

Executive Summary

The economic history of India since independence on August 15, 1947, can be characterized as a transition from a controlled economy to one embracing progressive liberalization. A foreign exchange crisis amidst political instability in 1991 provided the impetus for policymakers to reform the socialist economy under the leadership of P.V. Narasimha Rao, the twelfth Prime Minister of India. He has since been seen as the father of Indian economic reforms. The then Finance Minister Dr. Manmohan Singh, the present Prime Minister of India, launched India's free market reforms that saved the country from financial ruin and placed it on a path to sustained economic growth.

This report presents an in-depth study of the issue of illicit financial flows (or illegal capital flight) from India using the World Bank Residual model adjusted for gross trade misinvoicing which excludes illicit inflows through export over-invoicing and import under-invoicing. For reasons enumerated (Section III, paragraphs 36-41), the method used in this study estimates gross illicit outflows without netting out illicit inflows as in the Traditional method used by economists. As discussed in greater detail in this report, netting out illicit inflows seriously understates the problem of illegal capital flight which worsens income distribution, reduces the effectiveness of external aid, and hampers economic development.

According to the estimates provided in this study, India lost a total of US\$213 billion dollars due to illicit flows, the present value of which is at least US\$462 billion based on the short-term U.S. Treasury bill rate as a proxy for the rate of return on those assets (Section III A (i), and Appendix Table 11). In all likelihood, this estimate is significantly understated because economic models can neither capture all the channels through which illicit capital can be generated nor the myriad ways in which the capital can be transferred. While this estimated stockpile of illicit assets held abroad by resident Indian nationals falls far short of the US\$1.4 trillion reported by the Indian news media in the run-up to the General Elections in April-May 2009, the figure still represents a staggering loss of capital. If India would have avoided the flight of capital over such a long period, it would have enabled the country to either contract less debt or pay off the existing debt at the time. A country that is still struggling to eradicate poverty with a shortage of capital relative to its development needs can ill-afford to lose funds of such magnitude.

The total value of illicit assets held abroad represents about 72 percent of the size of India's underground economy which has been estimated at 50 percent of India's GDP (or about US\$640 billion at end 2008) by several researchers (see Chart 2). This implies that only about 28 percent of illicit assets of India's underground economy are held domestically, buttressing arguments that the desire to amass wealth without attracting government attention is one of the primary motivations behind the cross-border transfer of illicit capital. While the relative proportion of foreign to domestic illicit assets that make up the underground economy can be expected to vary across countries depending upon a number of economic, legal, and political factors, efforts to hide illicit wealth leads to what we call the "iceberg effect," wherein the visible domestic portion of illicit assets represents only a sliver of the vast portion, mostly foreign, that is hidden from view.

In an effort to identify the root cause of illicit flows from India, we formulate a block-recursive dynamic simulation model that incorporates three sets of complex drivers—macroeconomic factors like government deficits, inflation and inflationary expectations, structural factors such as increasing trade openness and faster rates of economic growth and their impact on income distribution, and overall governance as captured by a measure of the underground economy. As complex as these factors are, illicit flows are also driven by the desire to hide ill-gotten wealth, a motivation that is extremely difficult to model and test. Keeping these caveats in mind, model simulations provide some interesting insights into the drivers and dynamics of illicit flows from India.

We find scant evidence that imprudent macroeconomic policies drove illicit flows from the country. After all, the central government budget deficits have been rather limited as has been the impact of deficit financing on inflation (Table 1). This finding is subject to two caveats. First, lack of comprehensive data on consolidated government revenue and expenditure (i.e., including state and local governments and not merely the central government) did not allow an assessment of larger deficit financing on inflation and the impact of larger deficits themselves on driving illicit flows. Second, the shifting list of items subject to price controls and the varying intensity of implementation detracts from the quality of the wholesale price index as a measure of inflation. On balance, the report supports the IMF, Panagariya (2008), and others who observe that macroeconomic policies in India have been prudently managed and played a stabilizing role. The reason that changes in the deficit and inflation do not adequately explain illicit flows is probably because macroeconomic drivers have a far stronger influence on *licit* capital movements (involving private portfolios) than on flows that are illicit.

Model simulations strongly indicate that the cause of illicit outflows from India lie in a complex web of structural and governance issues. The results show that reform itself had a negative impact on illicit flows in that liberalization of trade and general deregulation led to an increase in illicit flows rather than their curtailment (Section IV, paragraph 72). The result is counterintuitive in that one would typically expect economic reform to dampen illicit transfers as economic agents gain more confidence in the domestic economy. In order to explain this result, it is necessary to analyze how the “by-products” of reform, namely economic growth and income distribution, and increasing trade openness relate to illicit flows. Because these structural by-products of reform behaved quite differently during the pre- (1948-1990) and post-reform (1991-2008) periods, the report examines their relationship to illicit flows by splitting the sample period into those two phases. Collapsing the two periods and simulating the model over the entire period 1948-2008 obscured the effects of the variables so that they no longer seem significant in explaining capital flight. At the same time, the longer sample period was imperative for testing the robustness of the model.

There was no statistically significant link between trade openness and misinvoicing (captured in the GER estimates of trade misinvoicing) in the years prior to reform. However, in the years since 1991, when economic reform led to increasing trade openness (as the size of external trade to GDP more than doubled from 10.8 percent in the pre-reform period to 21.7 percent after reform), results

show openness to be statistically significant and positively related to trade misinvoicing (Section IV, paragraph 73-74).

It seems that trade liberalization merely provided more opportunities to related and unrelated companies to misinvoice trade, lending support to the contention that economic reform and liberalization need to be dovetailed with strengthened institutions and governance if governments are to curtail capital flight. Otherwise, deregulation will merely provide an added incentive for those seeking to transfer illicit capital abroad. That deregulation needs to be accompanied by stricter oversight is nothing new—we now know that deregulation without adequate oversight of financial institutions on Wall Street has helped, not hindered, their abuse.

Data also confirm that economic reform since 1991 has fostered a faster pace of economic growth. However, analysis shows that more rapid economic growth in the post-reform period has actually led to deterioration in income distribution (Section IV, paragraphs 75-80 and Charts 6 and 7). The rising trend towards greater income inequality during a period of rapid economic growth is corroborated by Sarkar and Mehta (2010), Sengupta et. al. (2008) and others.

A more skewed distribution of income implies that there are many more high net-worth individuals (HNWIs) in India now than ever before. Based on the capacity to transfer substantial capital, it is the HNWIs and private companies that are the primary drivers of illicit flows from the private sector in India (rather than the common man). This is a possible explanation behind our findings that the faster rates of growth in the post-reform period have not been inclusive in that the income distribution is more skewed today, which in turn has driven illicit flows from the country. This result does not hold in the pre-reform period when growth rates were low and income distribution was more equitable.

While a great deal of information is available with respect to structural factors, governance indicators for the period 1948-2008 are scarce. For example, traditional governance indicators compiled by the World Bank or Transparency International (Corruption Perceptions Index) only cover a fraction of this period. A review of the literature suggests that the underground economy not only acts as a proxy for governance, it grows by absorbing illicit inflows and provides the funds for cross-border transfers of illicit capital. While the underground economy the world over often involves illegal activities, in India even legal businesses and the government contribute to it. According to the Indian Council for Research on International Economic Relations, legal businesses controlled by the government, government expenditures and taxes have also contributed to the creation of illicit funds.

A time series on the size of the underground economy was developed assuming that it was zero percent at independence and grew to 50 percent of GDP by the end of 2008, as found by a number of researchers. The series was subject to spline interpolation using these boundary conditions and ensuring that estimates for intervening years, 1967/68-1978/79, correspond to those found by Gupta and Gupta (1982) using the monetary approach. According to this measure, the post-reform period

is characterized by a much larger underground economy (averaging 42.8 percent of official GDP compared to just 27.4 percent in the pre-reform period). The one period lag, rather than the current size of the underground economy, was found to be more statistically significant in explaining larger illicit flows from the country since reform (Section IV, paragraphs 70-71).

We also analyzed the absorption of illicit financial flows from the Indian non-bank private sector into developed country banks (henceforth 'banks') and offshore financial centers (OFCs) for the period 1995-2009 (Section V). This is the longest period for which cross-border deposit data are available from the Bank for International Settlements (BIS) which offer some useful insights into investor behavior regarding illicit flows.

For the period as a whole, there is an unmistakable trend showing that the Indian private sector shifted away from bank deposits to deposits in OFCs. As the share of OFC deposits increased from 36.4 percent of total deposits in 1995 to 54.2 percent in 2009, deposits in banks fell commensurately to 45.8 percent in the last year (Appendix Table 14). As OFCs are subject to even less oversight than banks and typically hold a larger share of illicit funds, the increasing recourse to OFC deposits relative to banks could be symptomatic of the burgeoning underground economy in India from which such funds emanate.

Following the terrorist attacks on the United States in September 2001, private sector deposits from India into banks in the United States, United Kingdom, and other developed countries fell in 2001 and further in 2002. In the next year, there was a modest increase which was followed by steady increases in 2004-05 and a jump in 2006. But the growth in external bank deposits was short-lived. After the collapse of Lehman Brothers and other Wall Street investment banks in 2007 and the beginning of the global financial crisis later that year, private sector deposits from India into banks in developed countries declined, followed by a modest rise in 2008-2009 when there was a large increase in illicit flows.

A number of policy implications arise out of this study (Section VI). For instance, given that growth of the underground economy is a major driver of illegal capital flight, it follows naturally that policy measures that shrink the underground economy can be expected to curtail illicit flows. Since tax evasion is a major driver of the underground economy, efforts to expand the tax base and improve tax collection can be expected to curtail illicit flows. Moreover, the finding that faster growth by itself is not sufficient in curbing illicit flows implies that redistributive policy measures are needed to ensure that growth remains inclusive so as not to leave the poor behind or, worse still, generate many HNWIs who drive illicit flows. In order to curtail illicit flows, the government would need to (i) ensure that the rule of law is applied fairly and swiftly, (ii) strengthen regulatory and legal institutions, and (iii) adopt a host of policy measures to improve both public and corporate governance such as improving tax compliance and collection. These domestic measures need to be complemented by tighter regulatory oversight of banks and OFCs by developed countries in order to ensure that financial institutions do not facilitate the absorption of illicit capital.