also pose significant risks for those invested in the current world order who want to see the maintenance of the rules-based system upon which open societies depend.

Closing the legal loopholes and limiting the activity of professional enablers

The Panama Papers and the 'Azerbaijani Laundromat' drew attention to tax-haven, secrecy-heavy offshore jurisdictions. Focus on these jurisdictions is justified, but should not come at the expense of the EU monitoring developments in its member states or in its immediate neighbourhood. In Europe, significant progress has been made at the regulatory level, especially with the EU's 4th and 5th Anti-Money Laundering Directives (adopted in 2015 and 2017 respectively). These step up the fight against illicit financial flows by, first, establishing a requirement to maintain registers of beneficial company owners, preventing misuse of bearer shares and other anonymity-promoting measures; second, imposing obligations to report suspicious activity on financial and other professionals; and, third, enhancing due diligence on politically exposed persons.¹¹⁰

However, loopholes do remain. EU regulations impose the obligation to identify beneficial owners who control 25% or more of the company's shares or assets; if nobody owns 25% or more shares, company managers can be named instead. This is a high threshold, one that makes it easy for beneficial owners wishing to stay under the radar to circumvent the spirit of the regulations. While some member states have lowered that threshold (it is, for example, 5% in Denmark),¹¹¹ many have kept to the Directive's specifications and have therefore seen limited improvement in the availability of information. In one probe, 10% of companies listed in the UK claimed to have no beneficial owners, as nobody owned 25% or more of their shares.¹¹²

The regulations also open the door to nominees – including managing directors – being named if beneficial owners cannot be identified, which can result in a misleading picture of who controls a particular company.¹¹³ This is a key risk: a 2011 review of 150 cases of grand corruption carried out by the World Bank's Stolen Assets Recovery Initiative (STAR) indicates that in over two-thirds of cases, surrogates – such as nominees – were used to obscure the identity of company owners or management, greatly complicating efforts to understand who exerts control over and derives benefits from a company.¹¹⁴

Enforcing AML regulations and imposing sanctions for breaches poses a separate set of challenges. Beneficial ownership information is based on company self-reporting and most national authorities do not appear to have the capacity to verify its accuracy. Other stakeholders in the field who are obliged to verify beneficial ownership information and the identity of beneficial owners – such as company service providers and law firms – appear to neglect this duty, partly due to a lack of awareness,

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understanding and the capabilities to do so, and partly due to a lack of enforcement by supervisory institutions.¹¹⁵ Service providers, such as Mossack Fonseca, featured frequently in the corruption and tax avoidance schemes revealed in the Panama Papers, and reports from the Netherlands indicate that service providers neglect to report suspicious activity or verify client data.¹¹⁶ A Transparency International – EU analysis indicates that out of six countries whose regulations it has examined, none have comprehensively regulated the activity of nominees or company service providers offering, among other services, assistance in setting up EU-based subsidiaries of foreign companies. This appears to further the cause of anonymity rather than accountability.¹¹⁷

One approach which could enhance monitoring is making data accessible to the public and thus enabling oversight from civil society. The EU's AML regulations currently mandate the creation of public beneficial ownership registers, but access to these at national level can still be restricted by fees, functionality of design, or the limiting of access to those with a 'legitimate interest.'¹¹⁸ In Switzerland, whose banking sector is linked to the EU and which remains a key destination for foreign investment, including the activities of Politically Exposed Persons (PEPs),¹¹⁹ the public has no access to the beneficial ownership data of Swiss companies, unless companies are listed. While an online database of the Swiss company registry is publicly available, it provides no information on beneficial owners. Confirmed registration information can only be requested for a fee and beneficial ownership data is available only to authorities.¹²⁰

The area that has perhaps seen the most progress is regulation of bearer shares, as many European countries have restricted their circulation or generated plans to phase them out.¹²¹ In Switzerland, while issuing bearer shares is still permitted, legal changes introduced in 2015 obliged individuals purchasing them to identify themselves to the company which issued them, otherwise they cannot exercise shareholder rights. The company itself has a duty to maintain an up-to-date list of individuals holding bearer shares. These measures appear to have increased transparency and accountability in the financial sector: 75% of companies have chosen to convert their bearer shares to registered shares, and the percentage of companies newly registered in 2015 which chose to only issue registered shares rose to 81%, from 72% in the previous year.¹²² In early 2018, the Swiss government announced a plan to entirely abandon bearer shares.¹²³

Companies are also obliged to keep registers of bearer shareholders, and the transfer or sale of bearer shares needs to be reported to the company in question within 1 month of the sale or transfer. However, with the duty to report placed on shareholders, it is unclear how effective the system is and whether companies verify the bearer share registers they hold.¹²⁴ The Swiss system does not

include any sanctions, administrative or criminal, aimed at shareholders who purchase shares or acquire beneficial ownership and fail to report it. It is also not clear whether sanctions are imposed on companies that fail to maintain a register of shareholders and beneficial owners.¹²⁵

But even more importantly, it is not clear whether a sanctions regime aimed at disrupting the functioning of a company would deter corrupt actors for whom company profitability is less important than the role it can play in furthering their political goals. The rationale behind the sanction regime appears to be based on the assumption that shareholders' main goal is to improve company functioning and to generate profit. Deterring the use of money laundering vehicles for foreign policy purposes might require a whole new approach. At the very least, it is unlikely that a sanctions regime judged to be of limited efficacy would pose a sufficient deterrent to those motivated by political, rather than business, considerations.

WHAT NEXT? HOW TO PROTECT AGAINST CORRUPTION AS A TOOL OF STATECRAFT

While significant progress has been made to address the vulnerabilities that can enable the use of corruption as an instrument of statecraft, elites in some states might attempt to use it again. Democratic societies need to pay a lot more attention to these issues than they currently seem to, and they must start working on a more unified approach.

Understand the systemic nature of the threat and design reforms to match

It is clear that the use of corruption as a tool of statecraft is underpinned and enabled by extensive corrupt networks and complex rationales. The stories of Oleh Rybachuk, Viktor Yuschenko and RosUkrEnergO illustrate a crucial issue: tackling corruption and the networks that sustain it requires a systemic approach. Focusing on 'clean' individuals as agents of change will not be sufficient if what they face is a well-entrenched network combining the search for private gain, secretive payoffs, and a strategic imperative which helps it to continue through the changes in presidents, prime ministers, and their chiefs of staff.

With such a resilient network in place, the system of incentives is geared not towards integrity, but rather towards wholesale corruption. Backed by cash, directed by those with access to state resources, facilitated by weak governance and able to draw on the methods of organised crime, these networks pull the most important strings. Resisting them can be difficult and risky, and threats to those who try can be all too real. External supporters of anti-corruption reforms should therefore understand the systemic and enabling factors supporting corrupt systems in order to design comprehensive, effective reform programmes that focus not only on corrupt individuals but also on the companies and systems that support them. While sanctions for corrupt individuals and effective systems for returning assets stolen through corruption are indispensable, predominantly punitive approaches are unlikely to work if the existence of underlying, systemic networks, through which external actors can feed corrupt systems, are not addressed.

Consider the balance of support and conditionality

For the European Union, faced with member and partner states' exposure to unsustainable debt burdens and infrastructure projects that might not be viable, the key question is how to balance commitment to enlargement and integration with pressing for fulfilment of membership conditions. There is no question that BRI funding and contracts often do not meet EU procurement standards and that they can engender harmful practices in both the public and private sectors. Debt levels brought about by these unsustainable investments might make countries inside and just outside the EU vulnerable to foreign policy influences that could destabilise the region. The EU might therefore face a similar choice in the future to the one it faced in Ukraine: if it is serious about helping countries extricate themselves from a debt-based dependence, there will be a significant price tag attached.

The EU also has a role in preventing further areas of strategic dependence from developing, but understanding how to do this is neither easy nor simple. The conditionality inherent in the EU partnership and enlargement process is designed to push countries toward greater transparency and accountability, including in public procurement; accepting the more opaque BRI practices therefore takes countries further away from membership. But for this to work and to be used as either a carrot or a stick, the prospect of membership has to be real and achievable for candidate countries; otherwise, frustrated by the stop-and-start processes, they are more likely to be tempted to avail themselves of other investment opportunities. While either decision – to speed up or postpone enlargement or closer partnerships – is legitimate, the consequences of strategic dependence need to be considered when making those decisions.

Appreciate and address the areas of strategic dependence enabling corruption

Corruption as a tool of statecraft utilises inter-state dependence in strategically important sectors, such as energy or defence and security, and can rely on financial dependence and debt burdens. In order to support anti-corruption reforms in Ukraine and elsewhere – especially in countries struggling with strategic dependence on others – these very real drivers of corruption, capable of holding a state captive, will need to be addressed. An opening for reform such as a change in government will only stand a chance of success if anti-corruption initiatives are coupled with efforts to mitigate the strategic pressure points which enable corrupt systems to survive. This will require allies to be ready to invest significant resources and lend political support.

In 2005, that support for Ukraine had not yet materialised. The US, which had advocated the renegotiation of the gas deal between Russia and Ukraine, called for the EU to support the process, but with no apparent results.¹²⁶ Oleh Rybachuk remembers a ‘cold reception’ for the new Ukrainian government in Europe, with a corresponding puzzlement as to how to conduct negotiations with the EU in Kyiv.¹²⁷ His search for guarantees that Ukraine would not be pushed into a deal if Russia cut off the gas were forestalled by Gazprom’s decision to turn off the gas tap on 1 January 2006, and the Yushenko agreement three days later.¹²⁸ EU countries which lost a part of their expected gas supplies due to the crisis in Ukraine (supply in France fell by 25-30% and in Hungary the loss was 40%)¹²⁹ were perhaps ill-prepared for offering support to Ukraine while securing their own energy needs.

Overall, the costs incurred by Ukraine and the forceful pushback from domestic political forces indicate that countries are unlikely to be able to extricate themselves from corrupt networks without substantial external assistance in addressing the sources, and not only the symptoms of, corruption.

Keep up the momentum: tackling legal and professional enablers

The recent moves toward greater transparency and accountability for companies – especially more stringent regulations on beneficial ownership – are to be applauded. The impetus, however, should not falter, but rather be shifted to challenges in the sphere of implementation and investigations. In particular, it will be necessary to monitor the implementation of regulations regarding beneficial ownership transparency, and to provide resources to ensure that anti-money laundering regulations are fully

implemented across the EU. Governments and the EU institutions need to allocate resources and provide enforcement authorities with real power in order to, first, proactively verify information provided by companies, second, identify the means through which beneficial ownership is exercised, third, train obligated entities to recognise and report red flags, and fourth, enable investigators to follow trails across borders.

EU member states also need to exert pressure on third parties whose regulations could have influence beyond their borders. While it is imperative to address shortcomings in tax havens from Panama to the Isle of Man, good neighbours such as Switzerland should also be encouraged to continue their AML reforms. International pressure has helped bring about significant reforms in Switzerland and should be continued as the Swiss government conducts a consultation aimed at revising company laws and eliminating anonymous instruments such as bearer shares.¹³⁰

Strengthen resilience, build integrity

While ‘hybrid warfare’ – the mixture of conventional military tactics and political, economic and communication endeavours deployed by the Kremlin to undermine other states – has been recognised by the NATO Alliance and by the EU as a key challenge, the analysis and response to this challenge has been predominantly focused on cyber attacks, fake news, and the legal implications of unconventional tactics.¹³¹ In order for both NATO and the EU to be prepared to tackle hybrid threats, they need to appreciate the role that corruption can play as a tool of hybrid warfare, used to undermine the independence and well-being of states. Protecting political and especially defence and security institutions from illegitimate influence should become a priority for EU and NATO members. The possible repertoire of actions includes:

- **Regulating and preventing the occurrence of conflicts of interest.** When not reported and monitored, conflicts of interest can expose national and EU institutions to influence which can undermine their effectiveness and their entire purpose: to serve the populations rather than narrow interests. EU institutions, including Parliament, should take the lead in reforming and enforcing the Code of Conduct, thereby minimizing the opportunities for conflicts of interest and malicious influence, and preventing authoritarian powers from influencing democratic institutions to the detriment of democracies. European-level regulations can then help strengthen parliaments at the national level.
- **Protecting defence and security institutions.** The defence of sovereignty for open societies in a digital age is less about defence spending and

more about preserving the integrity of institutions. Greater secrecy surrounding defence and security issues as well as the key role defence institutions play in providing security can make them a target for corrupt networks. Recognising that the security and defence sectors, similarly to the energy sector, could give rise to strategic dependence should lead to better oversight and greater care in guarding the integrity and independence of defence and security institutions.

- **Protecting journalists and civil society organisations.** Chinese influence in Malaysia and Australia was brought to light because of strong efforts by independent journalists and civil society organisations. Similarly, the Azerbaijani Laundromat case would not have been exposed without the efforts of the OCCRP. Democratic societies need to invest in independent journalism and advocate for other governments to ensure that civil society organisations and journalists in other countries have adequate space and resources to work with. The recent murders of three European journalists, all of whom worked on corruption issues, in EU countries – Daphne Caruana Galizia in Malta, Jan Kuciak in Slovakia and Viktoria Marinova in Bulgaria – make it clear that the EU cannot rest on its laurels.

Help others build resilient institutions

The best way to maintain the stability of the international rules-based order is by investing in the success of developing countries and emerging powers and shoring up their ability to act in the interest of their own populations. Influence on, and control of, institutions appears to be the key prize of 21st-century international politics, and the policies of democratic states need to match that. Therefore, rather than supporting international strongmen in the name of short-term stability, democratic powers need to support agents of change attempting to build inclusive, legitimate governments catering to the needs of the wider population rather than a narrow segment of society.

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