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# Addressing development's black hole: Regulating capital flight

A EURODAD, CRBM, WEED and Bretton Woods Project report

May 2008



### About Eurodad

**EURODAD** (the European Network on Debt and Development) is a network of [54 non-governmental organisations \(NGOs\)](#) from 18 European countries working on issues related to debt, development finance and poverty reduction. The Eurodad network offers a platform for exploring issues, collecting intelligence and ideas, and undertaking collective advocacy. More info at [www.eurodad.org](http://www.eurodad.org). To keep up to date on the issues tackled by Eurodad and its members subscribe on-line for free to our fortnightly Development Finance Watch publication.

### About this report

This report sets out evidence on the impacts of unregulated finance on developing countries, arguing that increased regulation and different policies are needed as a matter of justice and to improve stability for citizens in richer and poorer countries.

The report was written by Marta Ruiz and Andrea Baranes.

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## EXECUTIVE SUMMARY

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In the aftermath of the Asian financial crises ten years ago the international community recognised the importance of financial stability. Today new troubles infect the global financial system, leaving governments and financial analysts uncertain how to react. The media is full of the credit crunch, write-downs by private banks and dramatic price rises. There is discussion of how these incidents are spilling over across the economy in the U.S.A., Europe and elsewhere, with people losing their homes and jobs and struggling to provide meals for their families. Very little attention is given to the specific impacts in the world's poorest countries. Yet global financial stability – like climate change – is a key global challenge and one that the current financial and regulatory system is ill-equipped to handle.

The sub-prime crisis that started in the U.S. and spread through contagion has shown that market-based solutions and conventional crisis management are completely insufficient. Central bankers and finance ministers have tried injecting liquidity, lowering interest rates, and even nationalising a bank. Yet regulators and central banks are largely playing catch up. In France a single trader caused a €5 billion loss to Société Générale by evading in-house systems. In Germany the scandal of hidden deposits in Liechtenstein exposed the tip of the tax havens scandal iceberg.

The crisis is not just due to individual misbehaviour. There are deep flaws in the international financial system. Finance has become an end in itself: to make money out of money in the shortest possible time. This speculation leads to instability and widens the gap between rich and poor. Recurrent crises are inevitable. We are very far from achieving what the world's governments signed up to at the Monterrey Financing for Development conference in 2002. There they pledged to encourage “the orderly development of capital markets aimed at addressing development financing needs and foster productive investments”. They agreed, correctly, that this *“requires a sound system of financial intermediation, transparent regulatory frameworks and effective supervisory mechanisms”*. Finally they said they would introduce measures *“that mitigate the impact of excessive volatility of short-term capital flows”* and to strengthen *“prudential regulations and supervision of all financial institutions, including highly leveraged institutions”*.

The financial system is not only unstable, it is also unjust, resources are flowing from poorer to richer. Experts estimate that every year \$500 - \$800 billion leave Southern countries due to criminal activities, tax evasion, and corruption. This makes South-North financial flows several times higher than the average \$90 billion annual aid flows, the \$240 billion foreign direct investment to the South and the couple of hundreds of billions of dollars of remittances transferred from migrants.<sup>1</sup>

The International Monetary Fund is the main international public body responsible for overseeing the financial system. Since the 1980s it has instead spearheaded the liberalisation and deregulation of financial markets in most developing economies. This has made these economies more vulnerable to external shocks and to capital flight. The IMF's failed response to the Asian financial crisis has encouraged Asian countries and other emerging economies to accumulate huge reserves in order to prevent future crises. This diverts enormous sums of money from development needs.

Many proposals have been put forward for a fundamental reform of the international financial architecture to guarantee stricter regulation, more transparency and better control of capital. The implementation of such measures would be a win-win game for both the North and the South, generating productive and sustainable development-oriented economic growth. European governments – which committed at the Financing for Development Summit and under the Eighth Millennium Development Goal to develop a rule-based, predictable financial system – must play a leading role in promoting these reforms.

This paper addresses the major structural problems faced by developing countries under the existing global financial architecture. It points out how the financial sector lacks regulation and threatens development by facilitating capital flight and tax evasion, exposing developing countries to volatility in financial markets, and allowing unregulated actors such as hedge funds to exacerbate those risks through speculation.

The paper then underlines the failure of existing financial regulatory attempts by the IMF and other institutions. The last chapter points out that progress towards a just and stable global financial system will require vigilant advocacy at many levels and advances recommendations to build a stable and development-friendly financial system.

Among the recommendations, the report calls for the dramatic reform of the IMF's structure and mandate and the strengthening of regional financial architecture and a stronger UN mandate to combat capital flight. It proposes regulatory measures to combat capital flight and speculative actors such as hedge funds and private equity funds and stresses the need for greater transparency. The report finally calls on European governments' to take up their responsibilities directly and in international financial institutions. The paper points out two particular regulatory measures in which the EU can play a leading role, namely on improving transparency of the accounting standards for Transnational corporations and on ensuring enhanced automatic disclosure of information through an expanded EU savings tax directive.

The Doha summit that will review the financing for development process in December 2008 will be a unique occasion to put these systemic issues at the forefront of the international agenda and should open the necessary political space to start taking concrete steps for a development-friendly reform of international finance and financial institutions.

# IMPACT OF FINANCIAL MARKETS ON DEVELOPING COUNTRIES

Since the early 1990's private capital flows, namely foreign direct investments (FDI) have been privileged by the International Financial Institutions (IFIs) as the most effective means for growth in developing countries. But despite all the interest FDI have been given, very little can be said about their positive impact on development and productive growth. Firstly, FDI have followed rather than created growth in developing countries. They've been highly concentrated in a few countries experiencing economic growth. Secondly, many FDI directed to low income countries are focused on some strategic sectors linked to the exploitation of natural resources. Thirdly, a big share of the inflows goes out of the countries in terms of profit remittances and capital flight driven by tax evasion and avoidance schemes.

## A. Reverse capital flows and capital flight

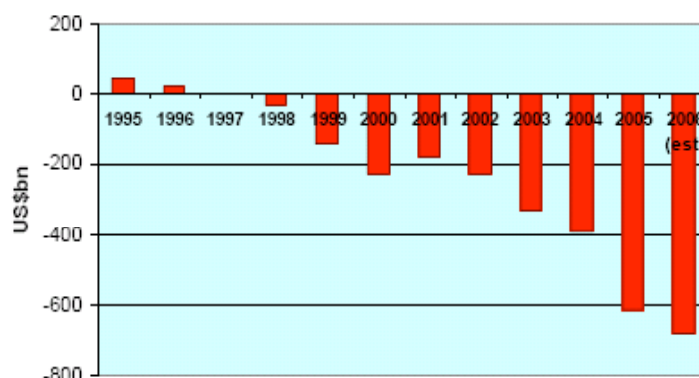
### Capital flight from poor countries

According to the UN report on the Millennium Development Goals (MDGs) \$348 billion will be needed to cover MDG costs in 2010 and \$529 billion in 2015.<sup>2</sup> But official commitments on aid and debt already fall short of these very basic financial needs. Global average overseas development assistance (ODA) between 2003 and 2006 was \$90 billion/year. Global debt cancellation under HIPC and MDRI is estimated to cost \$67.7 billion and \$47.9 billion.<sup>3</sup> But part of this amount is not additional as it is already accounted for as ODA by most donors.

Consequently there is a financial gap that needs to be filled by increasing the flow of predictable new resources towards developing countries and by reducing capital flows leaving developing countries. Most people assume that low income countries are net recipients of financial flows. However a close look at the numbers reveals this is not the case. The UN Department of Economic and Social Affairs estimates that for Sub Saharan Africa and more generally for the least developed countries, the net flow has become progressively smaller and turned negative.<sup>4</sup> Figure 1 shows the volume of financial flows between Southern and Northern countries. Net financial flows from developed to developing countries are increasingly negative.

The aggregation of financial flows to and from developing countries can be misleading because there are different categories of flows and of developing countries. For middle income countries, that receive more investment, an important part of their outflows are the result of interest and debt repayments and profit remittances. For emerging economies in general - and especially for China - a large share of the outflows results from the accumulation by the government of U.S. Treasury bonds. While this outflow is not a loss, it prevents them from using their reserves for domestic productive investments. At the same, time excessive inflows to developing countries are not automatically positive, particularly if they have a short term speculative nature.

**Figure 1: Net financial flows between developed and developing countries, 1995-2006<sup>6</sup>**



Source: UN DESA. World Economic Situation and Prospects, 2007

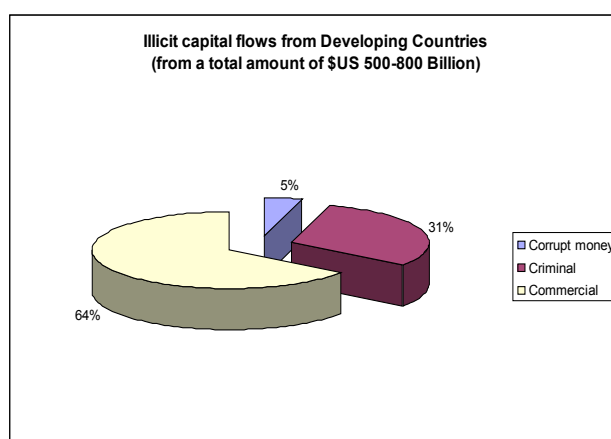


According to Raymond Baker, a former international business man and current senior fellow at the Center for International Policy, a huge portion of the growing resource transfer, which is not recorded in the official statistics, is illicit capital flows, which are estimated to amount to between \$500-800 billion each year.<sup>5</sup> As a consequence, it is estimated that for each dollar that goes to the South in aid, more than 7 dollars come back to the North through illicit means. Illicit capital flows comprise three main types of transactions: flows arising from criminal activities such as the drug trade, capital flight due to corruption, and commercial illicit flows through abusive transfer pricing and other tax evasion and avoidance practices.

Commercial illicit flows account for around two-thirds of the illicit capital outflows from developing countries, and far outweigh the potential gains from increased aid or debt relief (see figure 2). However, there is no effective policy to tackle this capital drain. The proceeds of corruption, estimated to be the smallest part of the illicit flows problem, captures the attention of decision makers and international institutions like the World Bank. This focuses on the demand side of corruption in developing countries while turning a blind eye to the supply side, in which Northern actors (such as banks, investors, insurance groups) and tax havens are critically involved.

The proceeds of illicit capital flows are usually lodged in developed country banks and tax havens under developed country jurisdiction with impunity and secrecy. While the international community points to Southern corrupt elites as the only ones responsible, capital flight relies on financial advice and bank secrecy provided by Northern actors.<sup>6</sup>

**Figure 2: Illicit capital flows from developing countries**



Source: Global Financial Integrity, 2007.

Capital flight from African countries represents a higher burden, as a percentage of GDP, than in other regions. Janvier Nkurunziza, economist and co-author of a 2007 UNCTAD report on African economic development states: “the stock of capital flight from the African continent between 1970 and 2005 is about \$400 billion. If we compare it with the debt stock for the same period is \$215 billion, we can then conclude that Africa is creditor to the rest of the world. This haemorrhage must be stopped”.<sup>7</sup> Economists Boyce and Ndikumana from the University of Massachusetts have estimated that for some countries, the results are even more dramatic: for Côte d’Ivoire, Zimbabwe, Angola, and Nigeria the external assets are 4.6, 5.1, 5.3, and 6.7 times higher than their debt stocks, respectively.<sup>8</sup>

The 2007 UNCTAD report shows that around \$13 billion per year have left the African continent between 1991 and 2004. This represents a huge 7.6% of annual GDP. The UNCTAD report concludes: “if these resources were spent in productive investments they would allow the creation of new jobs and supply revenues to large segments of the population”.

Boyce and Ndikumana have found clear relationships between capital flight and external debt. “Foreign debt can cause capital flight by contributing to an increased likelihood of a debt crisis, worsening macroeconomic conditions and the deterioration of the investment climate”.<sup>9</sup> According



to their estimates, an increase in the debt stock by one dollar leads to two to three cents of capital flight in subsequent years. The reasons for this are that investors may expect a highly indebted country not to perform economically in the coming years. Another reason is that private actors may expect that high future debt service will force governments to raise taxes, reducing accordingly incentives to investors and thus leading to capital flight.<sup>10</sup> Capital flight may lead as well to an increase in indebtedness since capital flight drains national foreign exchange resources, which can force governments to borrow abroad.

The loss of capital has huge consequences on the ability of the state to deliver essential services to the poorest people and the private sector to access resources for productive investment. Besides this direct economic effect, tax havens and linked capital flight have other major impacts on southern countries.

## Tax Havens

Over the past thirty years the number of offshore finance centres and secrecy jurisdictions commonly known as tax havens has increased rapidly to more than 70.<sup>11</sup> This rise has been facilitated by technological development that has increased the mobility of capital flows. Today more than half of global trade occurs via tax havens even if these account just for 3% of global GDP.<sup>12</sup> Nevertheless, official sources, namely the OECD, the IMF and the Financial Action Task Force tend to give a more restricted definition.



Following the 2001 terrorist attacks on New York and the subsequent global fight against terror, the United States pushed the Bretton Woods institutions to lead in tracking money laundering activities. But according to Chavagneux and Palan,<sup>13</sup> the role they've played, under the influence of major financial interests, has in fact led to the legitimization of the major financial centers and most tax havens as important players in the global economy. The authors add that *"the implication of the IMF (in tracking tax havens) reveals the fundamental ambiguity in which the fight against tax havens has*

*evolved"*,<sup>14</sup> explaining that one of the key reasons the US wanted the IMF to lead was to ensure that legislation brought in to counter money laundering in IMF member countries would not undermine financial market deregulation schemes.

Today the OECD counts only 3 *non co-operative tax havens*: Andorra, Monaco and Liechtenstein. The Financial Action Task Force, created by the G7 to fight money laundering has also set up a list of non-cooperative countries and territories but since its last update in October 2006 the list is just empty.





In order to cover the entire spectrum of activities involved in tax havens, there is a need for a clear definition of tax havens that includes their major features, namely strong bank secrecy and/or low-zero taxation. The Tax Justice Network and other analysts have identified more than 70 tax havens.<sup>15</sup>

According to major studies,<sup>16</sup> some of the most important tax havens are located in Europe. Others are currently under review: Austria, Denmark and Macedonia. Many others are dependencies or overseas territories of European countries, such as: Anguila, Bermuda, British Virgin Islands, Cayman Islands, Gibraltar, Guernsey, Isle of Man, Jersey, Montserrat, (UK dependencies), Aruba and Netherlands Antilles (dependencies of the Kingdom of the Netherlands).

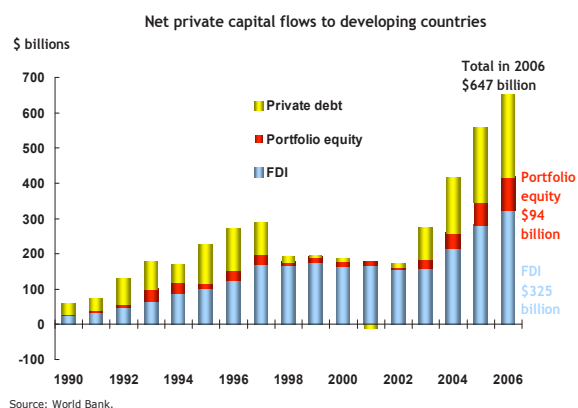
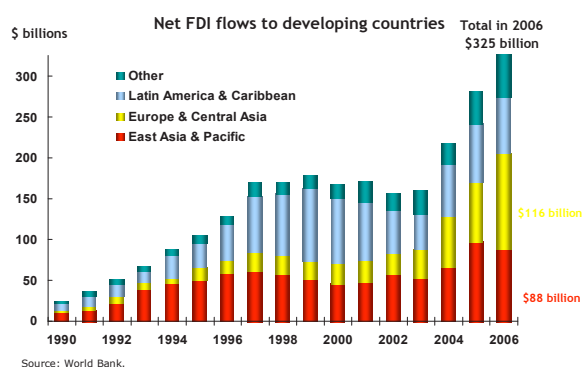
By providing high secrecy, tax havens are the privileged destination of money from crime, the drugs trade and corruption. But this is just the tip of the iceberg. A much bigger share of activities taking place in tax havens are the result of legal operators. Transnational corporations commonly use tax havens in order to escape tax burdens and regulation as well as to disguise their accounts and indebtedness levels. Big international banks and insurance companies have subsidiary companies registered in tax havens and most of the hedge funds and private equity funds are registered in tax havens.<sup>17</sup>

Tax havens also provide shelter for other predatory financial actors - vulture funds. These companies buy up the debt of poor nations cheaply when it is about to be written off and then sue for the full value of the debt plus interest. According to the World Bank estimates, 44 litigating creditors have targeted HIPC countries with lawsuits and most of them are based in the US and the UK – both of them host the two biggest financial centres in the world and in the British Virgin Islands, a UK dependent tax haven.

## Investment and abusive transfer pricing

UNCTAD defines foreign direct investment as “investment made to acquire lasting interest in enterprises operating outside of the economy of the investor”. In order to qualify as foreign direct investment (FDI) the investment must afford the parent enterprise control over its foreign affiliate. Foreign direct investment has been presented since the 1990s as the best solution for the lack of capital in developing countries, as it can help develop infrastructure, provide employment, and contribute to economic growth and development.

It all depends on the quality of the investments. As explained above for the net North-South flows, an excessive amount of FDI inflows can have negative impact on developing countries not only if they are not efficiently absorbed but mainly if these FDI flows are volatile and driven by short-term and speculative profits rather than long term productive interests.<sup>18</sup>



There is an increasing trend of FDI and other private flows being directed to developing countries, but it is important to analyse more closely the pattern they follow. According to the figure above, a growing share of private flows going to developing countries is portfolio investment and private debt. Portfolio investments are passive holdings of securities, bonds and other financial assets but they do not convey financial control. They are driven by pure financial interests and are held by institutional investors as well as speculative, short-term investors such as hedge funds.

Secondly, the greatest share of FDI directed to the South goes to a small selection of countries. Over 75% of FDI flows to just ten countries and most of it is concentrated in China, Hong Kong Mexico and Brazil. Low income countries generally offer very favourable conditions to attract any investment. In return, one of the main benefits of FDI is supposed to be the tax revenue generated from the profits. But tax holidays or exemptions for investors are becoming commonplace. We are witnessing a race to the bottom, in terms of environmental, social, economic conditions for FDI, in which low income countries compete with each other to attract investment.

FDI is concentrated in countries rich in natural resources and in a few sectors (such as oil and gas, mining, forestry) that guarantee high profits for the companies investing but often offer little return, both in terms of wealth and development, for the country itself. Because low-income countries are generally viewed as risky environments for investment, the private sector expects higher profit margins from their investment. The World Bank estimated in the late 1990s that the average rate of return on investments was 18% for the global South, and reached 36% for Sub-Saharan Africa.<sup>19</sup>

#### *Profit remittances*

For many developing countries, the balance of the last 10 years between FDI income and profits leaving the country has been negative. In many cases, of course, the investments may contribute to national economic growth, therefore somehow compensating for the profit outflow. But the outflow of hard currency poses a problem for policy-makers. From a macroeconomic perspective the net outflow can be compensated in two ways. The country may try to attract new FDI, using “fresh” money to pay the profits on their previous investments. Often countries will have to accept even worse conditions and promise even higher rates of return in order to attract new FDI, further worsening their situation. The second option is to hope for increased export earnings that might come with associated economic growth.<sup>20</sup>

**Table 1: FDI income and profit outcome in some African countries between 1995 and 2003**

Country	FDI (\$US millions)	Profits leaving the country (\$US millions)	Net Balance
Democratic Republic of Congo	1,623	2,773	-1,150
Gabon	-822	3,432	- 4.254
Nigeria	10,784	12,387	-1,603
Guinea	244	332	-88
Mali	807	817	-10
Bostwana	943	5,621	-4,678

Source UNCTAD data elaborated by Kavaljit Singh – Why Investment Matters - Madhyam Books, 2006.

Additionally, profit repatriation may take place using techniques that further impair the ability of developing countries to raise the revenue badly needed for investment in infrastructure, job creation and public services.

#### *Transfer mis-pricing*

The abuse of the transfer pricing mechanism is very damaging for Southern countries. Transfer mis-pricing is the practice by which affiliated companies within a transnational corporation sell goods or services to each other at artificially high or low prices in order to minimise taxes paid. As a result, transnational companies escape taxes, not only undermining developing countries' revenues but

also unfairly competing with smaller domestic companies. According to some estimates, more than 60% of international trade happens between subsidiaries of corporations in different countries which means the goods and services are not sold on the open market.<sup>21</sup> According to a survey made of 476 companies across 22 countries, 77% of the companies acknowledged using transfer pricing in their strategies from 2006 to 2007.<sup>22</sup> A Christian Aid report on capital flight shows that 45-50% of trade transactions in Latin America are falsely priced by an average of more than 10% and 60% of trade transactions in Africa are mispriced by an average of more than 11%.<sup>23</sup>

The use of transfer mis-pricing to spirit capital out of Africa has accelerated significantly. A study of import and export transactions between Africa and the US found that between 1996 and 2005 net capital outflows grew from \$1.9 billion to \$4.9 billion (a jump of 257%) through the use of low-priced exports and high-priced imports.<sup>24</sup>

Some concrete examples of commonly practiced transfer mis-pricing are: plastic buckets imported at \$972.98 per unit, or toilet gloves imported at \$4,121.81/kg. The other way around, exports are also mis-priced: video cameras sold at \$13.45 per unit and missile launchers sold at \$52.03 per unit.<sup>25</sup> Buying and selling at these prices makes it easy for transnational corporations to shift profits from one country to another.

Tax havens play a key intermediary role in the process of FDI. According to UNCTAD, more than 30% of FDI involves tax havens and the trend is increasing, distorting statistics on investment and capital flows. For instance, some tax havens like Bermuda receive more US investment than countries such as China.<sup>26</sup>

The mechanism allows even more tax evasion when it is applied to intangibles like logos, brands, consultancies or property rights. The corporation assigns ownership of its brand to a shell company created in a low tax territory. All the productive parts of the company, wherever in the world, then pay royalties and other fees to this shell company. This guarantees a continuous shift of money to tax havens. Microsoft saved \$1.8 billion in taxes between 2001 and 2004 by registering its intellectual property rights in a subsidiary company in Ireland, taxed at a 12.5% rate instead of the US rate of 35%.<sup>27</sup>

Some of these flows then come back to the country of origin through so-called “round tripping”. With this practice, a company that has shifted profits towards a subsidiary in a tax haven can reinvest part of those profits in the country, this time being considered as foreign direct investment and thus benefiting from favorable fiscal conditions offered by the host country. This allows not only tax evasion and avoidance but also takes advantage of the tax exemptions that many countries grant on incoming investment. Similar mechanisms are also used to recycle money coming from criminal activities into the legal economy.

Some studies indicate that around a quarter of the more than \$100 billion that China loses every year is due to capital flight coming back into the country after round-tripping. It is estimated that the Chinese own most new companies created in the British Virgin Islands, who are the second biggest investor in China.<sup>28</sup>

## Tax concessions

Conditions attached to loans and grants have reduced policy space in recipient countries and pushed them towards economic liberalisation, increasing economic volatility and making them more vulnerable to financial instability. Such conditions have often led to a decrease in social spending and a loss of fiscal revenues. As UNCTAD states, *“governments had to undertake fiscal reforms to adjust to lower income from import taxes resulting from trade liberalisation and in some cases to reduce social security contributions resulting from reforms in social security systems. Privatisation led to a reduction of fiscal revenue (...). The alternative sources of revenue (...) were value added tax and other indirect taxes on goods and services”*.<sup>29</sup>

Some recent cases suggest that today intrusive conditions are still imposed through IFI programmes in poor countries. Eurodad’s report on World Bank conditionality finds that despite the application of the “good practice principles” aimed at reducing of the number of conditions since 2002, more than

70% of grants and loans still contain privatisation and liberalisation related conditions.<sup>30</sup> For instance, the World Bank has attached conditions to loans with Afghanistan which will lead to the privatisation of more than 50 public enterprises over the next two years with an estimated loss of 14,500 jobs.

Conditions attached to the mining sector have negatively affected poor countries' budgets. The revenue from taxes on mining companies has fallen following privatisation. In contrast, transnational companies exploiting the mining sector have generally benefited from very favourable fiscal conditions, allowing them to repatriate huge profits while depriving poor countries' budgets of precious resources.

For example, in Mali, the total income tax paid by the Sadiola mine was \$20 million during 2000-2003, accounting for 3% of its gross revenue or 10% of its income before tax. Two other mines in the same country (Morila and Yatéla) did not pay any taxes during that period because of tax holidays. The Malian mining code of 1991 provided mining companies a 5 year tax holiday after first production. The review of the code in 1999 abolished the tax holiday but the mining convention guaranteed that the companies could still opt to remain under previous fiscal rules.<sup>31</sup>

### **Zambian mining sector privatisation and the IFIs**

Zambian President Levy Mwanawasa recently announced the cancellation of all tax concessions for copper mining companies operating in Zambia, saying they were “*unfair and unbalanced*”. In their place the government decided to introduce a new fiscal and regulatory regime that would bring “*equitable distribution of the mineral wealth*”. This change is expected to double the revenue from mining concessions to \$650 million per year.

The World Bank and IMF have helped define the national mining code, including the concessions it grants to foreign mining companies. The IMF has a strong role in taxation policy in the country. In its 2004 PRGF agreement with Zambia, the IMF required the government to “*define a policy for the granting of tax concession*” and in December 2006, the IMF proposed levying a 17.5% value-added tax on food, agricultural inputs, transportation, and other basic goods and services to increase government revenues. Rather than requiring regressive taxes, the IMF should accept the Zambian parliament's proposal to accept an increase in royalty rates on the country's copper mining industry. Copper contributes more than half of Zambia's GDP. But royalty rates on mineral resources currently stand at only 0.6%, well below the 3% average rate found in many other countries. Although copper prices are currently at record levels, the generous investment conditions designed to attract mining companies earlier this decade, mean little benefit accrues to the country.<sup>32</sup>

## **B. Capital account liberalisation and its implications**

“Financial globalization has not generated increased investment or higher growth in emerging markets. Countries that have grown most rapidly have been those that rely least on capital inflows. Nor has financial globalization led to better smoothing of consumption or reduced volatility. If you want to make an evidence-based case for financial globalization today, you are forced to resort to indirect and speculative arguments.”

*Dani Rodrik and Arvind Subramanian*<sup>33</sup>

Capital account and financial sector liberalisation, encouraged in developing countries by the IMF, has increased their vulnerability to shifts in the global financial system and has fostered capital flight. Capital account liberalisation involves the removal of controls on both domestic residents' international financial transactions and on investments in the home country by foreigners. Financial liberalisation involves the elimination of government intervention in financial markets, essentially allowing the market to determine who gets credit and at what price. These policies have been applied in many developing countries for more than 20 years, on IMF advice. Flows to developing countries were less than \$10 billion in 1973 and rose to over \$300 billion in 1997. One of the major causes for

this has been capital account liberalisation through the dismantling of barriers to cross-country capital flows over this period.<sup>34</sup> This was supposed to increase foreign investors' activities and improve the performance of industries and of the economy in general, increasing trade integration. Nevertheless, experience has shown that the impact of these measures on investment, economic growth and poverty reduction is often negative. As expressed by Kenneth Rogoff, former chief economist at the IMF *"benefits from an international financial integration are relatively low, even for countries receiving large amounts of capital"*.<sup>35</sup> Other experts add that financial globalisation *"does not lead developing countries to catch up to developed countries in a significant manner"*.<sup>36</sup> Alex Cobham, a researcher at Oxford University, has found: *"domestic capital account liberalisation brings further risks as the economy is opened to considerably more volatile flows and the potential for the banking sector to become dangerously overexposed is extended"*.<sup>37</sup> Capital account liberalisation leaves countries vulnerable to rapid outflows of capital when market sentiment turns against them. On the other hand, it has been observed that where capital controls have been actively used there has been a positive effect on growth.

Moreover, analyses have shown a causal link between capital account liberalisation and the deterioration of worker's conditions.<sup>38</sup> Capital account openness has been strongly associated with declines in labour's share of income and has subsequently undermined workers' bargaining power, initiating a race to the bottom. In developing countries where workers' organisations are generally weak this can have a powerful effect.<sup>39</sup>

Finally, by removing controls, capital account liberalisation facilitates capital flight and increases vulnerability and, by doing this, the risks of crises and contagion are multiplied. At the beginning of a financial crisis, capital flies away from the country, looking for higher profits and less risk, thus worsening the situation. Premature capital account liberalisation was a major factor in the financial crisis that started in Asia in 1997 and spread to Russia and Latin America as well as to the US and Europe. At the beginning of the crisis that hit South-Eastern Asian countries, between July and August 1997, \$100 billion left the countries involved within a few weeks.<sup>40</sup> The liberalisation of capital accounts and other financial deregulation measures had removed countries' immunity to this financial contagion. The IMF was partly responsible, having promoted capital account and financial sector liberalisation without a thorough or fair appraisal of its potential consequences.

### **C. New financial actors and financial market volatility**

*"Private equity houses and activist fund managers of all kinds - including hedge funds - play a much more valuable role than any government or any regulator in reducing the cost of capital"*, suggests European Commissioner McCreevy. But this position is far from being shared by other stakeholders. As expressed in the Party of European Socialists' (PES) report on hedge funds and private equity, *"With the exception of Commissioner McCreevy, all others have reached recognition that some change is needed to ensure a better-functioning capital market"*.<sup>41</sup>

### **The emergence of hedge funds and private equity**

The lifting of capital controls together with new technical means to move large volumes of money across the globe with a mouse click have led to the emergence of completely new profit opportunities through the trade of currencies, bonds, securities<sup>42</sup> and other financial instruments, by using the differentials in exchange rates, interest rates and asset prices.

The new financial system offered average profits twice as high as normal profits in the real economy. Leading players in the finance industry have achieved as much as 25% return on equity. As a result, investors prefer to put their money into the financial industry rather than into the real economy. One consequence is a relative underinvestment in the real economy with a respective negative impact on growth and employment on the one hand, and a disproportionate orientation towards financial asset and wealth creation.<sup>43</sup> The search for the maximum profit in the shortest term possible has become the chief rationale of the activities of institutional investors such as hedge funds and private equity funds.



In 1986 the new arrangement was christened the *shareholder-value regime*, *investor capitalism* or *finance capitalism*. In previous periods financial markets had a subordinate and instrumental role to the real economy, now this relationship is reversed. More than just a shift in the economy, it is a new model or mode of accumulation – driven and dominated by the finance sector - which affects the whole society: economy, social structure, politics and culture. Hedge funds and private equity funds are the most advanced expression of the dynamics of the shareholder-value regime.

Hedge funds were originally conceived to “hedge” the risk for investors, especially by using derivatives. These are financial instruments used to reduce risks of price changes for an asset holder. They allow an actor to gain or lose from the change in prices of an asset (like a company, currency, or commodity) without ever actually owning the asset. After the liberalisation and deregulation of financial markets in the 1980s and 1990s the ground was prepared for a remarkable explosion of these actors that were not subject to oversight or regulation. Today, hedge funds have become high risk, destabilising financial instruments. Apart from derivatives, they also invest in speculation with securities, commodities, currencies, or any other financial instrument which can lead to high profits in the short term. They generally require a minimum investment of normally \$1 million or more of assets, and are therefore usually reserved for institutional investors or rich individuals. The best performing of them have recorded super profits upwards of 20% return on equity.

Private equity firms create and manage funds to gain partial or full control of companies. This is often done through the use of leverage, meaning that the funds borrow additional resources from banks to finance their acquisitions. They often then transfer the debt to the acquired company. Their aim is to “extract” as much value as possible from the acquired company, then to sell it back onto the market realizing the highest possible profit. Typically a private equity fund owns a company for a period of 3-5 years, quite often for less time.

Hedge funds, like private equity funds, borrow money from investment banks or commercial banks, to invest alongside their own assets, giving them a financial power that goes far beyond their nominal fund values. In 2007, hedge funds globally managed \$1.7 trillion, while private equity managed \$500 billion. However, with their assets leveraged at an average of 4-5 times with loans, they can exercise much greater influence. Hedge funds, by investing in derivatives, can control a high number of securities with a relatively small investment.<sup>44</sup> Private equity funds can engineer corporate takeovers with only 20% or less of the capital needed.<sup>45</sup> Their objective is to maximise profits in the short term, without any attention to long term objectives of the companies, currencies or commodities they invest in, thereby fostering instability and volatility.

#### *New financial actors in developing countries*

A number of hedge funds are located in emerging markets. According to the commercial database of *Hedge Fund Research*, 423 hedge funds can be classified as emerging market hedge funds.<sup>46</sup> This category means that the majority of its assets are invested in emerging markets, and not that they are based there. These 423 are 4.7% of the 9,000 existing hedge funds.<sup>47</sup> They had \$62.57 billion in assets under management in 2006, corresponding to 8.6% of the total in that year.<sup>48</sup> The number of hedge funds active in emerging markets has been increasing in the last years.

The reality is very different in low income countries, where it is very unlikely that there will be any hedge funds because these funds need developed national financial markets and an infrastructure of financial services for their operations. Low income countries cannot offer such an environment. Therefore the impact of hedge funds on low income countries is indirect through their effects on the stability of the international finance system.

Hedge funds operating in emerging markets transfer the specific risks of these players to the target countries. Professor of finance Stephany Griffith-Jones reported that in 1998 Brazil was affected by the speculative operations of hedge funds attempting to compensate for their losses in the Russian crisis in the same year.<sup>49</sup> The *Carlyle Group*, whose hedge funds crashed in March 2008, has over \$1.3 billion invested in India through its subsidiaries.<sup>50</sup> If hedge funds can destabilise the financial markets of the industrialised countries, these players can be even more dangerous for the vulnerable economies of the South, as Griffith-Jones states “*A new source of financial vulnerability for developing countries lies in the rapid growth of hedge funds, and more broadly highly leveraged institutions*”.<sup>51</sup>

Emerging economies are particularly attractive to hedge funds' practices because of their high share of emerging markets bonds (45%) and distressed debt (47%) that provides higher returns given their higher risk. If hedge fund investors concentrate on certain countries, this leads to greater risk exposure for that economy.

A specific risk from hedge funds, not only for emerging markets but for other developing countries, comes from their reaction to the present crisis. As the credit crisis has reduced the availability of bank loans and thus leverage which were essential to the high rates of return, hedge funds are partly reorienting their deals towards speculation with raw materials, oil and food.<sup>52</sup> This leads to an increase in raw material and food prices. This particularly hits the oil and food importing countries and those who depend on raw material imports. Together with other factors, such as the production of bio-fuels, the high food prices will lead to an increase in hunger and poverty (see below "Speculation and Volatility").

Just like hedge funds, private equity funds are also beginning to be active in developing countries, in particular in emerging markets. The data available are very scarce. According to *International Financial Services* 6% of all private equity funds' investments in 2005 were outside the industrialised countries. This would correspond to \$ 8.1 billion.<sup>53</sup>

According to UNCTAD, private equity funds are particularly active in mergers and acquisitions. They were involved in 18% of the global total mergers and acquisitions deals in 2006 worth a record \$158 billion. Among the few developing countries targeted we find India, China, Turkey, South Africa, Colombia and Nigeria. The main "buyer" Southern countries are big oil exporters, namely the United Arab Emirates and Saudi Arabia and Egypt and China.<sup>54</sup>

India is both the target of private equity funds and at the origin of an Indian private equity-industry. The country is top for private equity funds investment in Asia. The investments of foreign private equity funds in the country have increased from \$1.1 billion in 2004 to more \$10.8 billion in August 2007.<sup>55</sup> This is an increase of more than 1,000%. Among the investors are major players in the business such as Blackstone, CitiGroup, KKR, TEMASEK and Carlyle. However, 80% of the capital was not used for buyouts but for acquiring minority stakes without taking over the management.<sup>56</sup>

The target sectors in India are infrastructure, real estate, financial services and media.<sup>57</sup> Like their counterparts in the industrial countries, the Indian private equity funds go offshore, mainly to Mauritius, in order to avoid taxation and supervision.

UNCTAD comes to the conclusion, that private equity funds in developing countries are questionable players: "Investments by private equity firms are often more akin to portfolio investment than to FDI, in that they tend to have relatively short time horizons. This has raised some concerns regarding the impact of such investments, in particular as regards the dismantling of the acquired companies and worker layoffs."<sup>58</sup>



### Effects of HF and PE on workers' rights and decent work<sup>59</sup>

Effects on jobs, wages and work organisation by LBOs and HFs have been substantial, if little understood by the general public or some policymakers apparently 'dealing' with this phenomenon. It is often alleged in the business news pages that PE funds have triggered considerable corporate growth and created many new jobs. However, we are not aware of any serious academic findings that would support this position. Academic studies carried out to date have for the most part been commissioned by groups of investors. They suffer from a lack of representation and are based on scientifically assailable methods and often they wrongly compare various sorts of PE, including venture capital funds.

In the case study of the company **Friedrich Grohe** in Germany, it is described how 770 jobs are to be cut. In the case study of the company **Viterra** also in Germany, it is described how the plan is to sack a total of 500 of employees— more than a quarter of the entire work force. Even with PE commitments in a relatively good market situation and a stable company (take the investor KKR's involvement in MTU Aero Engines in Germany), PE funds take job cuts immediately into account.

In most of the cases studied by the Hans-Böckler Foundation in Germany, PE investors have very quickly pursued a reduction of wage costs. The higher the levels of debt in the target enterprise, particularly with secondary sales, the stronger the attempt to cut wages.

This alternative investment model is inherently damaging for workers. As European Trade Union Confederation (ETUC) General Secretary John Monks put it recently, *"the drive for higher returns inevitably exerts downward pressure on wages and conditions"*.

In a case study on the company **Autoteile Unger** in Austria, it is described how the working hours have been lengthened from 37½ to 40 hours per week as a result of the buy-out.

In the vast majority of existing examples new owners have withdrawn from social dialogue and, in some cases, failed to honour existing collective agreements. LBOs – have little or no experience in dealing with organised labour unions or employee representatives and often fail to live up to even the most basic requirements on information and consultation and restructuring.

Trade unions often have great difficulty in establishing a negotiating relationship owing to the mystery of who is genuinely in charge of the company. One example of this lack of transparency from the commerce/retail sector, where alternative investment is already prevalent is Somerfield Stores. Following purchase by the Apax group and subsequent de-listing from the stock exchange, Somerfield decided to withdraw from the Ethical Trading Initiative (a multi-stakeholder alliance including retailers, NGOs and trade unions), in order to reconsider "short- and medium-term business priorities"

#### *BTC case, Bulgaria*

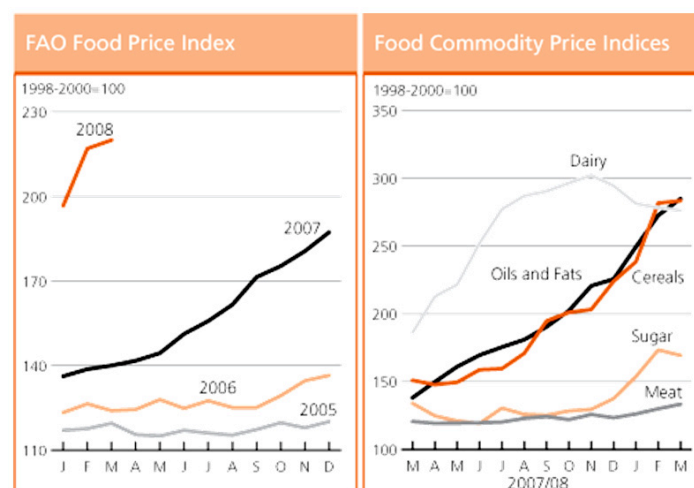
Set-up in 1992, the Bulgarian Telecommunications Company (BTC) is the former national operator in Bulgaria. The company provides 97% of fixed line services in the country as well as holding a substantial interest in the mobile market. Following a lengthy two-year privatisation process, Advent International agreed the purchase, through the Austrian operation, Viva Ventures, of a 65% stake in BTC in June 2004 for EUR 230 million plus a E 50 million capital increase. In 2004 the owners took dividends of EUR 75m. During this period, relations with BTC employees have deteriorated very badly. Employment has been reduced from 24.000 to less than 10,000 under conditions seen as secretive and arbitrary by the employees, and in violation of the BTC privatisation agreement. After local unions filed complaints with the Bulgarian government of BTC's failure to live up to its commitments in the Bulgarian Labour Code and European directives on information and consultation (98/59/EC and 2002/14/EC), a social partnership agreement was finally agreed with the company in July 2006. There is no confidence that BTC will be able to build a modern telecom network for Bulgaria in the near future.

The difficulty of regulating these instruments is also linked to their lack of transparency. Nearly all hedge funds and private equity funds make use of off-shore financing instruments and tax havens. While some of the funds are registered in the countries they operate from, others are actually registered in tax havens. Regardless of the registration, almost all make use of 'investment vehicles' registered in tax havens, as the avoidance of taxes is part of the business model. The lack of transparency, banking secrecy, and low regulation in tax havens may be used to facilitate tax avoidance, money laundering or other illicit financial activity.

## Speculation and volatility

The majority of raw materials and agricultural goods are produced in developing countries but the prices are decided in a handful of financial centres. Commodity markets are essentially oligopolistic in nature. Ten companies control more than 50% of the global seed market.<sup>60</sup> This problem is all the more dramatic, given the fact that many low income countries only export raw materials, with a small profit margin – if any – while they must import intermediate and finished goods. It is hard to envisage any development for a country that exports copper but which imports electrical wires – made of copper – when both the price of the raw material and the finished product is decided abroad, and when the free trade agreements oblige its small newborn factories to openly compete with the world's biggest transnational companies that also benefit from favourable fiscal conditions for foreign direct investment. The African continent, which hosts the poorest countries in the world, is also host of an important share of mineral reserves<sup>61</sup> and other natural resources, many of which are controlled by private transnational companies.

**Figure 4: Food and food commodity prices**



Source: Food and Agriculture Organisation (FAO), 2008

Another major problem stems from the enormous volatility of the commodity prices, sometimes varying by as much as 50% in the same year.<sup>62</sup> Despite a clear trend of increasing prices of some commodities over the last few years, commodities have always followed a volatile pattern. Figure 4 shows the structural volatility of commodity prices.

Volatility and speculation have increased in the last years with the surge of financial instruments such as derivatives, hedge funds and private equity funds, that are starting to speculate on agricultural products<sup>63</sup> as explained before. As professor Michel Aglietta explains, derivatives do not reduce risks, simply because they have no effect on the risk factors. They just redistribute the risks and allow a higher level of risk. To this he adds *"Derivatives are ambivalent products. While they disseminate the risk for the final users, they concentrate it dangerously within the markets"*.<sup>64</sup> As of January 2007, Wall Street investment funds accounted for 20-50% of financial instruments (derivatives) on commodities, including wheat, live hogs, cattle and corn.<sup>65</sup> This speculation is contributing to an increase of some food prices. Overall food prices have increased by 75% in dollar terms since 2000. The increase of some of the basic food international prices, such as rice - the basic food for some 2.5 billion people

in the developing world, is posing serious problems to many developing countries that have become increasingly dependent on food imports, under the World Bank advice that recently announced that *“For many countries and regions where progress in reducing poverty has been slow, the negative poverty impact of rising food prices risks undermining the poverty gains of the last five to ten years”*. To what the FAO general director added *“there is a risk that this unrest will spread in countries where 50-60% of income goes to food”*. This is the case of most Sub Saharan African and some south-east Asian countries.<sup>66</sup>

Many low income countries are also facing huge problems with the rise of oil prices up until and beyond US\$ 100 per barrel even if the depreciation of the US dollar creates a certain counter trend. The low income countries that must import oil and that base their economy and exports upon a few raw materials face enormous problems in their trade balance. Some of them concretely risk another debt crisis, very similar to the one that started in the seventies, after the first oil crisis.

Deputy Director for Sectoral Policies and MDGs in the French Ministry of Foreign Affairs states “To put things in perspective, the debt relief we announced at the G8 Gleneagles Summit will reduce repayments by countries in Sub-Saharan Africa by about US\$ 1.5 billion per year. In comparison, the International Energy Agency (IEA) believes that the 2005 increase in oil prices could cost these countries US\$10.5 billion per year, or seven times the debt relief”.<sup>67</sup>

# REGULATORY FAILURE CONTRIBUTES TO A BROKEN SYSTEM

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The main problems with the current system of global financial governance can be traced back to failures in oversight and regulation. International financial institutions have trumpeted the desirability of leaving the markets alone without democratic regulation. This not only has led to instability and subsequent crises (in the 1980s, 1990s, early 2000s and today) but has also led to a dual global economic system where a virtual economy driven by speculation and short-term private interests has taken the lead over the real economy.

The current crisis is one of the clearest examples of this problem. Of course these failures are not the sole cause of financial crises nor of poverty; but they are key obstacles that have been overlooked on the development agenda and need to be tackled. Significant reform needs to be achieved if we are to have a global financial system fit for purpose, one that promotes just, equitable and sustainable development.

## ***D. IMF failure in surveillance and financial regulation***

In the aftermath of the Great Depression, the IMF was founded in 1944 with the aim of ensuring financial stability at the global level. It is supposed to promote monetary cooperation, assisting countries with balance of payments deficits, providing technical assistance and surveillance of national economies. Article I of the IMF includes “the promotion and maintenance of high levels of employment and real income”. But the last decade’s experience has shown that the IMF has failed to achieve those goals. More than sixty years later, the IMF has failed to prevent economic crises, and in some cases its prescriptions have worsened their consequences. The global exchange crisis in 1971, developing countries’ debt crisis in 1982, the Asian financial crisis in 1997, the Russian and Brazilian financial crises in 1998, the financial crisis in Turkey in 2000, in Argentina in 2001 and in Brazil in 2002 and more recently the subprime crisis which started in August 2007. By promoting financial liberalisation policies for countries that are not prepared to manage them the IMF has not only increased developing countries’ vulnerability to speculative attacks but has also undermined global financial stability.

As highlighted by a paper by academics Richard Webb and Devesh Kapur, “the IMF is rudderless and ineffective, that it is suffering from an identity crisis, waning influence, and a reduced role, that is on the brink of irrelevance, that, as a result, the world economy basically is not managed at all, that the IMF has long since lost its role as the world’s central banker, has lost sight of where it wants to go, and suffers from a mismatch between aspirations and authority and instruments, and that no single step will restore the Fund to its prior respected position”.<sup>68</sup>

As explained by former UNCTAD chief economist Yilmaz Akyüz, the IMF has been unable to impose discipline over the policies of non borrower countries and has “*paid very little attention to how instability of capital flows on the supply side could be reduced through regulatory measures targeted at institutional investors or how transparency could be increased for institutions engaged in destabilising transactions such as the hedge funds.*”<sup>69</sup>

Developing countries and their citizens are heavily hit by financial crises, even ones with their epicentres in the North. Barry Eichengreen estimates that the financial crises of the last 25 years have reduced developing country income by 25%.<sup>70</sup> The present financial crisis that started in summer 2007 shows that the systemic problems of the international financial architecture have not been solved.

The IMF is meant to be the world’s financial watchdog and rescue force but was unable to react rapidly and effectively to the crisis. Furthermore, it demanded Asian countries tighten monetary and fiscal policies, and this exacerbated the economic slowdown in these countries and caused long term economic and social damage. Under IMF advice Indonesia had to diminish its fiscal deficit by reducing health expenditure by 8% in 1998, then by 12% in 1999. Education expenditure was also cut by 41% in 1999.<sup>71</sup> According to World Bank estimates, the Indonesia, Chile, Thailand and Uruguay crises cost more than 30% of their respective GDPs.<sup>72</sup> As a result of the financial crisis, real wages in

Indonesia fell by 41% and 2.5 million jobs were lost. In Korea, 2.1 million non agricultural workers lost their jobs and 1.4 million in Thailand, as a consequence of the financial crises.<sup>73</sup>

Ten years after the Asian crisis, the IMF has not yet learnt the lesson. Speculation, wide open capital accounts and insufficient transparency or regulation of financial products can be blamed. Ratings agencies such as Standard and Poor that assess companies have proven neither independent nor effective. They have on several occasions given highly inaccurate ratings for financial products and they are insufficiently independent of their clients in the larger investment banks. There is therefore a clear regulatory gap which has not been filled by the IMF.

In response to the current financial crisis the IMF has recently assessed its costs, estimated at \$945 billion, while simply invoking a “collective” responsibility. Jaime Caruana, IMF Director of capital and monetary markets recently raised the need to be “humble”, adding in a veiled manner that we are facing a “*collective failure*” in appreciating the scale and the risks of the leveraged institutions.

Beyond its inadequacy in fulfilling a regulatory role, the IMF has done very little to change its unbalanced and undemocratic internal governance structures by which developing countries are dramatically underrepresented. Only some minor changes have been approved since 2006 but they have not fundamentally changed the current imbalances.

For all these reasons, it is clear that there is a need for dramatic change, both of paradigm and governance structure if the IMF is still to play a legitimate role in today's global economy. A new governance structure and mandate that is relevant for the global context today is needed. A new deal of this type would include the effective integration of the IMF's mandate under the UN framework, democratic governance reform of the institution and limiting its mandate to ensuring a regulated and stable global financial system.

## **Global imbalances, dollar based monetary system and the risks for developing countries**

Developing countries have learnt the lessons from financial crises and decided to build up buffers against future ones. Middle income countries have accumulated huge reserves and are developing regional stabilisation funds. Following the latest financial crises, developing countries have moved from a collective deficit of \$90 billion in 1996 to a surplus of almost \$600 billion in 2006, while the United States moved from a deficit of \$125 billion in 1996 to a deficit of \$857 billion in 2006.<sup>74</sup> Yet, this scenario is not sustainable. Instead of investing these huge reserves in their domestic productive sector and creating jobs, developing countries are financing the US deficit by buying US Treasury bonds. But this situation is hard to change. Most economies are closely tied into the US economy and a slow down in US demand would imply a slow down in their economies. In any case, developing countries will still need to keep a huge amount of reserves in hard currency, diverting these resources from local or regional development purposes.

Despite their scarce resources, low income countries are also substantially increasing their exchange reserves. Some of the poorest countries like Senegal, Sierra Leone, Zambia, Ghana, Mali and Niger have substantially increased their reserves, following IMF advice. A UN analysis on Sub-Saharan Africa reserve accumulation explains “*Countries with reserves equivalent to less than 2.5 months of imports used aid almost exclusively to boost reserve levels*” The study assesses that building up reserves in Sub Saharan Africa is also a response to volatility, which could be tackled if donors provided more predictable flows. “*Instead of financing real resource transfers into the economy, a sizeable proportion of aid money has been committed needlessly to securing greater liquidity*”.<sup>75</sup>

## **E. IFIs fail to curb capital flight**

The architects of the Bretton Woods institutions already intended the IMF to help regulate capital flight.<sup>76</sup> This is why John Maynard Keynes and Harry Dexter White wanted governments to share information on capital received from abroad. But this proposal was watered down by government negotiators and the agreement was to allow rather than require such information exchange. Over the years, subsequent crises raised the need for stronger cooperation and capital controls but little has been fixed. For instance, during debt crisis in Latin America in the 80's, a number of observers



suggested that reducing capital flight by using regulatory measures and sharing information would help to deal with the debt crisis. But instead, the Reagan administration's response was that *"the better solution to capital flight was not a regulatory one but rather one involving the implementation of anti-inflationary, liberalising policies in Latin American countries"*<sup>77</sup> which corresponds exactly to the kind of policies prescribed by the IFIs in the region at that time with the damaging consequences that are known today.

The situation is still the same today, the IMF continues advising its member governments not to use capital controls. The IMF's autumn 2007 editions of both the *Global Financial Stability Report* and *World Economic Outlook* discussed how emerging-market countries can deal with capital inflows. The GFSR concluded that "capital controls should be used only as a last resort" and "may have uncertain effectiveness and unintended side effects." The WEO advised central banks not to intervene and for governments to spend less money.<sup>78</sup>

The IMF made very little progress in tracking tax havens that facilitate capital flight. In 2005 the IMF analysed 41 territories and concluded that important reforms had been achieved despite some difficulties regarding international cooperation and exchange of information and unadapted regulatory policies, which is like saying that we go in the right direction but nothing is moving in the right direction. The same year, the Financial Stability Forum<sup>79</sup> announced *"With the first phase of the IMF's assessment program complete, the FSF's 2000 list of 42 OFCs which helped the IMF to set priorities for its assessment program has served its purpose and is no longer operative"*.<sup>80</sup>

More recently, in line with the UN Convention against Corruption, the World Bank launched in 2007 the Stolen Assets Recovery Initiative (StAR). This is definitely an important step in tackling the sensitive issue of capital flight from developing countries, which is intrinsically linked to the odious debt issue. But much needs yet to be done since the StAR does not consider the fact that there should be a shared responsibility from banks and financial centres that host stolen assets. Furthermore, by exclusively focusing in corruption related illicit flows, the World Bank is ignoring the biggest part of the picture represented by commercial flows namely through tax evasion and avoidance schemes used by transnational corporations as described earlier. Moreover, the Bank limits its role to a technical one and is not promoting any regulatory measures whatsoever in order to tackle capital flight.

## European countries facilitate capital flight

As explained above, official lists of non cooperative tax havens have been narrowing down over the years but alternative research shows a much higher number of tax havens, many of which are in Europe or depend on European countries. According to some observers the City of London alone accounts for 40% of all the tax haven related activities.<sup>81</sup>

According to Tax Justice Network research, the Netherlands, Belgium and Switzerland provide 'conduit' arrangements that allow dividends, royalties and capital flows like FDI to move through those states with almost no tax, often on their way to a tax haven. These practices generally happen in intra-company channels. According to one estimate, the Dutch tax haven features facilitate a net loss of €640 million in tax revenue in developing countries, which amounts to approximately 15% of national ODA.<sup>82</sup>

Ireland offers artificially low tax rates to encourage the reallocation of profits to be taxed there and many other European countries offer strong bank secrecy, like Switzerland, Andorra, Monaco, Liechtenstein, Luxembourg, Malta, and Cyprus.

Tax havens facilitate tax evasion and capital flight between European countries as well as from developing countries. German Finance Minister, Mr Steinbrück says tax evasion costs Germany about €30bn a year in lost revenue, the UK loses a similar sum and the EU may lose €100bn in all.<sup>83</sup>

The recent scandal involving German and other businesspeople hiding assets in private accounts in Liechtenstein has raised concerns from decision makers in some European countries, starting with Germany. One measure currently discussed is the expansion of the existing European Savings tax

Directive (aimed at information exchange among EU countries on individual's deposits in Europe) which current loopholes and restricted scope facilitates capital flight.<sup>84</sup>

## **Taxation in extractive industries: some steps in the right direction**

As a result of the increase of mineral prices, some Southern governments have started to take steps in order to ensure higher income generated by the extractive sector. The higher commodities prices have given them greater negotiating power with foreign investors.

### **According the UNCTAD World Investment report 2007:**

- Algeria promulgated regulations in December 2006 that impose a windfall tax (between 5% and 10%) on oil when production values exceed \$30 per barrel.
- Bolivia passed a new hydrocarbon law in 2006 repealing privatisations, cancelling contracts, and requiring negotiation of terms more favorable to the government. The minister of mining also proposed that the tax rate be raised from the current level of 5% to at least 30%.
- The Chamber of Deputies in Chile has approved 4-5% special tax on gross operating profit of mining companies.
- Ecuador passed a new hydrocarbon law in 2006 that increased the share of government revenue from oil and gas projects.
- Mongolia introduced a windfall profit tax in 2006 on key commodities: 68% on copper and gold profits after deduction of costs and only if prices exceed a certain level. Royalty rates on minerals were doubled from 2.5% to 5%.
- Peru introduced in 2004 a 1-3% royalty tax on mining companies' annual sales. Current debates discuss possible new renegotiations.

These steps herald a welcome change in the right direction, but they remain individual countries negotiated on a case by case basis. The progress is limited to the extractive sector, where global conditions strengthen the hand of governments, which is not the case in other sectors. Experience in the extractives sector has also highlighted that the mechanisms used to reverse the granting of favourable treatment to foreign investors are controversial and may expose countries to significant liability from lawsuit by investors. In order to achieve long term changes on investments at the global level structural reforms are also needed at the multilateral level.

## **F. Regulatory failure on hedge funds and private equity funds**

At the Monterrey Financing for Development summit in 2002 governments agreed to strengthen *"prudential regulations and supervision of all financial institutions, including highly leveraged institutions"*. Little has since been done about this. In 2007 the German presidency of the G8 asked for more transparency of hedge funds but the British and the US government were strongly opposed. The result was a weak compromise, which reads as follows: *"The global hedge fund industry should review and enhance existing sound practices benchmarks for hedge fund managers; in particular in the areas of risk management, valuations and disclosure to investors and counterparties in the light of expectations for improved practices set out by the official and private sectors"*.<sup>85</sup>

At the World Economic Forum in Davos in January 2008, Malcolm Knight, chief executive of the Bank for International Settlements said as he called for more global co-ordination to match the increasing integration of the financial system that the *"major challenge"* for regulators was the *"the Balkanisation of regulation – fragmented across market segments, across national jurisdictions and yet we want to have a global financial system"*. At the same forum, Gordon Brown called for greater transparency within banks and other financial institutions and for the IMF itself to take on the role of providing an early warning system for the global economy.<sup>86</sup>

Last 11<sup>th</sup> April G7 communiqué reads "The current financial market turmoil also has raised broad policy issues about the appropriate regulatory frameworks of our financial sectors. We have reaffirmed the importance of reviewing regulatory frameworks to consider whether changes are necessary to ensure that our financial systems are as efficient and stable as possible in the future." G7 ministers are also committed to stronger cooperation between regulators and increase market transparency but it remains to be seen how effectively they will be implemented and to what extent they will effectively target these financial actors.



## CONCLUSIONS AND RECOMMENDATIONS

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The complexity of the current financial system makes it impossible to resolve the problems easily. At the same time, great opacity granted by the existing financial system makes it extremely difficult to assess the real dimensions of the problems and to effectively resolve them. There is thus a need to dramatically increase transparency as a very first step.

Insufficient data exists on the financial mechanisms that facilitate illicit capital flight from developing countries and prevent those countries from mobilising domestic resources. Even with the scarce existing estimates, it is easy to conclude that there is an urgent need to stop capital flight from the South toward the North channelled by tax havens. International financial institutions have ignored rather than tackled the causes of this problem. There is a need for new thinking that addresses the links between poverty and capital flight, poor domestic revenue mobilisation, speculation on commodities and financial instability.

The finance system in its present shape has proven to be unstable, inefficient and harmful for equality, general welfare and development. Systemic changes are necessary. Democratic control is required as well as international cooperation between regulatory bodies instead of anarchic competition of national economies. In economic decision making, priority has to be given to sustainable development and human rights.

Civil society organisations have a strong role to play in researching, building awareness and conducting advocacy in this area. There are many interest groups who are affected by this issue and parliamentary and political alliances can and should be built.

### **G. Institutional changes**

In response to the absence of an effective international financial regulatory body, countries have moved to self- and regional-insurance models. Regional alternatives to the IMF are starting to emerge, such as the Chiang Mai initiative in Asia and the Bank of the South in Latin America. These are important steps towards regional-based financial governance. A regional approach is needed in order to ensure that the specific regional contexts are taken into account. This new architecture would also favour more democratic financial governance and the principles of cooperation and solidarity. But given the global cross border nature of financial markets there is need for their effective coordination at the global level. An international regulatory body is therefore needed. The IMF has proven to be ineffective in a regulatory role<sup>87</sup> and should therefore be dramatically reformed.

These reforms must be made at different levels. Firstly, by democratising its governance structure and giving substantial weight to developing countries. Secondly by dramatically changing its agenda from a neoliberal approach to a regulatory and development based one. G24 finance ministers recently called for *“the redesign of the global financial architecture”*, including the instigation of surveillance of advanced economies to prevent negative spill over effects on their own economies.<sup>88</sup> Within this new approach the IMF mandate should be monitored under the UN system.

The elements of the UN that deal with economic cooperation need to be dramatically strengthened and current initiatives aimed at fighting capital flight must be pushed forward. The UN Tax Committee was created in order to avoid harmful tax practices and needs to be strengthened. One of the major outcomes of this UN Committee should be a UN Code of Conduct on International Cooperation in Combating Tax Evasion to be implemented at the national and international level.

Donors need to support capacity building of tax authorities in developing countries in order to prevent tax avoidance and tax evasion. In this regard, donor countries should make specific efforts aiming at recovering and repatriation of stolen assets to Southern countries. While some important steps are being taken by the IFIs and the UN regarding corruption, the focus is still biased by looking exclusively into the demand-side of corruption while ignoring the supply side. This aspect of corruption needs to be tackled by putting the spotlight on capital flight facilitators and tax havens. A broader definition of corruption must therefore be internationally adopted that includes these aspects.<sup>89</sup> Since the IFIs

have played and still play a key role as lenders in developing countries, they should also be held accountable for corruption issues.

## ***H. Regulatory measures***

Capital account liberalisation has not led to sustained growth and development. On the contrary it has increased developing countries' vulnerability to financial crises. Capital controls have been successfully applied in some countries and have permitted a stronger growth and a better protection from contagion. Developing countries should be able to implement capital controls for development and stability purposes and this should be encouraged at the bilateral and multilateral level.

Offshore centres and tax havens are used by rich individuals, institutional investors and companies who want to hide their assets from tax authorities and criminal groups that want to launder money. There is no reasonable economic argument in favour of allowing such territories to continue their practices. Interim measures can be used, ranging from lifting the bank secrecy of the banks under their sovereignty, to putting a high levy on transactions with offshore centres. Some regulatory attempts are already underway such as the recent US "Stop tax haven abuse act"<sup>90</sup> and need to be enforced.

Just as tax havens, hedge funds are used by rich individuals with the only aim of making high profits through speculation. There is therefore no real economic purpose for hedge funds except for those rich individuals making money out of them. Given their lack of public interest and the risk they trigger by being opaque and speculative they should be forbidden, as it was the case until 2004 in Germany. As for tax havens, some interim measures should be immediately applied to curb their current opacity. Hedge funds should have the same capital requirements, strong supervision and transparency as banks. When at the 2007 G8 the Germans asked for some more transparency for hedge funds it was argued that these funds have a useful function because they take risks, which others are not ready to take. But in reality, these risks are the risks of speculation for maximum profit. Besides, due to the practices of leverage the risk is transferred to the banks. Strong supervision is thus needed to prevent banks from doing business with hedge funds so long as these do not have the same standards of regulation.

Derivatives can play a positive role if they serve as insurance against risk but there is need for much more transparency in the way they are traded. They should be traded at the stock exchange and supervised by financial regulators.

Private Equity Funds can improve efficiency in the real economy if they are regulated properly and transparently. Capital requirements have to be improved in order to limit leverage to a sustainable level and reforms in corporate governance are necessary. Trade unions, consumers and other stakeholders must be allowed to participate in corporate decision making.

The basic orientation for a real change has to aim at breaking the dominance of the financial markets over the real economy by the implementation of regulatory measures that would cope with speculation and reduce volatility. These would include progressive taxation of capital income including currency transactions, and capital controls for inflows and outflows according to the needs of each national economy.

Implementing a currency transaction tax (CTT) would not only raise extra funds to finance development but would as well play a regulatory role that would curb speculation on currencies. Some European countries, such as Belgium and France, have already started processes in favour of such a tax. A CTT should be implemented within the Eurozone as a first step towards a global implementation.<sup>91</sup> Taxes could also be implemented with the same double aim on other financial transactions including on commodity trading, where speculation can have tremendous impacts on developing countries.

## ***I. European leadership required***

European countries have a key role to play at different levels. First as donors, they need to stop capital flight from developing countries that is offsetting efforts to finance development and will prevent many poor countries from achieving the development goals. Secondly, as regulators, European countries have the possibility to show leadership in the current context of financial turmoil. Thirdly as hosts of many tax havens, European countries need to start taking measures at the European level in tackling capital flight facilitated by European tax havens.

European countries are major donors and have made commitments to place 0.7% of their GNI into ODA in the coming years. Notwithstanding, they have not developed any strategy to tackle the roots of poor countries' aid dependency in the long term. This means eliminating economic policy conditionalities that restrain policy space in recipient countries. Moreover, a coherent development strategy also needs to tackle any form of capital flight that perpetuates poor countries' dependence on external flows and fosters vulnerability.

The EU Savings Directive obliges the disclosure of information among most EU countries but contains some important loopholes and needs to be expanded and strengthened. Automatic exchange of information without exemptions, the inclusion of all types of capital income (not only individuals' savings but also other legal persons' capital income<sup>92</sup>) and the expansion to other non-European countries are some important steps. This would enable the identification of tax evasion and avoidance practices from EU member states' actors including private companies. European countries should encourage the adoption of codes of conduct by tax administrations which make clear that aggressive tax avoidance is unacceptable and ensure disclosure of information and fiscal cooperation aiming at eliminating bank secrecy. They should impose sanctions on tax havens that do not actively cooperate on information exchange.

International accounting standards have for a long time facilitated TNCs' ability to avoid paying taxes in the country where they operate by transferring those resources to tax havens. Jurisdictional (country-by-country) reporting of TNC accounts is a first step towards regulation of TNC revenues and thus the prevention of illicit cross-border capital flight. The European Parliament has recently approved a resolution that requests the European Commission to require from transnational corporations operating in the extractive sector to report their accounts on a country by country basis<sup>93</sup>. This means that companies would have to report the benefits they make in the country where they operate and cannot transfer them to subsidiary companies registered in tax havens. This is an important step that needs to be strictly tracked and should be expanded to all economic sectors.<sup>94</sup> A compulsory country by country reporting system adopted at a global level would dramatically improve the transparency of TNC activities and profits and thus detect capital flight driven by tax evasion and avoidance schemes.

It is urgent that European leaders express themselves on the financing for development agenda and make the links with the current financial and food crisis. The EU is well placed to introduce new regulations and pave the way for a financial system that will serve the interest of all citizens both in developed and developing countries. 2008, with the official financing for development process, is an opportunity that must be seized.

## ACRONYMS

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CTT: Currency Transaction Tax  
EU: European Union  
FATF: Financial Action Task Force  
FDI: Foreign Direct Investment  
FSF: Financial Stability Forum  
GDP: Gross Domestic Product  
GFSR: Global Financial Stability Report  
GNI: Gross National Income  
HF: Hedge Fund  
HIPC: Heavily Indebted Poor Country  
IFI: International Financial Institution  
IMF: International Monetary Fund  
LBO: Leveraged Buyout  
MDG: Millennium Development Goal  
MDRI: Multilateral Debt Relief Initiative  
ODA: Official Development Assistance  
OECD: Organisation for Economic Cooperation and Development  
OFC: Offshore Financial Centre  
PE: Private Equity  
PES: Party of European Socialists  
PRGF: Poverty Reduction and Growth Facility  
StAR: Stolen Assets Recovery  
TNC: Transnational Corporation  
UK: United Kingdom  
US: United States of America  
UN: United Nations  
UNCTAD: United Nations Conference on Trade and Development  
WEO: World Economic Outlook

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