Exposing the myth and plugging the leaks

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It is widely believed that rich countries are transferring substantial amounts of resources to poor ones. While many people, including the millions of people who were part of the Global Call for Action against Poverty (GCAP or White Band) mobilization last year, believe that rich countries are not doing enough, few ever question the truth of the assertion that rich countries are indeed helping poor ones. They should!

Every year, hundreds of billions of dollars, far in excess of aid inflows, flow out of poor countries to the rich. This money flows out in the form of debt repayments, private sector transfers and most significantly through the channels of trade and capital flight. These outflows undermine the mobilization of domestic resources, undercut local investment, weaken growth and destabilize countries by making them more dependent on inflows of unpredictable external resources.

Moreover, the inflows, in the form of aid, new borrowing and flows of private capital come with strings attached in the form of prescriptions and restrictions on the kinds of policies that developing countries can pursue. These limits on policy space undermine the exercise of democracy, challenge the implementation of domestically owned policies and emasculate efforts to reduce poverty and achieve sustainable development.

There is an urgent need to revaluate all the channels of the resource transfers between the rich and poor countries and take immediate steps to ensure an increase in inflows to the poor countries and a reduction of outflows from them.

This will significantly increase the availability of (especially domestic) resources and free up domestic policy space to implement policies targeted at eliminating poverty and achieving sustainable development.

Aid flows are insufficient and of poor quality. This can be addressed by making aid more predictable, untying it from policy restrictions and contracts with donor country companies and leveraging the proceeds of international taxes such as the airline ticket tax and currency transaction taxes to deliver the amounts needed.

As much as a quarter of the debt owed by poor countries is odious or illegitimate in origin having knowingly been lent to dictators or other illegitimate regimes such as the apartheid regime in South Africa. Much of this money was diverted and never made it to the country in whose name it was borrowed.

For all but three of the past twenty-three years, developing countries have paid out more money in the form of interest, repayments, penalties and fines on old debt than they have received in the form of new loans. Despite the fact that almost all poor countries have repaid more than they borrowed, their debts continue to mount and divert resources away from critical health and education spending.

An immediate cancellation of all odious, illegitimate and un-payable debts accompanied by a moratorium and the establishment of a fair and transparent arbitration process for the balance of debts outstanding and the adoption of clear transparent guidelines for new borrowing would help reverse this leakage of resources through the channel of debt.

Private flows in the form of foreign direct and portfolio investments that are supposed to contribute to the transfer of technology, create jobs, stimulate the local economy and increase tax intake have mostly failed to do so. Until as recently as 13 years ago, outflows in the form of profits and unwinding of old investments exceeded the inflows in the form of new investments. This is likely to be the case again in the near future.

Investments, especially in sub-Saharan Africa, earn returns as high as 30% per annum so countries are forced to try and attract ever-higher investments in order to keep resource inflows positive. This severely restricts policy space as countries reduce tax rates, grant tax holidays and introduce policies such as financial liberalization that put the interest of foreign investors over domestic development goals, and encourage the flight of capital through both legal and illegal channels in the banking system.

The increased threat of financial instability that comes about as a result of such policies has meant that developing countries have had to accumulate as much as USD 2 trillion in foreign exchange reserves to guard against financial crisis. The accumulation of this, most of which is invested in rich country bonds at very low interest rates, comes at the cost of development related investment that has much higher social returns.

More than half of developing country trade is controlled by multinational firms who are able to manipulate the prices on trade and financial transactions with related subsidiaries in tax havens and other countries to shift hundreds of billions of dollars out of poor countries.

Taken together, these leakages cost developing countries more than USD 500 billion in untaxed outflows which completely undermine the impact of aid and other resource inflows and hold these countries back from embarking on a path of sustainable development.

In order to plug these leaks, there is an urgent need to control and reverse the liberalization of the capital account and re-impose domestic performance requirements and profit repatriation restrictions on foreign investment. Other steps such as the elimination of bank secrecy, closing down tax havens, and firm action against financial institutions, accountancy and law firms, and multinational businesses that facilitate the leakage of these resources, would also help plug the leaks.

More than half of African and Latin American wealth now resides overseas, much of it in tax havens and financial centres such as London and New York – identifying and repatriating these assets, much of which were illegally acquired or transferred, and reversing the flight of capital, will mobilize domestic resources, free up policy space and allow developing countries to develop in a sustainable way.

The backdrop

> …defying all economic logic and need, for many years now the net transfer of resources and capital has been from the poor capital-scarce developing world to the rich capital-surplus developed world. Money, instead of flowing into productive investments in developing countries with high potential returns has gone into fuelling real estate and asset prices booms in rich countries such as the United Kingdom and the United States…

Despite the unprecedented media attention, the grassroots mobilization and political profile that development issues had in 2005, little was achieved in the way of provision of the scale of resources that are needed to achieve even the modest Millennium Development Goals (MDGs) leave alone fund sustainable development. The deal on debt cancellation and promises of aid increases provide only a fraction of resources that are needed with the funding gap growing each day.

The focus on the triad of debt, aid and trade was too narrow – the development debate has

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focused only on trying to increase inflows into developing countries with little if any attention to the significantly larger and increasing outflows of money and resources *from* developing countries. Despite unprecedented mobilization by civil society groups and widespread discussion of debt, aid and trade at the highest political levels, little tangible progress was achieved in terms of net resource flows.

One of the most disturbing phenomenons of recent decades has been the persistent and increasing outward transfer of resources from poor developing countries.[2] This has taken many forms both legal and illegal, some of which are discussed below.

This has serious negative consequences for both the development and humanitarian needs of these countries where because of a net outflow of already scarce domestic resources, these countries are left with fewer resources to target towards domestic development needs and towards life saving humanitarian interventions such as the provision of basic health services.

While occasional lip service has been paid to the importance of Domestic Resource Mobilization, this has been limited to increasing the level of domestic resources through new tools but has excluded a more fundamental consideration of 'retention' of resources mobilized domestically. This means that domestic resources continue to be susceptible to "leaking out".

Inflows have stalled – outflows are increasing

At the same time as the increase of inflows has stalled, outflows from the poorest developing countries, in the form of debt servicing, the build-up of foreign exchange reserve, trade deficits, profit remittances and – most important – capital flight have been on the rise.

This has severely restricted the room for manoeuvre within several countries. The "bleeding" of government revenues because of the rise of tax competition, tax avoidance and the fall of import tariffs, has further exacerbated the situation restricting the availability of resources to invest in basic health, education and infrastructure. It has also led to an increase in aid dependence.

Focus on inflows not outflows

However, the focus of development policy thus far has been limited to increasing aid, increasing foreign direct investment, channelling remittances and so on. Discussion on trade, which is also seen as a mechanism for resource delivery focuses almost exclusively on increasing exports from developing countries. Debt cancellation, which begins to address the question of reducing resource outflows, is discussed within very limited parameters which even under the most optimistic scenarios would have little impact on the direction of net resource flows.

2 Cf. Pietrikovsky, I. "Latin America: debt, investment, capital flight" in this Report.

Overseas Development Aid

Real aid, the aid money that is actually made available for funding development in the poorest countries, is running only at about USD 30 billion a year or only about 40% of the total aid volume. Administrative costs, technical assistance, accounting for debt relief, tying aid to purchases from the donor country, and aid to geo-strategically important but less needy countries are some of the reasons that more than 60% of the current aid volume is not available as money that can be spent on real and urgent development needs such as meeting the MDGs. This exists within a broader context of insufficient aid volumes which despite promises are currently running only at about 0.3% of the Gross National Income (GNI) of donor countries.

However, the new discussion on "innovative sources of financing" such as an airline ticket levy and currency and other financial transaction taxes among others, provide a promising avenue to improve aid quality and quantity.[3]

Debt

Debt, which has great potential as a source of funds for financing development has ended up being a channel for significant amounts of resource outflows from the poorest countries. For example, low-income countries, which received grants of about USD 27 billion in 2003, paid almost USD 35 billion as debt service. Sub-Saharan Africa has seen its debt stock rise by USD 220 billion despite having paid off USD 296 billion of the USD 320 billion it borrowed since 1970.

In fact, since 1984, net transfers to developing countries through the debt channel (net of inflows as new borrowing and outflows in the form of debt service) have been negative in all but three years. So debt, instead of providing a source of funding for development, has become a major source of leakage of scarce resources from developing countries.

What makes the situation worse is that a significant proportion of the debt owed never made it into the debtor country in the first place. Money lent to dictators and corrupt regimes such as Mobutu of Congo, Abacha of Nigeria and Suharto of Indonesia was stashed away offshore to personally enrich the dictators. Another significant chunk of the debt was used to fund projects where there was a suspicion of corruption and proper due diligence was not performed.

The Bataan nuclear plant in the Philippines, which has never generated any electricity because it was constructed on an earthquake fault, is one such example. Yet the government of the Philippines is still repaying the debt contracted to construct this plant. Even poor countries such as Zambia and Niger continue to pay a quarter of their budget towards debt servicing, much more than they spend on health and education combined.

3 Cf. Foster, J. "Beyond consultation: innovative sources" and Wahl, P. "International taxation: the time is ripe" in this Report.

While debt cancellation has been on the agenda for a while, the amounts under consideration are tiny in comparison to the scale of the problem and are funded out of already scarce aid budgets.

However, the Norwegian government's recent lead on the issue of odious and illegitimate debt offers a promising opening to finally tackle the real issues behind the debt crisis in an open, honest and effective way. It has the potential to finally 'wipe the slate clean' for countries that have been suffering under the burden of unjust and unpayable debt and allow them to make a fresh start. For creditor countries and institutions, it offers a chance of learning lessons from the mistakes of the past.

There is also hope that the recent debt deals struck by Argentina with private creditors, Nigeria with bilateral creditors and Heavily Indebted Poor Countries (HIPC) with multilateral creditors have finally opened the path for a serious discussion on a systemic treatment of debt problems with the establishment of a Fair and Transparent Arbitration Process (FTAP) preferably under the aegis of the United Nations.

Foreign Direct Investment

The reality of Foreign Direct Investment (FDI), which has grown to become the largest source of funds flowing into developing countries in recent years, is also disturbing. Despite the fact that on paper FDI can contribute significantly to development, in reality it has done little to deserve the focus and attention it has got in recent times where it is increasingly seen as the most important link in the development process by many policy makers.

Though since 1992 FDI has been the largest source of inflows into developing countries, it has been highly concentrated with a small group of countries such as China, India, Brazil and Mexico accounting for the bulk of recent increases in FDI. Countries in sub-Saharan Africa, most in need of capital, get very little FDI. Moreover, increasing amounts of FDI are used for mergers and acquisitions (they do not directly add to productive capacity or bring about technology transfer) where a foreign firm acquires an ongoing domestic operation.

FDI inflows are accompanied by large outflows in the form of profit repatriation. For sub-Saharan Africa, for example, apart from a period of ten years from 1994 to 2003, the inflow of funds through new FDI was exceeded or matched by an outflow of funds as profit remittances on existing FDI. As the stock of FDI in a country grows, the potential for future profit repatriation will also grow. In sub-Saharan Africa, the average rate of return on FDI is between 24% and 30%, which shows that the scope for an increase in future outflows is very large. For a number of poor countries, FDI continues to be a channel for net resource outflows.

The concerns highlighted above are exacerbated because there is strong evidence to believe that both FDI stocks and profit remittances are under-reported and may be as much as two to three times the reported figures.

One of the key benefits of FDI that is often touted is that the profits generated will increase government tax revenues. However, with the massive growth in tax competition and an exponential growth in enclave investment (export promotion zones among others) this benefit has all but disappeared. Honduras, for instance, offers permanent tax exemptions and tax holidays of up to 20 years are becoming increasingly common. This has been accompanied by a general and accelerating downward drift in corporate tax rates and in some export promotion schemes effective tax rates have fallen below zero!

The already grave situation has been compounded by the increasing trend of tax avoidance by multinational corporations (MNCs) operating in developing countries with the extractive sector being by far the worst culprit. Some of the tools used for this are:

- using inaccurate prices to value inter-subsidiary trade transactions in such a way so as to maximize profits in a low tax jurisdiction (transfer mis-pricing),
- using intra-corporate or parent subsidiary financial transactions such as loans from parent to subsidiary at exaggerated interest rates to shift profit out of the host country,
- using exaggerated values for intangibles such as goodwill or patents and royalties to underreport profit, and
- a whole host of other such practices such as mis-invoicing the quality and or quantity of imports and exports.

The overall focus on FDI, the generous incentives offered and the profits laundering/tax avoidance strategies of MNCs undermine the domestic private sector by putting it at a competitive disadvantage to already stronger MNCs with deeper pockets. This unfair competition is detrimental for the long-term development of poor countries.

Most of all, FDI has not fulfilled the promise of significant employment generation, integration with the local economy and technology transfer. While the costs of FDI have been very real, the benefits have been elusive. There is hence a need to rethink the current focus on FDI as a central tool in development, and for both developing and developed countries to take damage control measures to minimize the harmful effects and have a more critical cost-benefit analysis for future investments in developing countries.

Trade

The linkages between trade and resource mobilization are complex. There is no doubt that trade has the capacity to have a significant positive impact on development. However, at the same time the potential of the current trade regime to generate resources for investment in development is probably exaggerated. What is relevant from the perspective of external resource generation is the excess of exports over imports for a country or the trade surplus. The larger the trade surplus, the larger the resources the trade channel generates for development.

Under pressure from the World Trade Organization (WTO), the International Financial Institutions (IFIs) and rich countries, developing countries have been forced to lower their import tariffs and liberalize trade. While this has increased imports (including those of non-essential and luxury goods), exports have not kept pace. Continued rich country subsidies and protectionism especially in the farming (and textile) sector (where developing countries have a competitive edge) have also played a significant role in depressing exports from developing countries.

Many developing countries especially in the sub-Saharan African region and in Latin America run persistent trade deficits where they are forced to borrow (or use aid money or try attract FDI to generate scarce foreign exchange) to pay for the excess of imports over exports. This means that the trade channel, rather than boosting resources available for domestic investment, has also acted as a source for leakage of scarce domestic resources. Even in developing countries running trade surpluses (except for the major oil exporters) the trade surplus has seldom amounted to more than 1-2 percentage points of GNI which while significant is not enormous and can only contribute to development in conjunction with other sources of funds.

More than 60% of international trade is now intra-firm trade between various subsidiaries of multinational enterprises. A large faction of this passes through tax havens, which are characterized by secrecy and low or zero rates of taxation for non-domestic enterprises. This means that firms have massive opportunities to transfer profits out of developing countries into these low tax jurisdictions. The easiest and most exploited way of doing this is through the practice of mis-invoicing and of transfer mis-pricing when exports are under-priced and imports over-priced by firms so that higher profits are declared in tax havens and other non-developing country jurisdictions at the cost of a serious under-reporting of earnings in developing countries. Both domestic and international firms shift between USD 200 billion to USD 350 billion out of developing countries every year through this and related mechanisms.

The discussions on GATS, for liberalizing the trade in services, have the potential to exacerbate this problem of capital flight. Services are intangible in contrast to goods, more customized as compared to goods, which are more generic, and potential misreporting in services is much harder to detect because of their transient nature. All of this makes capital flight through the mis-invoicing of services easier and hence a much bigger potential problem than the capital flight through the mis-invoicing of goods. This means that there is a need to step back from the current trend towards a liberalization of services to redo the cost-benefit analysis for developing countries including capital flight in the analyses.

Hence, while trade can significantly enhance the efficiency of an economy and bring about many advantages, its potential as a source of development finance is perhaps exaggerated and the potential costs through resource flight because of mispricing are underreported. There is an urgent need to have a balanced discussion on trade issues that accurately reflects all the benefits as well as the costs – especially for developing countries.

Capital flight

For every dollar of aid that goes into developing countries, 10 dollars comes out as capital flight. Yet this is an issue which regularly gets sidelined in discussions on development. It has been estimated that developing countries lose more than USD 500 billion every year in illegal outflows which are not reported to the authorities and on which no tax gets paid.

The largest channel for capital flight is trade, where mis-pricing of transactions, the use of fake transactions and transfer mis-pricing between related affiliates of the same company with the help of tax havens and banking secrecy means that the tax and domestic resource mobilization ability of developing country governments is completely undermined.

Wealthy individuals and other domestic elite piggyback on the institutional apparatus of secrecy, private banking and tax havens to transfer billions of dollars out of poor developing countries depriving their fellow citizens of even the most basic needs such as health care.

Western MNCs, financial institutions, accounting firms, lawyers and financial centres have all been complicit in perpetrating, facilitating and actively soliciting this flight capital. No real progress on sustainable development can be achieved unless this stops.

If we are to move forward on the path of development, it is essential to first get our facts right and start an honest debate about development finance. No such fair debate can be had, leave alone corrective policies implemented until we expose the myth of current development flows and join hands to plug the leaks in the system. ■