Capital Outflows from Developing Countries

What Can Be Done about This Major Source of Poverty?

By Krishen MEHTA

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What are some examples of major global issues that are still unresolved today? One can say that they are the environment and the effect of climate change, the arms race and resultant proliferation of nuclear weapons, the pressure on the earth's resources in terms of food and water, and the challenges that societies face with respect to education and healthcare.

But there is one very important issue the public is not generally aware of. It has the effect of increasing poverty in developing countries, and making it more difficult for them to invest in infrastructure, healthcare, education, and other priorities. And that is *the outflow of capital* from developing countries through corruption, business mispricing, money laundering, and other means.

Outflow versus Inflow

The World Bank estimates that developing countries need about $40 billion to $50 billion annually to meet their Millenium Development Goals. Yet, the loss of revenue from these countries each year amounts to about $850 billion a year. If businesses and multinationals paid their taxes in a more responsible manner, and there was less trade and transfer mispricing, the improved tax collection from this source alone could amount to about $160 billion a year. The funds, if available, could be used for increased investments in education, job creation, healthcare, a cleaner environment, access to water, and the resources to fight infectious diseases.

Significant research on this subject has been done by Raymond Baker and his team at the Global Financial Integrity (GFI) group in Washington, DC. The work is documented in the book *"Capitalism's Achilles Heel."* But action has been slow. Why? The truth is that much of the money ends up in Western financial institutions and in tax havens, and those institutions have more of clout than the person on the street in a developing country. *(Chart 1)*

The long-term goal of developing countries should be to replace foreign aid dependency with tax self-reliance, and to stem the outflow through illicit means by businesses, politicians, and others. If even 10% of the annual capital outflow of about $850 billion is retained in developing countries, it could have a dramatic impact on their future. That is our goal, and the subject of this article.

Concept of Sustainable Development

Sustainable development is all about ensuring that the costs of one generation's activities do not compromise the opportunity of future generations. When we use up our capital through acts of war, excessive spending, or pollution of the environment, we create an added burden for our children's generation who then needs to make up for our actions.

Similarly, when we take away resources in our lifetime that our children's generation could use for hospitals, schools, roads, or infrastructure, we deprive them of assets that are essential for their future. In doing so we contribute to a pattern of unsustainable development.

Often the elite in these developing countries take advantage of power or connections, their opportunity to negotiate with multinationals on terms favorable to themselves, and seek to receive the proceeds for themselves in tax havens abroad. A number of multinationals welcome such a scenario as it reduces their global costs of operations and their global tax costs. And there is no international system today which can effectively stop them or hold them accountable. In fairness, not all multinationals act in such a manner. Many act responsibly and are accountable to the markets in which they do business. But there are others that do not.

Photo: Matias Echanove

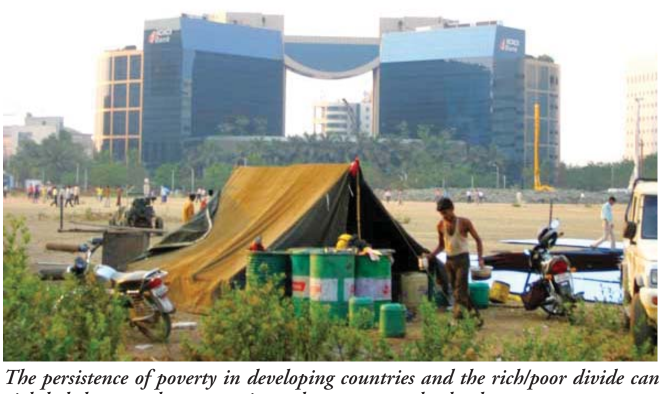
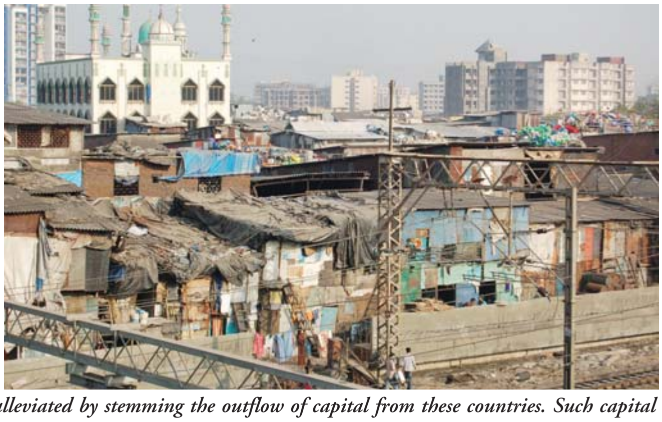


Photo: Sytse de Maat



The persistence of poverty in developing countries and the rich/poor divide can be alleviated by stemming the outflow of capital from these countries. Such capital rightly belongs to these countries and can support the development process.

CHART 1

Trade mispricing estimates

Latin America	Africa	Middle East Asia
40%-50% of all transactions	60% in extraction industries	50% of all transactions

Source: "Capitalism's Achilles Heel" by Raymond Baker, 2005

How Can Capital Outflows Be Stemmed or Reduced?

There are six main areas to help stem capital outflows, and Western institutions can play an important role in doing so. These are:

– Reducing opportunities for corruption and receipt of illicit money in Western banks;
– Understanding the role of trade mispricing by multinationals and encouraging more compliance;
– Seeking more transparency in the banking system globally;
– Legal requirements for better exchange of tax information among countries;
– Stemming the use of tax havens by individuals and companies; and
– Encouraging greater responsibility by accountants and lawyers who advise on these matters.

Reducing Opportunities for Corruption/Receipt of Illicit Money

From 1958 to 1968, 48 countries gained independence from colonial powers. It was not long before the economic and political elites in these countries began to find ways to take money or resources out by any means possible, and the European and American banking systems welcomed it.

The 1960s was also a time when multinationals began to expand aggressively overseas. There was rapid growth globally, and minerals and other natural resources were needed to fuel growth. This period also saw corrupt dictators in countries that had such resources in abundance. And we had evidence of corruption from leaders such as Abacha in Nigeria, Moi in Kenya, Marcos in the Philippines, Suharto in Indonesia, Pinochet in Chile, Mobuto in Zaire, and so on.

To help compensate for this, the World Bank and the UN Office on Drugs and Crime launched the Stolen Asset Recovery (StAR) Initiative in September 2007. This focuses on returning ill-gotten gains deposited abroad to their countries of origin. The initiative requires cooperation from Western governments, and often an articulated defense by the countries themselves to establish their rightful ownership of such assets. This is not an easy process.

For every country receiving development assistance, a list of politically exposed persons (PEPs) is maintained by government agencies, the World Bank, and others. Since these data are also known to financial institutions, they should be required to validate major deposits coming from overseas, and to confirm that they are not coming from individuals that are on these PEP lists.

A strict enforcement of the StAR Initiative and tracking of all deposits by PEPs would help at least in part to reduce the opportunities for funds to be stolen from developing countries by corrupt civil servants, political leaders or businessmen and then deposited overseas. Some will still get through, but at least it will be tracked and monitored, thereby becoming a disincentive.

Trade Mispricing by Multinationals & Encouraging More Compliance

Trade mispricing and tax evasion are made possible through falsified pricing, use of fictitious companies, fake documentation, and so on. Some 60% of global trade takes place through intra-group companies, and almost half of that is routed through subsidiaries located in tax haven countries. This makes it easier for the arms-length principle in such trade to often be violated in principle or practice.

Some companies are very forthright in ensuring that there is no trade mispricing, and that a fair share of taxes in the developing country and the home country is duly paid. But the temptation to maximize profits, increase share value, and reduce global tax costs is significant. It is also not uncommon to find many boutique lawyers, bankers, and accountants who can support those efforts.

Some countries have implemented systems to eliminate trade mispricing. Mexico, Argentina and Canada require the auditor of publicly listed companies to sign an affidavit confirming there is no such abuse. While this is sometimes a matter of judgment, the fact is that the very act of a signed declaration can have a dampening effect on engaging in such activity. Stronger tax and audit oversight in developing countries, and enhanced training of revenue officers who understand the nuances behind these planning techniques, can help reduce such practices.

More Transparency in Global Banking System

Financial institutions around the world should be required to know the beneficial ownership of entities with which they do business. The fact is that there are too many disguised entities in the shadow financial system for whom the beneficial ownership is either unregistered or inaccessible.

The US Patriot Act, enacted after the tragedy of 9/11, made it illegal for American banks to receive money from shell foreign banks. This was intended to stop illicit money coming in from activities relating to terrorism and drug trafficking. However, it remains legal in the United States to bring into the country proceeds generated abroad from handling stolen property, counterfeiting, smuggling, trafficking in women, environmental crimes, tax evasion and so on.

The United States could play an important role in setting an example to bring about more transparency. It could expand the requirements of the Patriot Act for the above-mentioned provisions. GFI leader Baker gave testimony in May 2009 before the House Committee on Financial Services chaired by Barney Frank to seek more transparency in this regard.

Transparency can be also improved if banks were to follow diligently the "know your customer" (KYC) requirement. Regulations to enforce this, and not just implementing it voluntarily, need to be in place. Otherwise, there is no way to hold to account disguised corporations for whom the beneficial ownership is a well-kept secret. Banks also should be required to file a suspicious activity report (SAR) in instances where they suspect corruption by either individuals or by companies. And they should be penalized if they don't. Also, if they agreed to deny deposits from people on the PEP lists, as mentioned above, it would help alleviate this problem.

Better Exchange of Tax Information

At present, it is only in the European Union (EU) that there is an automatic exchange of tax information on earnings of non-citizens on bank accounts held in each country. It is called the EUSTD, or the

EU Savings Tax Directive.

The EU is considering extending this to other forms of income (consulting, dividends, real estate, rental income, sale of property), and to entities such as corporations, trust funds and foundations. Such a law would go a long way in ensuring that each jurisdiction is able to collect its fair share of taxes, and there is lesser incentive to use a secrecy jurisdiction to hold assets or to evade taxes. This could then become a model for other countries to consider.

More transparency is at the heart of this requirement. If countries can cooperate with each other in providing information, the use of secrecy jurisdictions and tax havens will decline. This exchange of tax information is being studied by the International Accounting Standards Board and the British Treasury. It has already been recommended by the European Parliament for the extractive industry. If it could be expanded to other sectors, it could make a major difference.

Stemming Use of Tax Havens by Individuals & Companies

Compared to most developing and developed countries, tax havens have either very low or zero tax rates. It is natural therefore for companies and individuals to favor them. And for each market, there seems to be a haven that will accommodate them. It is Jersey for the London market, Panama for the United States, Mauritius for India, Cyprus for Russia, and so on. Then there are Singapore, Lichtenstein, Dubai, Bermuda, and the Cayman Islands catering to others. All tax havens welcome cash (legal or illicit) and offer secrecy in return.

The Cayman Islands alone are reputed to have about $ 1.6 trillion worth of assets held in part by about 10,000 hedge funds. According to the Tax Justice Network, using data from consulting firms Boston Consulting and McKinsey, it is estimated that around the world individuals with high net worth have about $ 11.5 trillion in offshore tax havens. The potential loss to developing countries in tax revenue from this is about $240 billion a year.

If we consider the fact that the amount of money all the developing countries need to come out of poverty, and to make investments for their future, is about $50 billion a year, imagine where they would be if they could get the above share of revenue that is their rightful due. *(Chart 2)*

In March 2008, US Senators Barack Obama, Norm Coleman and Carl Levin introduced a bill in Congress to stop tax haven abuse. The proposal went nowhere in the then political environment. In March 2009, this was reintroduced by Senator Levin. Treasury Secretary Timothy Geithner sent a signal of support, indicating the administration's willingness to go forward with legislation if approved by the Senate. The bill is still making its way through the various committees in Congress.

CHART 2

Some facts to consider

60	Over a million	$11 trillion
Number of tax havens & secrecy jurisdictions around the world	Dummy corporations shielding their owners' identities	Amount parked offshore Over $1 trillion in Cayman Islands alone

Source: "Capitalism's Achilles Heel" by Raymond Baker, 2005

Encouraging Greater Responsibility by Accountants & Lawyers

Major accounting and law firms have an important role to play in advising multinationals and individuals with respect to their global activities. Fortunately many of them perform that role in a judicious manner. This is generally true of the larger accounting firms and law firms that have their client's risk and their own reputations to protect.

However, there are also a number of boutique law firms and accountants who specialize in exploiting the existence of tax havens to minimize the tax liability of their clients and are impervious to the social consequences that result. And there is little opportunity to curtail their actions.

Clearly, a progressive tax philosophy is in our common interests and in the public interest. Public accounting firms and major law firms have a responsibility to society in contributing to a better tax system across national boundaries. They need to act in instances where a client's practice in transfer pricing could put them at risk. They need to encourage more transparency in transfer pricing advice so that not only are their clients protected but there can also be a contribution to trade and development at the same time.

There are opportunities for accounting firms to set an example, collaborate, share best practices, and ensure consistency and quality in the advice rendered to multinationals. The Aspen Institute's Business and Society Program in New York is taking a leadership role in this regard, bringing together accounting firms and lawyers advising multinational companies to work together to enable such change.

Conclusion

We seek a world in which developing countries can replace foreign aid dependency with tax self-reliance. In the long run it is taxes, not aid allowances, that are the most sustainable sources of finance for developing countries. This is because foreign aid makes governments accountable to donors, while taxes make governments accountable to their citizens.

Japan is already playing an important role in stemming the outflow of capital, but can do more. On Sept. 5, 2009, Japan agreed with other G-20 finance ministers at its meeting in London to set a deadline of March 2010 for measures against tax havens that do not meet international regulatory standards. However, Japan can also do more in encouraging better exchange of tax information with other countries, and discouraging any trade mispricing by its companies operating globally.

Nobel prize-winning economist Amartya Sen stated quite eloquently that "what is needed is a fairer distribution of the fruits of globalization." Capital flows, whether leaving a country or retained within, are an important fruit of globalization. If we can keep them where they belong, in developing countries where they are needed most, we reduce economic deprivation in those countries. And in the long run, that can do more for human rights than anything else. JS

Krishen Mehta has been with PricewaterhouseCoopers for 30 years, and worked in their NY, London and Tokyo offices. While in Tokyo he was partner in charge of international assignment services in Japan, South Korea, Singapore, China and India. He is now director of Asia Initiatives, an NGO devoted to microfinance and education in developing countries. He is also advisor to Global Financial Integrity and to Aspen Institute's Business and Society Program.