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Capital flight recycling in India

Kannan Srinivasan examines how the billions of capital flight dollars leaving India every year may be re-entering the country in the form of handsomely rewarded'foreign' investment.

Large-scale capital flows from India, from the conquest of Bengal in the second half of the eighteenth century onwards, were instrumental in financing the Industrial Revolution as well as the British Empire and its expansion. Even the Mediterranean Fleet was largely paid for from Indian revenues, as was the development of petroleum in Persia and Mesopotamia. Re-circulated through the London bond markets, such funds also played an important role in the development of the United States, for example by financing its railways.

The end of Empire in the second half of the twentieth century saw the installation of corrupt elites in many of the former colonies; government officials who collaborated with their former rulers in the plunder of their countries' natural resources and consumer markets. Leaders such as Mobuto in the former Zaire banked their profits in the Francophone world; while Nigerians and Indians, among others, opted for London banks and their related offshore tax havens.

Capital flight from India

During the fifties and sixties, most of the Indian princes sent much of their wealth abroad to private banks and jewellers in London and New York. More recently, Indian arms deals have been banked in private banks located nominally in the Channel Islands, but effectively located in London. The money then reappears, for example via funds in Mauritius, as speculative investment in India in the stock market or real estate. Much of the wealth of the Indian rich is routed through financial centres such as London on its way to tax havens. The unwillingness of successive Indian governments to tackle the problem is matched by the eagerness of the authorities in countries such as the United Kingdom, Switzerland and the United States to encourage flight capital.

When the Bretton Woods Agreements were being set up, Keynes urged White to ensure that arrangements for cooperation between those countries which received and those countries which lost capital were included, so that capital flight could be returned. However, no such mechanism was ever put in place.

Zdanowicz and others have estimated that several billions of dollars are laundered annually through Indian trade. The authors developed a global price matrix and analysed every single India–United States import and export transaction for the years 1993, 1994 and 1995, to identify where abnormal pricing occurred and the magnitude of consequent capital flight (Zdanowicz et al, 1996). In the most recent year studied, 1995, capital

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flight from India to the United States effected through the mis-pricing of trade between the two countries is estimated at around US$5.58 billion. If this figure could be taken as being representative of other countries with which India trades today, Indian money laundering through trade would exceed US$50 billion annually.

Indian weaponry imports and money laundering

There is some evidence of inflated prices in Indian defence deals, suggesting kickbacks and money laundered. Rear Admiral Suhas Purohit, former Deputy Chief of Naval Logistics investigated such over-invoicing and money laundering in Indian naval purchases over a period in the 1990s. Deals have been generally conducted through intermediaries in London or New York, even though there was no need for this as the goods supplied came from Russia and the CIS states.

London plays a role in these procurements because it is an important private banking centre, and major arms dealers are located in London for this reason. Purohit showed that even when suppliers were Russian equipment manufacturers such as the Baltic Shipyard, the invoices were still routed through firms such as M/S GS Rughani in London. The US may also have become important for the same reason, since it too is a major global player in the arms business, as well as in non resident Indian (NRI) finance.

Money in, money out

Economic theory of international trade suggests that when the value of a country's domestic currency falls, its exports become cheaper on the global market and therefore more competitive. Indian trade, however, doesn't fit with the theory. This raises important questions over whether money has been flowing into India through the over-invoicing of exports and via non resident Indian remittances, and what connection there may be between this and the appreciation and depreciation of the Indian rupee. There are also questions over whether trade, including the export and import of invisibles (including services and software), is used to move funds in and out of India for the purpose of speculation.

In keeping with such systematic over-invoicing and under-invoicing, very large sums of money have entered India which are not linked to any specific transactions. The category of Current Account 'miscellaneous' inflows which rose from a few million dollars in the 1980s to about US$4 billion in the early 1990s, has risen to US$39.83 billion in 2004-05. At the same time, 'miscellaneous' outflows (other than Business Process Outsourcing [BPO] and software) have grown from US$6.10 billion in 2001-02, the first year of liberalisation, to US$24.97 billion last year.

Capital flow recycling

Further examination is needed to determine whether there are continuous flows of capital flight and reverse capital flight; whether money is taken out of the country for safekeeping, with the assets therefore protected from Indian inflation and income tax, and then re-circulated into India as foreign portfolio inflows, or software export earnings, or other invisibles or trade remittances.

Given that the Indian markets are narrow and shallow, and to all intents and purposes insider trading is unregulated, major investors have earned returns of between 50 and 100 per cent in recent years. Foreign institutional investors are now allowed to invest in real estate by proxy by trading in real estate firms. In the last six months, Bombay real estate shares have risen by 100 per cent. One Calcutta brokerage house offers an illegal debt instrument to foreign institutional investors with an assured annual return of 25 per cent. This is well above rates of return in developed markets, providing great opportunities for arbitrage. The 2005 market boom, entirely driven by foreign institutional investors, has caused a dramatic rise in the index.

It is important to question whether this chain is only broken (ie becomes a one way flow) when there is some crisis such as the one that occurred in 1991. In that situation, Indian capital goes out of the country through the *havala* system, but it does not return. Or at least there is no return flow until the domestic economy has resettled and again provides lucrative opportunities for so-called 'foreign investment'.

Even if Keynes had his way today, corrupt officials in developing countries would be unlikely to demand the return of their own stolen wealth. Drawing the world's attention to such theft and concealment is important so that the citizens of these countries may ultimately control their economic future.

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Editorial

Capital flight is rarely out of the news. In November, former Chilean leader Augusto Pinochet was charged with tax evasion relating to the US$27 million he allegedly hid in secret bank accounts abroad. Over the last four years Russia is reported to have lost around US$100 billion in capital flight; this in a country where private sector debt is soaring and nearly one fifth of the population live below the poverty line.

Capital flight is a serious problem for many developing and transition economies, where capital and foreign exchange are often in short supply. Public sector corruption, private sector fraud and economic instability; all are bound up with capital flight, and all have serious implications for growth, poverty and inequality. Raymond Baker, in his book *Capitalism's Achilles Heel* (which made this year's FT list of best business books), estimates that some US$5 trillion of 'dirty money' has flowed out of developing countries.

In a new book reviewed in this edition of **TJF**, *Capital Flight and Capital Controls in Developing Countries,* Gerry Epstein describes capital flight as "international capital flows that are trying to escape government controls or the consequences of government policies". Tax avoidance and tax evasion are often motivating factors. TJN has estimated global capital flight at around US$11.5 trillion. This is costing governments around the world approximately US$255 billion in tax revenues every year. The consequences for developing countries are

particularly serious, as a strong and reliable tax base is essential for funding sustainable development and poverty reduction.

Capital flight is an integral part of the broader story of financial globalisation as our articles on Brazil, by Deger Eryar, and India, by Kannan Srinivasan, show. In India, some of the billions of capital flight dollars that leave the country each year through trade later reappear as 'foreign' portfolio investment, often earning spectacular rates of return and fuelling stock market booms.

The Brazilian case illustrates the problems that can ensue when developing countries, often lacking financial resources, open up to foreign capital in order to boost domestic savings and stimulate economic growth. This openness increases economic volatility and exposes countries to the vagaries of international capital markets. In Brazil, where the level of foreign debt was very high, capital flight peaked exactly as the country was integrating with the global economy. Residents, concerned about the threat that mounting economic instability posed to their assets, responded by taking their money out of the country. Some of the worst financial crises in recent years – Mexico, Russia, East Asia, and Argentina – have made clear the link between increased openness, financial crises and capital flight.

So what can be done to combat capital flight? The Epstein book identifies a range of controls on capital inflows and outflows, or "capital management techniques", which could be used to help prevent capital flight. And as Eryar forcefully argues, any such measures will need to be accompanied by a genuine shift in policy towards a more sustainable development approach.

Enhanced international cooperation will also be essential. This is particularly the case in combating tax avoidance and tax evasion, because it is bank secrecy and the existence of jurisdictions offering low or no taxes that facilitate capital flight motivated by taxation. David Spencer's article shows why it has become so difficult for national tax authorities to be effective in the era of financial globalisation, and explains how automatic exchange of tax information between governments could help tackle the problem.

Reducing capital flight and recapturing lost tax revenues are clearly possible; what appears to be lacking is the political will to apply the solutions. Two articles in this edition of **TJF**, on the OECD Global Forum and the new UN Committee of tax experts, reveal the disappointing progress towards international action on tax issues. This is in no small part due to the huge vested interests of the tax haven states which are amply represented in these fora. Why would an offshore turkey vote for Christmas?

Campaigns and TJN news

TJN in Finland launches a campaign to combat tax evasion through dividend payments

Tax Justice Network Finland is campaigning for tighter rules to prevent tax evasion through the payment, by Finnish listed companies, of dividends to nominee shareholders registered abroad. Revenue losses from this practice were estimated at around one billion euros for the year 2002-03, yet the Inland Revenue has failed to address the issue. The response of the Finnish government has also been woefully inadequate, despite the concerns raised by the security services over the potential use of these mechanisms for money laundering and the financing of terrorism.

TJN Finland has lodged a complaint to the parliamentary Ombudsman about the Inland Revenue's practices, and is currently awaiting the result. TJN Finland is also opposing the government's proposed legislative changes which would be ineffective in addressing the problem and calling for increased transparency on the identity of shareholders. For more information, see:

Volunteer translators needed

TJN is committed to the principle of multi-lingualism and is therefore seeking volunteers who could translate Tax Justice Focus into the network's core languages: French, German, Portuguese and Spanish.

If you would be willing to help, please contact John Christensen:

Network launch in France

A network of development NGOs and civil action groups engaged in poverty alleviation has been formed in France to tackle concerns about tax havens and criminality. Plateforme Paradis Fiscaux et Judiciaires (PFJ) has emerged from the '2005 - Plus d'Excuses' campaign and will be formally launched in Paris on 2 February 2006. PFJ members include Secours Catholique, Attac, Eau Vive, Survie and Transparency International. PFJ is a member of the Tax Justice Network.

Further details from Claire Bertucat

TJN Germany launches a campaign on alternatives to VAT increase

More than 3,500 citizens have so far joined TJN Germany's campaign to oppose the grand coalition's plan for a 3 per cent increase in VAT. In cooperation with the metal workers' union IG-metall, Attac and the internet NGO CampAct, the online-based campaign shares the government's view on the need to increase tax revenue but argues for alternatives to the proposed higher VAT rate. Such an increase would damage consumer confidence and undermine social justice.

TJN Germany supports instead the closure of tax loopholes; the taxation of wealth and inheritance; an increase in the effective tax rate on the staggering prof-

its of German transnational corporations; higher top marginal income tax rates; and combating tax evasion and avoidance by limiting tax competition between states within Germany through a more effective federal tax administration.

You can join the campaign:

Italian NGOs present alternative proposals for the 2006 State budget.

Sbilanciamoci, a network of 40 NGOs, networks and civil society organisations in Italy, presented a set of alternative proposals for the 2006 state budget on 18 October 2005. Voting on the budget has been ongoing since October, in the uncertain political context caused by upcoming elections in spring of next year when a change of government in expected.

The group's main alternative proposals in the fiscal arena include a minimum tax on the profits of shell companies (based on the model of the US Alternative Minimum Tax) and the standardisation of rates on bank deposits and financial market incomes to the same level of 20 per cent, as opposed to the current levels of 27 per cent and 12.5 per cent respectively. Taken together, these measures could be expected to raise Treasury income by €5 billion in 2006.
For further information see:

Spain. The National Library hosts a debate on tax havens.

On 26 October, the Spanish Biblioteca Nacional hosted a discussion on tax havens. Juan Hdez. Vigueras (TJN Spain) spoke on the issues arising in his recent book *Tax havens: how offshore financial centres undermine democracy* (Los paraísos fiscales: Cómo los centros financieros offshore socavan las democracias).

The Spanish version of ***tax us if you can*** is now available for download from the TJN website.

Switzerland. Public eye on irresponsible corporate behaviour

The Berne Declaration and Pro Natura are organising the second

Public Eye Awards for irresponsible corporate behaviour in Davos, Switzerland on 25 January 2006 to coincide with the World Economic Forum. The Public Eye Awards go to companies which excel in harmful social or ecological behaviour. Prizes are awarded in the categories of environment, social (human and labour) rights and taxes. In 2005, TJN nominated KPMG for an award in the tax category which KPMG deservedly won. Updates about the Public Eye Awards are available by registering for the Public Eye Newsletter, contact

UK. Early Day Motion on tax havens.

In October, Plaid Cymru Member of Parliament Adam Price tabled an Early Day Motion (EDM) calling on the UK government to address the problem of tax havens as highlighted in the reports by Christian Aid and TJN's *tax us if you can*. Putting down an EDM is a way for MPs to draw attention to a particular issue and to canvass support from other MPs who can then add their signature. Fifty MPs have added their signatures to the tax havens EDM.

For further details see EDM 699 on Christian Aid report on tax havens:

UK. Plugging the leaks

The role of tax havens in facilitating capital flight and tax incentive competition was the focus of attention for the UK All Party Parliamentary Group on Debt Aid and Trade (www.debtaidtrade.org) when it met with John Christensen, Sony Kapoor and Jean-Pierre Landau on 10th November. Those attending the meeting agreed that tackling capital flight and harmful tax practices is crucial to creating an economic framework in which developing countries can reduce their dependence on debt and aid.

New director named for TJN USA

Bill Fant has been named the director of Tax Justice Network USA.

Bill has worked in the area of tax policy and legislation for 24 years – beginning with the first Reagan tax cut – as a journalist, in the legislative and executive branches of the U.S. government, and in the private sector. He was on the tax policy staff of the late Senator Daniel Patrick Moynihan, and was Special Assistant to the assistant Secretary for Tax Policy, and acting Deputy Assistant Secretary for Legislative Affairs (Tax and Budget) at the U.S. Treasury Department in the Clinton Administration.

Bill will be putting together the U.S. network and coordinating U.S. activities of the worldwide TJN.

TJN appoints new media adviser

Mike Lewis is Tax Justice Network's new media and communications adviser. He is a press officer and researcher, with a background in advocacy and communications.

Mike has developed media strategy and campaigns for several conflict and security NGOs, and is a founder member of the Iraq Analysis Group, which aims to provide accessible economic and political information for media and advocacy.

He trained as an economic historian at the University of Cambridge, where he was affiliated to the Centre for History and Economics, specialising in international economic organisation and development technology in Southeast Asia.

Media Digest

UK. ***Accountancy Age.*** 29 September 2005. '**What is the difference between avoidance and evasion?**', differing viewpoints presented by Loughlin Hickey (KPMG) and Andrew Pendleton (Christian Aid) and Richard Murphy (TJN UK).

In his piece, Loughlin Hickey bemoans the 'smudging' of the term tax evasion to include actions which although legal have negative fiscal consequences and wants certainty restored on the status of tax avoidance. Andrew Pendleton and Richard Murphy are more concerned with the impact of tax avoidance and the use of tax havens on government finances in developing countries where lost tax revenues could be funding investment in infrastructure and public services, helping to improve the living standards of poor people.

Spain. ***Pymes***. October 2005. '**Tax havens and their impact on Spanish firms**' an interview with Juan Hdez. Vigueras (TJN Spain)

In this interview with a magazine focused on SME (small and medium enterprises) issues, Juan Vigueras explains how transnational corporations structure their trade and investment flows through subsidiaries in tax havens in order to gain significant tax advantages. This gives TNCs an unfair competitive advantage over those SMEs which only operate in the local or national context. SMEs lack the same opportunities to avoid taxation and are therefore unable to reduce their operating costs and prices as a result.

Vigueras also explains how tax havens are undermining fiscal revenues in Spain and other countries: two years ago the Financial Times estimated that Spain was losing around 10 per cent of GDP (or some €60,000 million) due to tax evasion from the use of havens. He then puts forward a range of proposals that governments – and, in particular, the Spanish government – could adopt to address the problem.

The full interview in Spanish is available on the PYMES website:

W **www.pymes.tai.es**

UK. ***The Observer.*** 2 October 2005. '**Uproar at BAT's tiny UK tax bill**', Conal Walsh.

This article reported on TJN research revealing that British American Tobacco (BAT), a UK domiciled cigarette manufacturing company, paid a negligible amount of UK corporation tax over the last five years. Campaigners including Christian Aid and Action on Smoking and Health (ASH) condemned BAT. The article quoted Richard Murphy calling on the government to ask "why the UK is offering itself as a tax-free head office location to companies like BAT".

UK. ***The Financial Times***. 4 October 2005. '**Regime change in bid for mainstream status'**, Vanessa Houlder.

The Isle of Man (IoM), despite being keen to loose its 'tax haven' reputation, is currently planning to introduce changes to its tax regime which will increase its appeal to investors. The article reveals that the IoM government plans to offer nearly all businesses a zero rate of corporation tax, with a counter-balancing 'distributable profits' charge on companies owned by residents that retain profit.

Richard Murphy (TJN UK) is quoted taking issue with the IoM government's claim that this is an anti-avoidance measure rather than a revenue-generating measure, and he states that the charge contravenes the EU Code of Conduct by offering advantages to non-resident companies.

Spain. ***Diagonal.*** 13-26 October 2005. '**A serious political problem'**, Juan Hdez. Vigueras (TJN Spain)

Despite the rhetoric of the international organisations and governments worldwide, this article argues that very little real progress has been made over the last five years in combating the use of tax havens for tax evasion, money laundering and financial speculation. Even the OECD initiative on harmful tax practices has been watered down following US pressure, effectively leaving civil society organisations and a small but growing number of concerned experts to force governments to address the problems posed by tax havens. The article refers to the work of TJN, as well as to the campaign against tax havens run by Attac Spain.

Ireland. ***The Sunday Business Post***. 13 November 2005. '**IRS focuses on American companies in Ireland**', Niall Stanage

As the IRS (US Internal Revenue Service) seeks to tighten tax laws in relation to companies which set up operations overseas and intellectual property, this article illustrates the problem through the example of Microsoft which used a Dublin-registered subsidiary to avoid US$500 million in tax in the year to June 2004. The article quotes at length from Richard Murphy (TJN UK) who argues that while there is nothing illegal in what Microsoft are doing, their actions do look like "a very aggressive tax strategy".

UK. ***The Observer.*** 13 November 2005. '**Who gave £350,000 to save Edward's failing TV firm?**', Antony Barnett.

This article exposes a seemingly incredible situation: a company of which Prince Edward (son of the British queen) is director, the struggling Ardent Productions, received an injection of funds of £350,000 from a company called Intercap Ventures in the British Virgin Islands – and neither the Prince nor the chairman of Ardent had any idea who was behind this 'gift'. Richard Murphy (TJN UK) is quoted in the article saying that it is inappropriate for a member of the royal family to receive funding from a source disguised by the use of an offshore haven.

UK. ***The Guardian.*** 15 November 2005. '**Blair's poor deal for developing countries'**, letter from John Christensen (TJN UK), Alex Cobham (the Oxford Council on Good Governance), Sony Kapoor (Christian Aid) and Richard Murphy (Tax Research).

In response to a Guardian piece on tax avoidance, this letter draws attention to the problem of companies shifting their profits out of developing countries into tax havens. This profit shifting, the letter states, deprives poor countries of billions of dollars in tax revenues which could be used to finance social services and reduce poverty and inequality. The letter calls on companies to pay tax in the countries where profits are really earned, and on governments everywhere to enhance cooperation on measures to address tax avoidance.

UK. ***Accountancy Age***. 18 November 2005. '**Tax gap "will widen" without trust'**, Alex Hawkes.

This article reports on a lecture given by Loughlin Hickey (head of tax at KPMG) for the Institute of Chartered Accountants in which he called for greater trust between tax collectors and business. The article also reports on comments made by Richard Murphy (TJN UK) in light of KPMG's operations in tax havens. Murphy asked: "If the trust gap is to be reduced, shouldn't advisers and corporations pull out of these territories that do so much harm to the credibility of our profession and the commercial world?" To which Hickey responded that he was proud of KPMG's presence in tax havens: "Quite frankly if principled firms like ourselves are not in these territories we don't aid them."

UK. ***The Guardian.*** 5 December 2005. '**Where they hide the cash'**, Duncan Campbell,

On the opening day of the first meeting of the UN Committee of Experts on International Cooperation in Tax Matters in Geneva, Campbell, a staff columnist at the Guardian, welcomes the spotlight finally being shone on "one of the world's great hidden scandals". Drawing on the work of Raymond Baker, and with quotes from John Christensen (TJN UK), the article highlights the use tax havens and compliant banking systems by corrupt leaders in poor countries to hide vast sums of money that could be used to tackle poverty.

UK. ***The Financial Times***. 8 December 2005. '**Joined-up way to change culture of tax avoidance'**, letter from Alex Cobham (the Oxford Council on Good Governance), Richard Murphy (Tax Research), and Mike Lewis (TJN).

Following the introduction of limited new corporate tax avoidance measures in the UK's pre-Budget report (released 5 December), this letter responds to criticisms levelled at the anti-avoidance actions by the CBI (Confederation of British Industry) and calls for a more joined-up approach in the UK to the tax avoidance industry. The letter states that the interests of both government and business would be well served by the introduction of an anti-avoidance principle in taxation law.

UK. ***Private Eye***. 9-22 December 2005. '**Haven sent'**

Another report on Loughlin Hickey's Institute of Chartered Accountant's lecture, and Richard Murphy's (TJN UK) question on KPMG's use of tax havens, in the UK's leading satirical magazine.

Capital flight from Brazil in the era of financial globalisation

Drawing on research for his chapter on Brazil in *Capital flight and capital controls in developing countries*, Deger Eryar shows how the macroeconomic instability which typically accompanies financial liberalisation in developing countries triggers capital flight.

Just a few months before the 2002 presidential elections in Brazil, former US Treasury Secretary Paul O'Neill voiced his suspicions about the possible use of foreign capital flowing into the country. O'Neill's skepticism over the effectiveness of providing further financial assistance to countries like Brazil was based on the assumption that additional money pumped into the Brazilian economy would simply end up in Swiss Bank accounts; in other words, he was worried about capital flight.

In his statement, O'Neill cited the so-called 'Lula Effect' as the reason why external funds coming into Brazil were leaving the country. But the story is more complicated than that. Structural changes in the Brazilian economy, particularly in the period after the introduction of the Real programme in 1994, had already triggered capital flight by increasing macroeconomic instability in Brazil.

Capital flight is usually affected by the loss of confidence in the overall economy. If the residents of a country perceive macroeconomic instability as a threat to their holdings of domestic assets, then they try to switch into foreign assets in order to protect the value from any sudden changes. These changes can take the form of a freeze on assets in the banking system or a postponement of interest payments on public debts. When a country has huge external liabilities, as was the case in Brazil, even capital flight of one dollar can be seen as a loss to the economy.

Measuring capital flight in Brazil

In *Capital flight and capital controls in developing countries* we used the 'residual method' that measures capital flight by comparing capital inflows (i.e., net increases in external debt and the net inflow of foreign investment) with the uses of these inflows (i.e., the current account deficit and additions to foreign reserves). The amount by which inflows exceed outflows constitutes the estimate for capital flight. Additionally, as misreported trade figures enable domestic actors to engage in capital flight by providing both a source and mechanism, we adjusted our capital flight figures to allow for the trade mis-invoicing.

Our calculations showed that between 1981 and 2000, capital flight from Brazil averaged US$5.7 billion a year. There are significant variations within this period. For example, in the years 1981 to 1989, the annual average stood at just US$ 2.8 billion whereas this figure rises to US$10 billion for the years 1995 to 2000 when financial market liberalisation had really taken hold. Capital flight peaked in 1998, when it reached US$43 billion.

The Real Plan: from success to vulnerability

In 1994, Brazil implemented the Real Plan which was the most successful of the country's economic stabilisation programmes. From the outset, the Plan's central premise was that only by slashing inflation could an attractive investment climate be created for foreign investment by multinationals in Brazil, and only massive inflows of such productive capital from abroad could provide a sound basis for long-term domestic growth. Initially, the Plan was successful. Inflation rates declined rapidly, aggregate demand expanded, and the country seemed to be poised for an extended period of growth based on capital inflows.

On the other hand, there was a huge jump in imports due to overvaluation of the currency. Between 1994 and 2000, Brazil steadily ran trade deficits. While a pegged exchange rate can be useful in the short run to fight inflation, it can also damage trade balances by making imports cheaper.

The combination of a widening trade deficit, and the need to build up foreign reserves to protect the overvalued currency against speculative attacks, required the support of massive inflows of capital that necessitated high interest rates as a permanent rather than a temporary feature of the Real Plan.

Due to growing interest payments and the repatriation of profits, the current account deficit also soared in the same period. Yet the continuous inflow of foreign capital depended ultimately on the decisions made by the international finance community based in developed countries. An eventual crisis in any link of the highly integrated world economy could create panic, leading to a withdrawal of external funds.

Each time financial market disturbances threatened in Brazil, interest rates were raised to continue attracting foreign capital inflows. However, any hike in the interest rate increased the fiscal fragility of the state which depended heavily on domestic debt to finance its deficit. High interest rates also caused problems for industrial capital, particularly in those

sectors that had to compete with cheap imports as a result of an overvalued domestic currency.

Macroeconomic instability and capital flight

High interest rates used to keep foreign funds coming to the country, their impact on the structure of domestic public debt in the face of growing budget deficits, growing balance of payment deficits as a result of the overvalued currency, and a ratio of foreign debt to the GDP approaching debt-crisis levels were the factors that contributed significantly to the instability and the loss of confidence in the sustainability of the new growth strategy.

Under these conditions, first the Asian crisis, then the Russian crisis the following year, triggered capital flight from Brazil in 1997 and especially in 1998. As a result of a renewed speculative attack on *real* after the debt moratorium declared by one of the Brazilian states towards the end of 1998, the government abandoned its defence of the currency in early 1999 and allowed it to float.

The analysis of the Brazilian experience shows the persistence of capital flight over this whole period. Whilst the annual averages for capital flight may seem relatively low compared with other developing countries, the capital flight peak was reached exactly as Brazil integrated successfully into the world economy by carrying out major institutional changes, particularly capital account liberalisation. Despite the government implementing policies designed to attract foreign capital as a way of bridging its so-called 'resource gap', this period saw an ever-increasing loss of confidence among Brazilian residents over the sustainability of the new growth strategy.

If capital flight is considered a major problem for developing countries, especially in times when these countries need the foreign exchange in order to cover their external liabilities, then any policy proposal to reverse capital flight should go hand in hand with other policy changes to shift the direction of accumulation towards a more productive, and employment- and equity-enhancing, growth process.

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Automatic exchange of tax information

The solution to the problem of capital flight and tax evasion in the international context is the automatic exchange of tax information between governments, writes David Spencer.

Globalisation and the liberalisation of economic activity have resulted in an exponential increase in cross border commercial and financial transactions, in effect converting the private sector into a world without borders. This has created a major problem for national tax authorities as their reach and enforcement powers continue to be constrained by national borders.

Governments everywhere are suffering from the loss of tax revenues, particularly as a result of transfer pricing and capital flight. The Tax Justice Network has estimated that around US$250 billion in tax revenues is lost worldwide every year as a result of capital flight.

As governments come under pressure to increase tax revenues, there is a growing recognition of the need to find better ways to enforce national tax laws. National tax authorities recognise that exchange of tax information between them is essential in confronting the challenges presented by private sector globalisation.

Problems faced by national tax authorities

In confronting the impact of globalisation and liberalisation of economies, national tax authorities face several problems. First, national tax authorities are precisely that, an administration of one national government, and there is a traditional legal rule that one government does not enforce the tax laws of other governments. In other words, governments do not help other governments collect taxes. Moreover, in many cases the expertise of national tax authorities has not developed sufficiently to cope with the growth in volume and complexity of commercial and financial transactions. In the absence of an international tax administration, these problems severely limit the enforcement of national tax laws.

Second, bank secrecy and other confidentiality laws ('de jure bank secrecy') in many jurisdictions prevent the disclosure by financial institutions and other payers of cross border income of relevant information to government authorities, except under certain specified circumstances. This de jure bank secrecy exists in some countries which are international financial centres, and in most tax haven jurisdictions.

Tax havens present a double problem, as many not only receive bank deposits and

other passive investments – which are protected by de jure bank secrecy laws – but are also used to route investments in order to acquire the cloak of confidentiality. For example, a resident (corporate or individual) of country X, sets up a corporation in country Y (a tax haven with a confidentiality and/or bank secrecy law) and uses it to make an investment in country Z.

Even where bank secrecy laws are not present, many governments to not normally obtain relevant information from financial institutions and other payers of cross border income. This means that they do not have information to exchange with other governments, resulting in 'de facto bank secrecy'.

Third, the laws of several countries prohibit the transfer of tax related information to other governments except if there is an international (bilateral) agreement between the two governments authorising such transfers. There are also practical problems in implementing information exchange. This is particularly the case with automatic exchange of information which entails the transfer of substantial amounts of information from one government to another.

Fourth, governments often have conflicting interests with regard to exchange of information. While they usually want to obtain information about the income that their residents and citizens derive in other countries, many governments in major international financial centres also want to attract bank deposits and other interest bearing investments from foreigners. They do this by offering tax free treatment on interest income and bank secrecy or other confidential treatment for such investments (i.e., no exchange of information). This has resulted in the reluctance of the main financial centres to cooperate fully on exchange of information, which is a major obstacle to international progress in this area.

Recent developments in exchange of tax information

There has been some recent progress towards increased exchange of information in tax matters. The OECD's 1998 Report, *Harmful Tax Competition: An Emerging Global Issue*, attacked bank secrecy in tax matters, and emphasized the need for effective exchange of information between national tax authorities. This report led to the OECD Proposals on Harmful Tax Practices, calling for restrictions on tax havens (required transparency and some limited exchange of information).

This year the OECD has revised article 26, *Exchange of Information*, of its Model Income Tax Treaty, in order to provide specifically that the obligation of national governments to exchange information must override bank secrecy and other confidentiality laws. It is expected that the United Nations Model Tax Treaty between Developed and Developing Countries will be similarly modified. The OECD has also added to its Model Income Tax Treaty a new article 27, *Collection of Taxes*, under which one government would agree to help another government collect taxes.

In addition, bank secrecy and other confidentiality laws have come under attack as a result of non-tax laws, such as in efforts against money laundering, terrorism financing and corruption.

Different methods of exchange of information

Exchange of information between governments normally occurs through three different procedures: exchange of information upon request; spontaneous exchange of information; and automatic exchange of information.

Exchange of information upon request**.** Income tax treaties and tax information exchange agreements (TIEA) normally require only exchange of information on request. This procedure is usually only effective if the requesting government presents a sufficiently detailed request (for example, the name and location of the bank or other financial institution where the taxpayer has a bank account) and the requested government is able to obtain the information.

Spontaneous exchange of information**.** Spontaneous exchange of information occurs when one government has information which it believes would be of interest to the other government and it spontaneously provides such information. This is clearly a very limited form of exchange of information, and in the case of governments with either de jure or de facto bank secrecy spontaneous exchange of information can be further constrained.

Automatic exchange of information**.** Automatic exchange of information may be the most productive type of exchange of information, but it is the most difficult to implement. Automatic exchange of information would normally cover cross-border payments such as interest, dividends and royalties.

The payers of such cross-border income (i.e., a bank) would provide the relevant information to their government (transmitting government) which would, in turn, provide that information to the government (receiving government) of the country where the recipient of such income is located; this would normally be the place of organisation for a company, and the place of residence and/or citizenship for an individual.

Automatic exchange of information is difficult to implement for three major reasons. First, the transmitting government and the receiving government have to specifically agree to such automatic exchange of information. The Commentary to the OECD Model Income Tax Treaty and the Commentary to the UN Model Income Tax Treaty refer to automatic exchange of information, but they do not require it. The EU Directive on the Taxation of Savings requires automatic exchange of information on certain interest paid within the EU to individuals resident within the EU (except for Austria, Belgium and Luxembourg which during an interim period impose a withholding tax).

Second, automatic exchange of information would normally involve the transfer by the transmitting government to the receiving government of a substantial volume of data. In order for the receiving government to be able to process such information, it should ideally be

compiled based on the Taxpayer Identification Number (TIN) used for taxpayers (companies and individuals) by the receiving government. However the transmitting government may not be technically equipped to gather relevant information based on the TIN of the receiving government. The OECD has been working on the mechanics of automatic exchange of information.

Third, two countries (country X and country Z) may agree to implement automatic exchange of information. But residents (corporate or individual) of country X may route investment in country Z through a corporation in a third country, such as a country Y tax haven, thereby defeating the automatic exchange of information agreement unless it is extended to the tax haven.

In summary, governments need to rely on exchange of information between them in order to overcome the challenges to national tax authorities presented by globalisation and liberalisation. But implementation of effective exchange of information between governments, especially automatic exchange of information, is not an easy task. The EU Directive on the Taxation of Savings, if successfully implemented, could serve as a model for the automatic exchange of information between other countries.

David Spencer is a practicing attorney in New York, specialising in tax law and banking law.

Unpromising start for new UN Committee

John Christensen was in Geneva earlier this month at the first meeting of the new UN Committee of Experts on International Cooperation in Tax Matters

The first meeting of the United Nations Committee of Experts on International Cooperation in Tax Matters got off to an unpromising start with a serious imbalance of representation from developed and developing countries and apparent conflicts of interest.

Meeting in Geneva from 5th to 9th December, the Committee, which replaces the ad hoc group of experts formed in the 1960s, consists of appointed Members representing 25 countries including tax havens such as Bahamas, Barbados, Ireland, Switzerland, the United Kingdom and the United States. Few of the Members come from developing countries, though the Member from Bahamas portrayed that tax haven as representative of developing countries. Interestingly enough, the Member for Barbados was listed as an International Tax Partner of Ernst & Young in Bridgetown.

Developing countries were also poorly represented among the 27 Governmental Observers at the meeting, which included Observers from Cayman, Israel, Liechtenstein, Monaco and Saint Kitts and Nevis. Civil society representation was limited to the Tax Justice Network delegation, which included Observers from France, Switzerland and the UK, and the International Chamber of Commerce, whose delegation of two included the Group Tax Director of UBS in Zurich.

In any objective sense undeclared conflicts of interest abounded, and were especially evident during the lengthy discussion on the issue of information exchange agreements, which was probably the most substantive item on the agenda.

The discussion began with an excellent paper by tax attorney David Spencer, but quickly faltered after an intervention from the Chair urged the Committee to work at a pace that was acceptable to all countries, thus providing the cue for stalling progress towards strengthening the existing UN Model Convention between Developed and Developing Countries. The Sub-Committee appointed to consider the issue is dominated by Members representing tax haven jurisdictions, so expectations for progress have been considerably dampened.

Concerns about imbalance of representation and conflicts of interest need to be addressed with the utmost urgency if the Committee is to avoid becoming an irrelevance in the arena of international cooperation.

John Christensen directs the TJN International Secretariat

OECD Global Forum on Taxation

Bruno Gurtner questions whether last month's meeting represent progress on tax matters.

In mid November official representatives from 55 governments, both OECD-members and non-members, met in Melbourne (Australia) to review progress in improving transparency and effective exchange of information in tax matters.

The last meeting had taken place in June 2004 in Berlin and had initiated a country review of legal and administrative frameworks in the areas of transparency and exchange for information. 81 countries have been now included in this review.

A draft report of the results of this review was circulated to all participants before the meeting and formed the background of the Global Forum's discussion. The draft report was prepared on the basis of information gathered using a questionnaire. The report will now be reworked and, after a consultation process with all 81 countries, a final report should be published in March 2006.

The statement released following the Melbourne meeting set out the main outcomes, including:

• 65 of 81 countries reviewed have legal mechanisms in place that permit the exchange of information or both criminal and civil tax matters.

• Of these, the majority do not require a domestic tax interest to obtain and respond to a request for information.

• 53 of the countries reviewed are able to obtain and provide banking information in response to a request for information related to a civil tax matter in some or all cases.

The review also found that an increasing number of non-OECD countries are negotiating agreements that provide for exchange for information.

Jeffrey Owens, head of the OECD Tax Centre was satisfied with the outcome of this review process and expects further progress in the future. Despite this optimism no date for the next meeting of the Global Forum has been agreed; a Sub-Group has been charged with setting the date. Informal sources have reported that open conflicting positions exist between different participating countries

In Melbourne, 12 of the 23 countries invited to attend the Global Forum under the new status of invitees did so including Austria, Singapore and Switzerland. Yet even before the meeting began, Switzerland made it clear that it would maintain its current position – particularly on banking secrecy – and pledged not to enter into any commitments. Can we call this progress?

Bruno Gurtner works with Alliance Sud (Switzerland) and is a member of the TJN steering committee. See the OECD website:

www.oecd.org

Reviews and new research

Gerald A. Epstein (editor)
Capital Flight and Capital Controls in Developing Countries
Edward Elgar, 2005

Cross-border capital movements have increased dramatically in the past three decades. The majority of these flows have been trade related, but there has been a significant growth in the volume of net unrecorded capital outflow from capital scarce developing countries. This is the phenomenon known as capital flight, defined in Epstein's book as the difference between the recorded sources and the recorded uses of funds.

The neo liberals expected that financial liberalisation and tax cuts would be sufficient to reduce capital flight and tax avoidance. But this has not been the case. This is largely because the globalisation of financial markets and corporate structures has increased the opportunities for engaging in illicit cross border trade, whilst reduced trade controls and the growth of offshore capacity have diminished the risk of discovery of mis-invoicing practices and similar capital flight techniques.

Capital flight is the Achilles' heel of the Washington Consensus. Using various econometric tools, contributors to this book find little support for the proposal that capital account liberalisation has been a stimulus for growth and plenty of evidence that capital mobility undermines the political power of labour, pitting the interests of labour in developing countries against those of workers in the developed world.

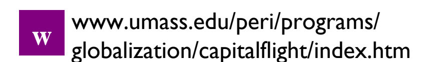
Mounting insecurity has increased the incentive for wealth holders to engage in capital flight, not only to avoid potential devaluation, or taxes, or the imposition of capital controls in times of crisis, but also because the ability to 'round trip' money via offshore trusts or companies creates opportunities to snatch up domestic assets at bargain prices, as happened in Argentina earlier this decade.

Using case studies covering a range of developing countries, Epstein and his colleagues explore the threat that capital flight poses to developing countries, offer a 'residual' definition of capital flight as a means of bypassing definitional debates, and consider a variety of capital management techniques to halt, curb or reverse capital flight.

Whilst too expensive for most personal bookshelves, this book makes an important contribution to our understanding of capital flight from developing countries and deserves shelf space in every serious library.

John Christensen

More information on this book together with an interview with its editor, Jerry Epstein, can be found on the PERI website:



www.umass.edu/peri/programs/globalization/capitalflight/index.htm

Thierry Godefroy and Pierre Lacoumes
Clandestine capitalism: the illusory regulation of offshore
La Découverte, 2004 (in French)

The title perfectly captures the structures and spirit of the new capitalism that has been steadily evolving since the end of the 19th century, a development which Karl Marx only sketched in outline in the third volume of Capital.

But the sub-title is more debatable. Where is the illusion? In the heads of activists and citizens who hope to see the State (or those in power) regain control through regulation of offshore centres? Could anyone living in the 21st century be so naive as to imagine that victory is within reach when we are constantly being presented with evidence of the irrefutable laws of harsh economic reality: delocalisation, unemployment, impoverishment, and the total dominance of the market?

This book is focused on stripping away the opacity which obscures the offshore realm. Readers will encounter French 'specialities' such as how major State agencies have systematically used offshore to hide corruption (Elf, Total in Africa . .), or losses (Crédit Lyonnais), practices which provide the back story to the campaign against money laundering pushed through the French Assemblée National by the Peillon-Montebourg Commission (2000-2001). They will also learn about the principal financial vehicles used offshore, such as trusts and Special Purpose Vehicles, and how since the 1960s Washington has allowed US multinationals to use Foreign Sales Corporations to hold their profits in tax havens, boosting earnings and distorting global markets to US advantage.

Clandestine Capitalism describes how the different players in the new capitalism (bankers, corporate big-wigs and high net wealth individuals) have created a financial system which allows them to avoid taxes whilst appearing to operate within the letter, if not the spirit, of the law.

But many questions are left unanswered, not least the crucial issue of what campaigners can do to mobilise workers and civil society generally against the cancer which is eating away at State resources, encouraging capital flight, distorting markets and generally undermining social justice. This will be the arena within which the campaign for 'another world' will be conducted.

François Gobbe

V Cerra, M Rishi, and S Saxena
'**Robbing the Riches: Capital Flight, Institutions, and Instability'**, *IMF Working Paper* WP/05/199.

The paper examines the determinants of capital flight from developing countries, and in particular the effect of countries' debt levels. With a data set comprising 134 developing countries from 1970-2001, the authors empirically examine whether capital flight is increased or reduced by different sorts of financial inflow or by the strength of domestic institutions.

The main findings are these:
• greater foreign debt increases capital flight, and this effect is strongest for short-term debt
• foreign direct investment (FDI) and aid inflows reduce capital flight
• weak institutions encourage capital flight.

The authors use this to reach two main conclusions: that debt relief may reduce capital flight by "reducing prospective taxation [needed] to finance debt repayments, […] consistent with our finding that foreign aid reduces capital flight"; and that "aid or debt relief should be complemented by sound macro policies and an institutional environment conducive to allocating available resources to useful projects within the country."

A number of problems with both the results and interpretation can be identified. Capital flight is notoriously difficult to estimate. Even if the data are assumed to be accurate, however, and the results 'true', they may reflect a rather different underlying pattern.

First, some capital flight is not related to corruption, tax evasion or other (initially) illegal activity, but simply reflects domestic capital-owners circumventing capital controls in order to invest overseas – in much the same way as most people in rich countries do, through pensions and insurance holdings if not more directly. Second, the stereotype capital flight – of funds stolen by corrupt elites – is typically able to flow easily. For this reason, it too responds (though perhaps less immediately) to domestic investment opportunities.

In fact, flows of flight capital inevitably react to the same things as foreign investment flows do – if the country is more risky (e.g. has higher debt ratios or weaker government), both groups will prefer to hold more money overseas. This can explain the associations with FDI, debt and institutions, without the deterministic view the authors favour. The standard prescription – the need to condition debt relief on 'sound' macroeconomic policies and institutions 'conducive' to suitable resource allocation – need not then follow; debt relief should simply be provided to countries in poverty.

Taxation issues are sadly not tested. To the extent that higher taxes do drive capital flight, itself an under-researched issue, stronger government and tax administration should reduce the opportunities. The authors do not test this channel however. They appear to simply accept that tax drives flight, and that debt relief is used to reduce taxation – rather than, for example, to provide greater education or desperately-needed healthcare. If this is actually the case, it is surely a highly important issue for research to address and for policymakers at creditor institutions like the IMF to consider.

Alex Cobham

The paper is available as a download from the IMF website:

www.imf.org/external/pubs/ft/wp/2005/wp05199.pdf

Andy Rowell, James Marriott & Lorne Stockman

The Next Gulf: London, Washington and Oil Conflict in Nigeria

Constable & Robinson, London, 2005

Despite US$300 billion in oil revenues over the past 25 years the average Nigerian is worse off today than in the mid 1970s and child mortality runs at 20 per cent. With its vast hydrocarbon wealth, Nigeria could have been the success story of West Africa, but instead, according to this excellent study of corruption and oil geo-politics, "the cupboard is bare. All has been looted or wasted. Or is in the bank accounts of City investors in London and Switzerland."

Published to coincide with the tenth anniversary of the judicial murder of writer and activist Ken Saro-Wiwa, *The Next Gulf* is a heartbreaking exploration of how the interests of European and North American governments have coincided with those of unscrupulous oil 'supermajors' and indifferent western consumers to oppress the people of the Niger Delta region.

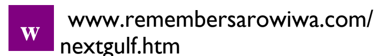
In the decade since Saro-Wiwa's death, the situation in the Delta appears to have deteriorated significantly, not least because 9/11 increased the strategic importance of the Gulf of Guinea for US oil and gas supply. As a consequence, the Gulf is increasingly militarised and widespread oil bunkering (theft) is funding the potential for future violent conflicts.

Turning perceptions of Nigeria on their head, a chapter titled 'Does corruption begin at home?', investigates how oil companies shift their profits to tax havens by loading costs onto Nigerian operations and withholding important accounting information from the revenue authorities.

"Many of the mechanisms that keep Nigerians poor" concludes Andy Rowell " . . are based in tax havens that were set up by the British and other colonial powers." Shamefully, Jersey, my native island, has profited enormously from this scandalous state of affairs.

John Christensen

The Next Gulf can be ordered from Remember Saro-Wiwa, with profits going to the project.



www.remembersarowiwa.com/nextgulf.htm

Arun Kumar

'India's black economy: the macroeconomic implications' in the *Journal of South Asian Studies*, August 2005, pp249-263

This paper shows that most analyses of the Indian economy fail to take sufficient account of the role of the black economy, which now constitutes around 40 per cent of national economic activity. Black economy incomes, the majority of which are generated with some element of illegality, are not disclosed to the tax authorities and therefore go untaxed. This implies a considerable loss of tax revenues for the Indian government. The author argues that the dominance of the black economy has led to a decline in the quality of governance in India and had a negative impact on key macroeconomic variables (savings, investment, level of output, etc). Kumar shows that the black economy is responsible for a sub-optimal growth rate in India – with negative consequences for poverty and unemployment.

Arun Kumar is the author of *The Black Economy in India*, published in 2002 by Penguin Books India.

Oscar Ugarteche (editor)

Public Vices: Power and Corruption

SUR and the Fondo de Cultura Económica, Lima, 2005 (in Spanish)

This book, the product of a conference of the same name held in Lima in 2004, brings together academics from a range of disciplines to advance our understanding of corruption. Using the perspectives of their respective disciplines – anthropology, political science, economics and psychology – and taking the experience of corruption in Peru during the 1990s as a starting point, the contributors look at the motivations behind corruption and the current crisis in ethics in both the private and public sectors.

Vicios Públicos: Poder y Corrupción

For further information contact:

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Alain Deneault

Paul Martin & Companies

Talonbooks, 2006

Now available in English translation, this book presents the story of Canadian prime minister Paul Martin's business dealings as an example of the current crisis in public ethics and outlines the implications of a global financial system that has gone beyond control.

Further information is available at:

nupress.northwestern.edu

Henderson Global Investors

Responsible Tax

October, 2005

As a follow-up to Hendersons' *Tax, risk and corporate governance – findings from a survey of the Chairmen of the FTSE350* (see TJF volume 1, number 1) published earlier this year, *Responsible tax* presents the conclusions derived from subsequent discussions with heads of tax at a number of FT100 companies.

It explores how tax decision-makers tread the fine line between investor pressure for high returns and serving shareholders' interests on the one hand, and the need to maintain good relations with tax authorities and a good reputation with governments and the wider public on the other.

It is clear from the report that the tax departments of leading companies recognise the increasing relevance of tax matters for their corporate reputation as well as the importance of abiding (or at least of being seen to abide) by the spirit, as well as the letter, of the law.

In this context, the report highlights issues raised in Christian Aid's September 2005 report *The shirts off their backs: how tax policies fleece the poor*. Internationally

active companies using aggressive tax planning, albeit legally, are now concerned about being perceived to be depriving developing countries of tax revenues which could be used to help alleviate poverty.

As the Hendersons report states, companies currently disclose very little information on tax to investors and other stakeholders. This, argues Hendersons, needs to change and companies should be encouraged to increase transparency on tax matters in their accounts. The report also urges companies to cover tax in their Corporate Responsibility (CR) reporting. The report ends by setting out a good practice 'self-assessment framework'. This framework consists of a series of questions which Hendersons suggests companies could ask themselves in order to reduce the likelihood of being criticised over their tax policies.

Responsible Tax is available as a download from:

www.henderson.com/home/sri

Calendar 2006

January 1
Austrian presidency of the EU

January 25-29
World Economic Forum and the Public Eye on Davos Awards
Davos, Switzerland

Polycentric World Social Forum
January 19-23
In Bamako, Mali

January 24-29
In Caracas, Venezuela

February 2
French network to combat tax havens - Plateforme Paradis Fiscaux et Judiciaries—launch in Paris, France

March
Nordic Tax Justice Network launch

April 6-9
European Social Forum in Athens, Greece