

Haemorrhaging Money

**A Christian Aid briefing
on the problem of illicit capital flight**

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2007



We believe in life before death

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Acronyms and abbreviations

BoP	balance of payments
FDI	foreign direct investment
GAO	General Accounting Office (US)
GDP	gross domestic product
GNI	gross national income
IPB	International Private Bank
IRS	Inland Revenue Service (US)
MDG	millennium development goals
MNC	multinational corporation
NGO	non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
UN	United Nations
UNCAC	UN Convention on Corruption
UNCTAD	UN Conference on Trade and Development
UNECA	UN Economic Commission for Africa
UNIDO	UN Industrial Development Organization

1. Introduction

Poor countries face huge challenges in mobilising the necessary resources to develop and meet even the very basic needs of their citizens. In large parts of the world – especially sub-Saharan Africa, south Asia and Latin America – hundreds of millions of people continue to live in utter destitution, deprived of the most rudimentary healthcare, education and other essential services such as clean drinking water or proper sanitation.

It was partly to address these challenges that, at the turn of the millennium, world leaders adopted the millennium development goals (MDGs) which sought to halve poverty and visibly improve other social and economic indicators in developing countries by 2015. The UN has estimated that meeting the MDGs would cost US\$150-200 billion a year.² So far, less than half of these resources have been found and it is clear that these and other development goals cannot be met by inflows alone.

It is widely recognised that the MDGs are not an end goal in themselves but merely a small step towards the development of poor countries. Even when the MDG targets are met, more than 658 million people will still be living in abject poverty, 520 million will be severely undernourished and 1.8 billion will have to make do without access to proper sanitation facilities.³

Clearly much more needs to be done beyond reaching these goals to set countries on a sustainable path to development, and this will require much more than the hundreds of billions of dollars needed just to meet the MDGs.

Raising these resources to meet and go beyond the MDGs requires simultaneous action on two fronts: raising the level and quality of external resources flowing into developing countries and maximising the generation and retention of domestic resources.

During 2005 some steps were taken towards the first of these. A deal on the cancellation of multilateral debt and promises to increase aid flows to the poorest countries have gone some way to address the external resource gap.

However, little has been done internationally to address the mobilisation and retention of domestic resources. Hundreds of billions of dollars – a figure far in excess of aid inflows – continue to flow out of poor countries every year in the form of debt repayments, private sector transfers and most significantly, capital flight.

Although the Commission for Africa's report⁴ proposed actions to plug some of these leaks, the scale and significance of resource losses to poor countries remains vastly under-emphasised.

This report investigates the scale and nature of one dimension of these leakages: capital flight – defined for our purpose here as the illicit and unrecorded outflow of money and resources from developing countries. It has been estimated that annually developing countries lose more than US\$500 billion in the form of capital flight.⁵ In comparison, global aid in 2006 was US\$104 billion.

Moreover, the manner in which capital flees developing countries often involves illicit activities such as the use of secretive tax havens, tax evasion and the manipulation of trade transactions, etc. These all subvert the rule of law, encourage corruption and reinforce power and wealth inequality.

This briefing looks at both the character and scale of flows, showing how capital flight is diverting scarce resources away from developing countries, undermining all other efforts to finance development. It looks at the causes of capital flight and the main channels used.

It further identifies the main perpetrators and suggests pragmatic steps for stemming this haemorrhage of resources and increasing both the mobilisation and retention of domestic resources. It is this domestic resource mobilisation that, according to both the UN Monterrey Consensus and the UN Millennium Project, lies at the heart of the development and MDG agenda. Additionally, such steps would help re-establish the rule of law, reduce corruption and help build a fairer and more equal society.

2. Why is capital flight important?

Capital flight involves the leakage of vast sums of money from developing countries, which undermines the resources available for development and for financing the MDGs. Where resources stay within a country, they can be locally consumed or invested to promote economic activity. The escape of such funds depresses economic activity and has a negative impact on long-term growth rates.⁶

The sustainable development of a country is only possible if it mobilises and retains sufficient resources domestically. These resources are needed for spending on social and welfare programmes, and for investment to help increase the stock of productive capital. Capital flight undermines sustainable development by increasing dependence on external resources such as aid that are needed to replace the gap left by the fleeing of domestic capital.

The flight of domestic resources abroad undermines the development of an accountable and participative relationship between the state and its citizens. This is reached when citizens' resources are mobilised to fulfil domestic needs – in other words, citizens pay taxes and then hold their governments to account to ensure that the money is utilised properly towards priorities defined by them. If a large amount of such wealth is transferred offshore, incentives to participate in the construction of a just and functioning domestic society diminish significantly.

In fact, tax evasion is often a strong reason behind capital flight; the two are closely linked. Because much of the capital that flees a country is untaxed, this reduces the tax base by shifting wealth and resources beyond the government's reach. Thus capital flight depresses both budget revenues, which are needed to finance the provision of essential services such as health and education, and the investments needed to meet the MDGs and the country's overall development. It also worsens the distribution of income by shifting the tax burden away from capital and onto less mobile factors, especially labour.

We shall see that corporations – which try and minimise the payment of taxes, sometimes through illicit means such as misreporting and mispricing commercial transactions – are a key actor in bringing about capital flight. It is ironic that many companies which claim to be socially responsible find nothing wrong about disrupting the rule of law through aggressive tax avoidance and capital flight.

The infrastructure of tax havens, offshore trusts and private banks that facilitates capital flight by allowing vast amounts of capital to flow across borders unchecked and in secret, is also vulnerable to being used by terrorist and criminal networks and thus puts our collective and individual security at great risk.

This infrastructure also makes it easier to engage in corrupt behaviour, especially through the payment of bribes to, and the diversion of funds by, domestic political and business elites. Such funds are usually stashed offshore, protected by secrecy and privacy which makes detection difficult and hence increases the rewards that can be earned by engaging in corrupt behaviour.

Their actions increase within country inequality, reinforce power imbalances, undermine democracy and the rule of law and lead to a deteriorating economic and social situation under which ordinary law-abiding citizens suffer.

Capital flight from developing countries deprives their citizens of a future. The poorest and most vulnerable are those most affected when resources that could otherwise have been used for life-saving and life-sustaining expenditure on basic healthcare and other essential services are illicitly taken out of a country. Viewed from this perspective, capital flight is directly responsible for the loss of innocent lives and human dignity, and has even been called a crime against society.⁷

Capital flight and the tax evasion associated with it put public assets in private hands and deprive citizens of what is rightfully theirs. In the worst scenarios – as seen in many sub-Saharan African and Latin American countries – inequality gets polarised in the extreme, with a small number of the elite owning vast amounts of undeclared assets abroad while the vast majority of the country's citizens (the poor) are crushed under the burden of public debts.⁸

Clearly, capital flight undermines development, breaks the social contract between a state and its citizens, encourages corruption, sharply increases inequality, threatens our security and is completely incompatible with ethical and socially responsible behaviour.

Christian Aid believes that we need to urgently tackle the problem of capital flight – not just because of its magnitude but also because of its character, which strikes at the heart of what is and is not ethical and responsible behaviour.

3. Defining capital flight

Christian Aid views capital flight through a lens of its potential impact on development. From this perspective, capital flight is best defined as the unrecorded and (mostly) untaxed illicit leakage of capital and resources out of country. Flight capital has certain characteristics that help distinguish it from normal monetary and resource flows, namely that:

- it is domestic wealth that is permanently put beyond the reach of appropriate domestic authorities, much of which is unrecorded because of deliberate misreporting
- it is usually associated with active attempts to hide its origin, destination, true ownership; it also flees to secrecy
- it is associated with public loss and private gain, because no (or little) tax is paid on it.

Defined in this way, capital flight refers to resources that are lost to the domestic economy where they could have been gainfully employed to generate growth, employment and development.

However, capital flight has also been used by several authors to define different elements of monetary and resource flows, some of which have little in common with the definition used in this paper. In order to avoid any misunderstandings, we clarify the overlaps and differences between the various definitions below. The term capital flight has also been used to describe the following:

- 1) **Sudden short-term capital outflows**, usually associated with the occurrence or the threat of a financial or political crisis – such as happened in the 1997 southeast Asian crisis. This is usually a reaction to unfavourable political or economic developments within a country.

Unlike ‘illicit capital flight’, which is permanent, unrecorded and usually untaxed, such sudden capital outflows may comprise elements which are both above-board and legal – for example, the sale of domestic assets and repatriation of profits – and secretive and illegal – such as manipulating the price of trade transactions to transfer undeclared profits out of the country.

This definition concentrates on the suddenness and short-term nature of capital outflows rather than on their legitimacy – a factor which is critical from our perspective. Sudden capital outflows from countries facing a crisis flees to safety (safe assets), whereas illicit capital flight is the long-term haemorrhaging of a country’s resources that happens even in the absence of an impending crisis and involves capital fleeing to secrecy.

- 2) **The difference between the recorded sources and uses of foreign exchange**,⁹ which is meant to capture the money that has left the country without being reported.

However, this definition is far too narrow and captures only a small part of the true illicit flight of capital. This is because the most important channel for capital flight – the manipulation of trade transactions – does not get picked up as a discrepancy between the sources and uses of foreign exchange.

Overpaying for imports and undercharging for exports are the most common methods used to illicitly transfer resources out of a country. Exporting a diamond worth US\$1,000 at US\$100, for example, includes a flight component of US\$900, which is very likely to be deposited in an offshore account belonging to the exporter. However, official statistics only show that a diamond was sold for US\$100. Because the flight component of US\$900 never enters or leaves the

country, balance of payments statistics which capture the cross-border flow of money fail to register it.

So, the difference between the sources and uses of foreign exchange is only one part of the broader measure of illicit capital flight used in this paper.

- 3) **Capital outflows or stock of wealth held abroad by the citizens of a developing country.** In addition to capturing illicit capital flight by citizens, this definition also captures the legal, reported and taxed outflows of wealth owned by citizens – an aspect that is not relevant to the discussion in this paper. Where it is illegal for citizens to hold wealth offshore, this will provide one of the components of illicit capital flight.

However, this particular definition fails to capture the illicit export of resources by non-citizens and entities such as corporations. Estimates show that this component of capital flight is at least as important as the illicit export of resources by citizens.

So, while there are significant overlaps between what the two definitions measure, they are conceptually distinct, as the Christian Aid definition emphasises the illicit nature of resource outflow, no matter who the perpetrator is.

Christian Aid uses the definition of capital flight described at the start of this section because it sheds light on the systemic issues that facilitate the leakage of resources from poor countries. As we discussed above, it is not the short-term capital or 'hot money' flowing back and forth, but rather the long-term outflow of resources that is associated with illegality.

It will become clear throughout the following pages that the structural mechanisms and incentives which drive illicit capital flight have little to do with the portfolio allocation decisions of international investors as is often stated. Instead, it has much more to do with a desire to evade taxes, maximise profits even when it means using illicit means, or hide the proceeds of illegitimately acquired wealth – for example, wealth gained through corrupt or criminal activities.¹⁰

This means that it is inappropriate simply to ask developing countries to 'set their own house in order' to prevent the flight of capital. The burden of actions needed to prevent capital flight falls equally on us in the West – indeed, our secretive tax havens, banks that actively promote the transfer of wealth offshore, complicit lawyers and accountants and tax-evading multinational corporations are as guilty as developing-country domestic elites of robbing poor countries of much-needed scarce resources that could otherwise be used for development.

Christian Aid strongly believes that we in the West have a moral, ethical and economic responsibility to act against the perpetrators and facilitators of capital flight. As we shall see in this report, the UK, its institutions and its overseas territories and dependencies lie at the heart of the sophisticated network that drives the illicit flight of capital. That is why the burden is upon us to act – and to act now.

3.1 Licit and illicit capital flows

Not all capital outflows from a country constitute capital flight. For the purpose of discussing how capital flight occurs, and which financial and resource flows it encompasses, we must first point out which capital flows do not constitute illicit capital flight. Above-board, legal, well-documented and reported flows of wealth on which proper taxes have been paid are a perfectly legitimate part of everyday commercial transactions.

These transfers happen in the form of payments for imports of goods and services or the purchase of assets. These legal remittances of legitimate profits earned on foreign investments constitute yet another channel for the transfer of wealth abroad. Such licit flows share the following characteristics:

- The source of the wealth being transferred abroad is legal. In other words, it has been earned through legitimate means and not through corrupt or criminal activities. The outflow of wealth earned in the form of a bribe, for instance, would not be covered by this definition.
- The outflows are offset by an equivalent fair-value transaction. In other words, when outflows are used to purchase goods or assets from abroad, their value is equivalent to the amount of money paid for them. For example, paying US\$1,000 for importing a machine worth US\$100 would not qualify as a fair-value transaction.
- The process of the transfer of wealth does not violate any laws of the country pertaining, for example, to foreign exchange or capital control.
- The appropriate taxes due on the capital being transferred have been paid to the domestic authorities.
- The flows constitute a part of official statistics and are properly reported, documented and recorded.

While capital flight often occurs through many of the same channels used for the legitimate transfer of funds, it does not meet some (or all) of the characteristics listed above.

4. The main channels of capital flight

In this section we discuss the mechanisms that are most commonly implicated in capital flight. These include:

- mis-invoicing trade transactions
- transfer mispricing
- using mispriced financial transfers
- unscrupulous wire transfers
- other mechanisms, such as smuggling cash
- paying bribes and corrupt monies offshore.

1) **The mis-invoicing of trade transactions** is a very significant channel for capital flight. Those who import or export goods can also export money by simply overstating the value of the goods they import or by understating their export

earnings. In other words, exporters under-invoice their exports and are paid the difference to the real value offshore. Alternatively, importers ask for an order to be over-invoiced as a way of getting hold of foreign exchange (this is particularly relevant in countries where the government rations foreign exchange). The funds to cover the inflated invoice are transferred abroad; part is used to pay for the import, while the rest – which constitutes capital flight – is deposited in the importer's offshore bank account.

The sheer volume of trade transactions makes mis-invoicing a simple and relatively secure channel for capital to flee. It is very hard to detect in official statistics as it is often based purely on verbal agreements and involves buyers and sellers cooperating with each other to move money offshore. The closer these illicit transactions are interwoven with genuine and legitimate transactions, the harder it becomes to detect them. Trade transactions are sometimes done with both a commercial motivation and a desire to transfer money abroad illicitly.

Capital flight from Nigeria: examples of under- and over-invoicing in trade transactions with the US ?

In January 2005, cashew nuts were exported from Nigeria to the US at just US\$0.49 per kg when the world median market price was US\$4.91 per kg (under-invoicing). This transaction had a capital flight component of about US\$4.42 per kg.¹¹ In November 2005, a Nigerian importer buying optic fibres from the US paid US\$1,372 per unit when the world median market price was US\$6 per unit (over-invoicing). This transaction had a capital flight component of US\$1,366 per unit.¹²

Capital flight is therefore disguised under legitimate-sounding trade transactions, and official statistics will record the amount on the invoice, regardless of whether the real value of the goods and services traded is significantly different. The difference between the real value of imports and exports and the amount paid and the amount earned through mis-invoicing constitutes capital flight and is not captured by official statistics. In the cases quoted above, then, official statistics merely register the US\$0.49/kg for cashew nuts or US\$1,372/unit for optic fibres as legitimate trade-related transactions and do not capture the US\$4.42/kg or the US\$1,366/unit lost in capital flight.

The following table lists some other examples where mis-invoiced trade transactions were used for illicit capital flight from Nigeria to the US in 2005.¹³

Table 1: Some examples of trade mis-invoicing from US-Nigeria trade transactions (2005)

Nature of goods	Amount (US\$)	Quantity	Unit	Price per unit (US\$)	US-world median price (US\$)	Price ratio (%)	Flight component
Underpriced exports							
Live reptiles	2,716	2,757	number	0.99	5.11	19	2,200
Coffee	25,105	36,562	kg	0.69	2.18	32	17,071
Gum arabic	41,280	60,000	kg	0.69	3.51	20	33,024
Bran	868,820	9,146	tonne	94.99	196.5	48	451,786
Overpriced exports							
Golf club set	4,976	1	number	4,976	82	6,100	4,894
Cassette recorders	5,640	4	number	1,410	56	2,500	5,416
Hair dryers	3,800	1	number	3,800	25	15,400	3,775
Starter motors	4,363	1	number	4,363	41	10,700	4,322

A recent Christian Aid report¹⁴ reveals some astounding examples of low-priced commodity imports into the US from other developing countries:

In 2004, nickel was imported from Chile to the US at a price just over one-thousandth of the world price. The US company paid the Chilean company US\$219,883 for the nickel – the median world price would have been US\$125 million. This means that the Chilean treasury lost out on nearly US\$125 million of taxable income.

Also in 2004, over 400,000 tonnes of platinum was imported into the US from the Dominican Republic; at a price that was only just over three-thousandths of the world price. Had the median price been paid, the Dominican treasury would have charged tax on more than US\$4.5 million of export income.¹⁵

The study states that on the whole there is significant evidence that commodity exports from developing countries are under-priced.

To minimise the risk of detection, importers and exporters use several techniques, such as:

- **Misreporting quality and grade.** This involves either reporting that the exports are of lower quality than they actually are to justify a lower price, or that imports are of higher quality than they actually are to justify a higher-than-normal import price. For example, an invoice may state that a jewel-quality diamond is an industrial cutting diamond to justify a lower price per carat, or that low-quality iron ore grade is of a higher quality.
- **Misreporting quantity.** This technique involves reporting a lower or higher number of units in a transaction. With exports, this means reporting fewer – for example, invoicing a shipment of a 100,000 shirts as 80,000 shirts – to justify under-pricing the transaction. With imports, the number of units reported is greater than it actually is – for example, invoicing or reporting 200 units of machinery when there are in fact only 150 – to justify over-pricing the imports.

Nevertheless, the most blatant cases of capital flight do not depend on misreporting real transactions, instead cooking up completely fictitious transactions. 'One well-worn wheeze is to pay for imported goods or services that never materialize.'¹⁶ As trade in services expands, this problem is becoming more severe: unlike goods, which have a customs or bill-of-lading record, services do not leave an equivalent paper trail. Also, by their nature they are more customised, intangible and thus hard to benchmark to a fair value. Who is to say whether the US\$10,000 paid to a foreign contractor for 'engineering consultancy services' is over-invoiced or not?

The money transferred abroad in the form of capital flight also means that the domestic entity (exporter or importer) will report below-normal profits and hence pay less tax than would be legitimately due. In fact, tax evasion is often a strong motive for the flight of capital.

The contribution of mispricing to tax evasion and capital flight may be truly enormous; one estimate is that around 45 to 50 per cent of trade transactions in

Latin America are falsely priced by an average of more than 10 per cent; while 60 per cent of trade transactions in Africa are mispriced by an average of more than 11 per cent.¹⁷ These numbers indicate that trade transactions in developing countries are mispriced by an average of 5-7 per cent, a figure that is lent further credence by the work of Simon Pak,¹⁸ a US academic who is a world expert in the field. Pak shows that capital shifted illicitly to the US through mispricing on the trade account amounts to 12.1 per cent of total US imports (where the exporting countries under-price goods) and 5.5 per cent of US exports (where importing countries over-price the imports).

2) Transfer mispricing – or the manipulation of the price of transactions between related affiliates of multinational corporations (MNCs) – is another major channel for the flight of capital. A transfer price is the price paid for an exchange of goods and services between related corporate entities. In most instances this involves either the parent firm trading with its subsidiary or two subsidiaries of the same parent group transacting with each other.

Transfer pricing itself is a legitimate practice and requires that an 'arm's length principle' be followed: in other words, the price should be equivalent to an open-market price which would exist between unrelated entities.¹⁹ However, in a great many cases, this principle is not followed and transactions are mispriced in order to allow MNCs to move money illicitly, mostly to evade taxes by booking profits in low tax jurisdictions.

'[Transfer] Mis-pricing is a major vehicle for capital flight. Around 60% of trade takes place between subsidiaries of MNCs. As these transactions occur between different parts of the same company, there is ample scope for mis-pricing and, as a result, in shifting of profits.'²⁰ Prices based on the 'arms-length principle' are notoriously hard to ascertain within the highly complex international production networks that exist today and where companies use trademarks, patents, brands, logos and a variety of company-specific intangible assets which are often parked offshore.

In theory, the transfer price is supposed to be the same as the market price between two independent firms, but often there is no market, so nobody knows what the market price might be. This is particularly true of firms supplying services or intangible goods. So multinationals spend a fortune on economists and accountants to justify the transfer prices that suit their tax needs which focus on minimising tax liability.

The use of transfer pricing and tax havens to avoid taxes²¹

Volcafe is the world's second-largest raw coffee trader and has a market share of 13 per cent. Papers leaked to Swiss NGO the Berne Declaration revealed a hidden world in which Volcafe transferred millions of dollars from its subsidiaries in coffee-producing countries to a phantom operation in Jersey called Cofina. It was a complex structure in which Volcafe bought beans from small cooperatives in developing countries at the market price – say, 80 cents a pound. It then 'sold' the raw coffee to Cofina in Jersey at a similar price. Cofina sold this on to customers such as Nestlé and Starbucks, at a mark-up. By trafficking the beans through the tax haven island, the bulk of Volcafe's profits were made there, meaning it paid minimal tax in the developing countries.

Cofina's 1998 accounts showed that, while most of Volcafe's subsidiaries in developing countries made marginal profits and paid no tax, Cofina sold US\$408 million (£224 million) worth of coffee and made a gross profit of US\$27m. The firm paid no tax because the profit was booked in Jersey.

Yet Cofina did not really exist: it was just a post box operation with one or two administrative staff. The beans Volcafe bought from farmers were delivered directly from the coffee countries to the end customers such as Nestlé.

Company documents revealed that the firm went out of its way to keep everything top secret. Volcafe employees were told to identify themselves as Cofina staff, although they were not. One document stated: 'You should program your fax machine in a way that your name does not appear on faxes dispatched in the name of COF [Cofina].'²²

According to the UN Conference on Trade and Development (UNCTAD), in the early 1990s there were 37,000 international companies with 175,000 foreign subsidiaries. By 2003, there were 64,000 with 870,000 subsidiaries.²³ Many have global brands, global research and development, and regional profit centres. The only reason for preparing national accounts is that tax authorities require it. But it is hard to say quite where global firms' profits are generated.

For example, oil companies have production, refining, distribution, marketing, sales and research and development spread across many countries and can structure transactions and prices to eke out the best tax advantage to report higher earnings. There is an increasing tendency for corporations to boost their post-tax earnings by reporting "higher taxable profits in countries where taxes are lower".²⁴

Oil companies such as Chevron, Texaco and Caltex are estimated to have avoided US\$8.6 billion in taxes by using a novel design of accounting and tax transactions with domestic and foreign governments between 1964 and 2002.²⁵

Developing countries are particularly vulnerable to these types of tax avoidance strategies and related capital flight. Typically, they lack sufficient information from the parent company to be able to challenge transfer pricing and other forms of tax avoidance. Because a considerable share of total developing country trade is under the control of TNCs, such countries are typically more vulnerable to tax avoidance practices through transfer mispricing by over- or under-invoicing imports and exports.

An early study into Colombia's pharmaceutical industry revealed that reported profits accounted for only 3.4 per cent of effective returns; royalties for 14 per cent, and over-pricing for 82.6 per cent.²⁶ This led to an additional cost to the Colombian economy of about US\$20 million a year for pharmaceutical imports alone, and a substantial loss of government tax revenue – amounting to US\$10 million a year. Some individual items were found to be overpriced by up to 5,000-6,000 per cent.²⁷

Imports and exports into and out of developing and transitional economies currently total approximately US\$6 trillion a year. Multiply this by a (conservative) 5-7 per cent²⁸ range of variant pricing (the rate of mispricing based on empirical findings),

and we get a total for falsified pricing of some US\$300-420 billion a year which is shifting out of these countries into western accounts. The following table lists some estimates of the amount of capital that flees developing countries annually through these channels.²⁹

Table 2: Annual capital flight from developing countries through commercial transactions

Transactions	High estimate (US\$ billion)	Low estimate (US\$ billion)
Mispricing	150	100
Abusive transfer pricing	200	100
Fake transactions	200	150
Total	550	350

3) Using mispriced financial transfers, such as intra-corporate financial transactions – for example, loans from parent to subsidiary company at exaggerated interest rates – to shift profit out of a host country is another way illicitly transferring capital out. Real estate, securities and other forms of financial trades can also be mispriced to facilitate capital flight. Purchasing foreign assets at inflated prices and selling domestic assets at below-market prices has a flight component which gets disguised as a legitimate financial transaction.

Using exaggerated values for payment of intangibles such as goodwill, royalties, franchising rights and the use of patents and copyrights held by a related corporate entity is another way of achieving the same end. Such devices are frequently used in capital-intensive industries such as pharmaceuticals.

The capital flight that occurs through these channels shows up as a part of legitimate current or capital account transactions and is impossible to identify through official balance of payments statistics. Only a thorough transaction-by-transaction analysis of legitimate-looking financial payments and transfers would allow authorities to capture the true extent of this phenomenon.

Using over-priced inter-corporate loans for capital flight and tax evasion³⁰

'Despite record levels of copper extraction in Chile, private mining companies, with only two exceptions, paid no taxes until recently. Private companies extracted and exported 20.8 million tonnes of copper between 1993 and 2002, roughly equivalent to two years'-worth of world consumption. The value of these exports amounted to more than \$34 billion, with the net income of private companies roughly half that sum.

'Meanwhile, they paid just \$1.7 billion in taxes, while accumulating \$2.6 billion in tax credits, thus holding the Chilean state liable for a net \$900 million. Compañía Minera Disputada de Las Condes, a mine owned by Exxon, ostensibly operated at a loss for 23 years. Therefore, it did not pay any taxes at all and, on the contrary, accumulated \$575 million in tax credits. Nevertheless in 2002, Exxon (by then Exxon Mobil) sold this "money-losing" operation for \$1.3 billion. Exxon had exported the mining operation's substantial profits, mostly disguised as above-market interest payments on a loan taken from Exxon Financials, a subsidiary in Bermuda.

Following the initiative of a group of members of the National Congress, the Chilean government introduced, on 5 July 2004, a 3 per cent royalty on the sales of copper producers.'

Using exaggerated royalty payments for tax avoidance and capital flight³¹

Microsoft, which has set up an Irish subsidiary, is being accused by the US Inland Revenue Service (IRS) of having avoided hundreds of millions of dollars in taxes. The IRS says that Microsoft has transferred the ownership of hundreds of its patents over to its Irish subsidiary for a below-market value and the Irish subsidiary is now charging significant royalty costs for the use of these patents from Microsoft entities worldwide, and avoiding taxes in many countries.

Microsoft subsidiaries in the developing world also have to pay these substantially higher royalties which means that they too are reporting lower profits than they otherwise would. This has a negative impact on taxes paid in developing countries.

The Wall Street Journal wrote that 'a law firm's office on a quiet downtown street [in Dublin, Ireland] houses an obscure subsidiary of Microsoft Corp. that helps the computer giant shave at least \$500 million from its annual tax bill. The four-year-old subsidiary, Round Island One Ltd., has a thin roster of employees but controls more than \$16 billion in Microsoft assets. Virtually unknown in Ireland, on paper it has quickly become one of the country's biggest companies, with gross profits of nearly \$9 billion in 2004.'

- 4) **Unscrupulous wire transfers** are yet another significant channel for the flight of capital and usually involve a bank or a non-banking financial institution illicitly transferring money out of a country. Wire transfers are of course a legitimate way of moving money between countries, but when such transfers violate laws, are used to avoid taxes or hide ill-begotten wealth, they constitute illicit capital flight. There is also an increasing use of non-bank financial institutions, such as remittance businesses, for the purpose of moving money illicitly.

Banks facilitating capital flight³²

In 2001, the year Argentina defaulted on its bonds, a client of Citibank in Buenos Aires secretly video-recorded a meeting with a Citibank official in which the banker offered to help him take money out of Argentina illegally. The client told the banker, a Mr Mariano, that he was a businessman who had just sold a company and didn't want to report all the profits. Mr Mariano detailed how he could help him – and assured him that he did the same for many other clients.

The video was shown on the TV programme *Behind the News* in 2002, at the height of the debilitating economic crisis that was a result of years of massive capital flight and tax evasion. The banker said he would send the money via a wire not in the client's name to a transit account at Citibank New York and move it from there to an international personal banking (IPB) account. As a non-resident foreigner, the client wouldn't pay taxes, and the Argentine authorities wouldn't know about his account.

For commercial institutions, techniques such as commingling legal and illegal money, using loan-back arrangements and layers of transactions through offshore shell companies all help reduce the risk of detection.

Banks played an important role in facilitating capital flight out of Russia, especially in the 1990s. There were numerous instances of enterprises being set up solely to present an import contract, which included a substantial advance payment to various banks. As soon as the bank had used its correspondent banks in financial centres to transfer the money, the enterprise was dissolved. Many of the illicit capital account transactions that were involved in leaking money out of Russia were also carried out using correspondent banking arrangements with less than fully diligent (or in the worst cases, complicit) western banks.³³

However much they protest otherwise, that [illicit capital flight] inevitably involves western banks, and not only those in traditional havens such as Cyprus or the Cayman Islands. A recent report by America's General Accounting Office says that Citibank in New York failed to supervise properly the transfer of \$750m through numerous Russian-owned accounts over the past ten years. Citibank admits that its monitoring at the time fell short of the standards that would be required today.³⁴

An example of some mechanisms used by banks to facilitate capital flight³⁵

Amelia Elliott, a private banker working for Citibank, listed Raul Salinas (the brother of the Mexican president at the time) as 'confidential client 2' (CC 2). The International Private Bank (IPB) then opened five accounts for CC 2 in New York. Another account, in the name of a shell company, was opened at the bank's trust company in Switzerland. The account itself was called Bonapart. Cititrust Cayman Islands then formed a shell called Trocca which was listed as the owner of all CC 2's private bank accounts. Three additional shells were listed as Trocca's shareholders and three more shells were listed as Trocca's Board of Directors. A Trocca account was also opened at IPB London.

The name Salinas was deliberately omitted from all IPB files, and never appeared in connection with anything. The one piece of paper that showed Raul Salinas was the beneficial owner of Trocca, and therefore all of the money, was purposely kept in the Caymans, where bank secrecy laws forbid anyone from divulging its existence and no foreign country could subpoena it.

They also gave him credit cards for his accounts in the names of the shells so that whatever charges he made would never be associated with him directly, or ever appear in Mexico, thus allowing him to use his money without paying taxes. Furthermore, IPB helped obscure any money trails by moving some funds deposited by CC 2 through concentration accounts.

The US General Accounting Office (GAO) determined that private banking personnel at Citibank helped Mr Salinas transfer US\$90-100 million out of Mexico in a manner that 'effectively disguised the funds' source and destination, thus breaking the funds' paper trail.'

- 5) **Other mechanisms such as smuggling cash** are also used for capital flight, but are less important overall than the mispricing and wire transfer mechanisms discussed above. The illegal export of currencies (especially hard currencies) by smuggling bank notes is fairly common. Diamonds,³⁶ gold, illegal drugs and other high-value commodities such as arts, antiques and rare coins, also serve as means to take wealth out of poor countries. The smuggling of rare animals and birds is also common and results in the plunder of a country's resources for the benefit of private individuals, in many cases in the form of offshore deposits.

The only one of these mechanisms that is not captured by official statistics is the smuggling of foreign exchange, which shows up as 'errors and omissions'.

One example of one such attempt to smuggle cash out of a country was the widow of General Sani Abacha, the erstwhile dictator of Nigeria. Shortly after his death, Mariam Abacha was stopped at Lagos airport trying to leave for Saudi Arabia. She had with her 38 suitcases – many of which were filled with foreign currency. 'Reports vary on the amount involved, ranging from \$50 million-\$100 million. She said she was going to the Hajj.'³⁷

Incidents of individuals smuggling cash and using other mechanisms for the flight of capital are of course not just limited to African countries. There are several instances of similar occurrences in other countries such as Russia.

- 6) **The offshore payment of bribes and corrupt monies** is another significant channel for the flight of capital. When corrupt public officials are paid bribes by various commercial interests such as oil firms for getting preferential oil concessions, there is always an element of capital flight involved. MNCs operate to maximise profits, so will only pay a bribe if they are able to extract the amount paid (plus more) in the form of super-normal profits. In such cases, countries do not get a fair value on the commercial activity undertaken by the firm; both tax evasion and capital flight deprive the country of scarce resources.

While it is true that MNCs can (and do) pay bribes domestically within developing countries, the secrecy and safety offered by tax havens and offshore bank accounts often substantially increases the incentive to accept bribes and engage in corrupt behaviour, because the risk of persecution, and the identification and confiscation of bribe money is minimised.

Defence contracts, oil drilling and mining concessions have been most closely associated with the payment of bribes and often result in the citizens of poor countries ending up with an unfair deal, paying over the odds for defence armaments they may not need and being under-compensated for the erosion of their non-replenishable natural resources. Many of the bribes associated with such contracts are paid directly into the offshore accounts of dictators (such as Suharto of Indonesia or Marcos of the Philippines) and other corrupt public officials, and thus constitute capital flight.

However, it is pertinent to point out here that, contrary to popular belief, such corruption, although important, represents a much smaller share of capital flight than the commercial transactions we discussed previously. According to one widely cited set of estimates, commercial motivations account for more than two-thirds of all

capital flight from developing countries; criminal activities for less than half of that; while the balance – around 5 per cent – is directly linked to corruption.³⁸

5. Why does capital flight occur?

While it is clearly difficult to identify the exact causes of capital flight, it is nonetheless useful to look at various motivations and estimates of their relative importance. Capital flight is driven by a complex web of perpetrators and facilitators who exploit an increasingly sophisticated but poorly regulated international financial and trading system. The perpetrators are mostly multinational corporations seeking to evade taxes and maximise profits for their share holders or wealthy domestic business and political elites trying to evade taxes or transfer ill-gotten money abroad to escape detection.

However, without facilitators in the western world, the means and incentives for capital to flee would not exist. These include: complicit business counterparts in western countries (for domestic exporters and importers); armies of well-paid lawyers and accountants who stand ready to design aggressive tax-planning and transfer pricing strategies; and complex offshore trusts, dummy companies and bankers who solicit and manage illicit flight capital. It is the knowledge that 'they can get away with it' that gives the perpetrators the incentive to act as they do.

The current international financial and trading systems, where secretive and low (or zero) tax jurisdictions such as tax havens play a central role, enable perpetrators and facilitators to flee with hundreds of billions of dollars in capital and unpaid taxes. With more than US\$11.5 billion – about a quarter of global wealth stashed by individuals alone in tax havens³⁹ – and more than half of world trade passing through them,⁴⁰ such jurisdictions lie at the heart of the phenomenon of capital flight and tax evasion, despite accounting for less than 3 per cent of the world's gross domestic product (GDP).

As the volume of cross-border financial flows and trade has grown exponentially, it has become easier to commingle illicit cross-border capital flight with legitimate financial transactions. As we saw in the last section, many trade and financial transactions could have both licit and illicit components, making it very hard to separate one from the other. The increasing role of MNCs and their complex international production networks has also made it easy for capital to flee through hard-to-detect transfer mispricing schemes.

International financial institutions such as the IMF and the World Bank have forced many developing countries to liberalise their current and capital accounts, decreasing government control and supervision over the money that flows in and out of the country by linking aid and debt relief to 'policy conditionality'. They are also responsible for pushing governments to: privatise banks; attract foreign direct investment (FDI) at preferential terms; eliminate 'performance requirements' on this FDI such as minimum local content requirements; liberalise and in many cases privatise crucial state functions such as custom duty collection; and generally decrease state control over cross-border flows of goods, services and finance. This tremendous dilution of state regulatory powers may also have acted as a catalyst in dramatically increasing the amount of capital fleeing developing countries by making detection much less likely.

Many actors are engaged in capital flight – some respectable, some not; some obvious, some surprising. Patrick Smith from *Africa Confidential* – a respected publication dealing with African issues – notes that '[the network supporting capital flight from Africa is] a system run by an international network of criminals, involving corrupt bankers laundering money, lawyers and accountants setting up “front companies” and trusts to collect bribes, contract-hungry company directors, local middlemen in Africa and the corrupt officials in African governments.'⁴¹ It is the perpetrators (such as corrupt businessmen and public officials), acting together with the facilitators (such as bankers), using regulatory weaknesses and loopholes in the international financial and trading system (such as tax havens that offer secrecy) who bring about the flight of capital.

None of these actors could act in isolation and thus it is irresponsible and incorrect to point the finger at any one of them without recognising the roles played by the others. Yet this is exactly how things are often portrayed in the West, where a mention of the phrase 'capital flight' often elicits a response that blames 'corrupt southern elites'. This is also factually incorrect, as by far the most significant players in the capital flight game are MNCs and other commercial entities acting to minimise taxes and maximise profits through illicit means.

Who is to say who is most guilty – the MNC offering to pay a bribe to get an oil concession over its competitors; the corrupt public official accepting such a bribe; the western bank actively soliciting to get a share of the money by offering to keep it 'safe'; the secretive tax haven which allows the other actors to hide their dodgy actions behind a cloak of secrecy; or the well-paid lawyers and accountants who register offshore trusts, shell companies and accounting vehicles to hide the origin and true ownership of the money?

6. How does capital flight take place? The movers and shakers in the world of fleeing money

In this section we discuss the role that each of these actors play in the complex web that makes up the world of capital flight. The role played by multinational and domestic commercial interests has already been covered in some detail in Section 4 and is therefore not discussed here. Instead, we focus on the role played by professionals such as lawyers and accountants, the banks, rich countries and the tax havens associated with them. It is clear that these are the main actors who work together to bring about resource and capital flight.

6.1 The professionals

An army of bankers, lawyers, accountants, tax specialists and many other outwardly respectable professionals play complementary roles in the game of capital flight.

Because criminals shifting drugs [and those engaging in capital flight] hire professionals to handle money, and because professionals handling money never have to touch drugs, those professionals live comfortably in a world of plausible deniability. Lawyers, bankers, accountants, company formation agents and brokers may or may not know the origin of the money they're handling, but most of them know they don't want to know. The excuse goes, "My client is an

attorney and I don't need to risk losing my fees by probing too deeply about his client."⁴²

Accountants help come up with creative accounting techniques which allow for the movement of money out of countries under the guise of legality. Creating artificial losses, new classes of assets (such as 'management foresight' that KPMG made up for WorldCom⁴³), seeking loopholes in the law, devising complex derivative and transfer pricing schemes are some of the techniques accountants use to help give legitimacy to moving money around illicitly. An accountancy firm partner stated recently: 'No matter what legislation is in place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken.'⁴⁴

Tax specialists are perhaps more accurately referred to as 'no-tax-specialists'. MNCs and the accountancy and law firms that advise them scour the international arena to find innovative loopholes that can diminish the companies' tax burden in order to increase post-tax profits. 'Whoever is able to lower the effective tax rate by 1 percent, can drastically improve the company's results. I enjoy showing CEOs graphs of how many cars or laundry-machines they would have to sell additionally, in order to achieve the same results,' says Dieter Endres, manager at PriceWaterhouseCoopers, one of the major auditing firms that helps MNCs find such loopholes.⁴⁵ According to the US Senator Joe Lieberman, 'The ranks of lawyers, accountants, and financial consultants have abused the law and their own professional ethics simply for the sake of huge sums of money to be made helping their clients evade taxes.'⁴⁶

Such actors often try to portray tax as a business cost to be minimised. Any text book on basic accounts will show that this is a completely disingenuous claim as pre-tax earnings are the focal point of measuring a firm's profitability. This is also the measure used in the calculation of earning per share. Tax is not a cost of doing business but the core element of the social contract that businesses have with society. While managers of a firm have a fiduciary obligation to shareholders to maximise earnings before taxation, this does not apply to earnings after taxation. In any case, the focus on shareholders alone is outmoded in current corporate governance practice which emphasises a focus on stakeholders' interests – and that includes the society and community where the firm operates.

6.2 Tax havens and offshore financial centres

Tax havens provide a pull factor for capital flight. These havens have proliferated over the last few years and provide enabling services in the form of dummy companies with post box addresses, secret trusts, shell banks, zero (or very low) rates of tax for non-resident companies and individuals, lax regulations with almost no reporting requirements and an assurance of secrecy that is mostly either encoded in local law or de facto practice. This design of legal systems around the needs of businesses and individuals seeking to minimise taxes and hide assets has perhaps correctly been referred to as the 'commercialisation of sovereignty'.⁴⁷

Nearly half of all world trade appears to pass through offshore financial centres, even though these jurisdictions account for only about 3 per cent of global GDP. A 1994 study found that at least 26 per cent of assets and 31 per cent of net profits of US MNCs were located in tax havens.⁴⁸ A more recent study⁴⁹ concludes that subsidiaries of US corporations now generate most of their profits in tax havens, rather than in the locations where they conduct the majority of their business. This is a practice

that seems to be on the rise: the profits of foreign subsidiaries of US corporations in just 18 tax havens increased from US\$88 billion in 1999 to US\$149 billion in 2002⁵⁰. Anecdotal evidence suggests a similar pattern among MNCs from other Organisation for Economic Co-operation and Development (OECD) countries.

US energy giant Enron created 3,500 domestic and foreign subsidiaries and affiliates, based in countries that include Turks and Caicos, Bermuda, Mauritius and the like. Some 441 were registered in the Cayman Islands, which does not levy any taxes on corporate profits. By designing appropriate transfer pricing policies that shifted money to tax havens, Enron's profits of US\$1,785 billion for 1996-2000 attracted no taxes. Using the same mechanism, it also avoided taxes in developing countries such as India.⁵¹

Each year some 200,000 new companies are being formed in tax havens; the cumulative number could be as high as three million.⁵² This practice enables corporations to devise complex corporate structures, suitable transfer prices for tax reduction and money-moving strategies. The favourite offshore vehicle is the international business corporation, which can be owned by a trust. Trusts are frequently fronted by accountants, lawyers and nominee directors. There are no public documents such as annual financial statements and the identity of the real owners remains unknown.

Of the 192 jurisdictions in the UN, at least 65 offer secret banking that, in some cases, is absolutely airtight. It has been estimated that more than 4,000 banks operate in the offshore world; most of them have no physical presence anywhere.⁵³

A significant percentage of FDI is also channelled through tax havens to provide zero tax jurisdictions that accumulate profits through the mechanisms discussed in Section 4. Another equally important reason for using these jurisdictions is the secrecy they provide, which makes detection very difficult and minimises the likelihood of being caught by tax authority investigations.

For example, the Cayman Islands – a tax haven of about 50,000 people – had an inward FDI stock of US\$25 billion in 2000. While this is very high for such a small population, the real story unfolds when we look at the stock of outward FDI, which was more than US\$20 billion.⁵⁴ So investment is merely being routed through the tax haven. Liberia – one of the poorest and most inhospitable countries in the world – had an inward FDI stock 483 per cent of its GDP in 2004, while outward FDI stock for the same year was a staggering 280 per cent of GDP.⁵⁵ As a tax haven, it is attractive for foreign investors, with the corporate entities registered here using mis-invoicing and mispricing trade and financial transactions to launder profits in these zero-tax subsidiaries.

Capital flight out of Russia – the role played by tax havens and banks⁵⁶

Nauru is located in the South Pacific, measures eight square miles, has a population of 11,000, requires no disclosures and has no taxes. Yet its secretive and permissive regulatory environment meant that it played a central role in the pillaging of Russia. 'The Russian Central Bank admitted that \$74 billion had been transferred from Russian banks to offshore accounts so far that year [1998], with \$70 billion going to accounts held by banks in the tiny Pacific island of Nauru.' The phenomenon was shocking by any standards '...with one single offshore bank registered in Nauru alone

acting as a turning point for \$3 billion of illegal flight capital from Russia to the United States.'

When a journalist visited the island in 2000, the country's entire banking system appeared to be contained within a shack stuffed full of computers and air-conditioners. 'I knocked on the door, and it opened slightly to reveal a woman holding a broom: "the cleaning lady of the new global economy". She wasn't particularly hostile when I asked if there was someone inside I could talk to. But she said that there wasn't and that I should telephone. When I asked her for the number, she said she didn't know it and closed the door.'

Offshore services: an invitation for capital flight, corruption and tax evasion?

Sovereign Group and Offshore Fox both sell offshore services on the internet. We examined them here in order to highlight the role played by professional offshore firms, the lawyers and accountants they employ, and tax havens in general, in soliciting and enabling the flight of capital.

The **Sovereign Group**,⁵⁷ a prominent offshore specialist that advertises regularly in *The Economist*, says on its website:

Offshore companies can be used extremely effectively to mitigate tax so most onshore countries have now enacted anti-avoidance legislation designed to limit or remove these tax benefits.

There will normally be ways in which a company can be structured to avoid being caught by this anti-avoidance legislation but a simple traditional offshore structure will rarely be able to legally reduce tax and a more sophisticated structure will be required, in addition to skilful ongoing management. Expert advice is crucial as a bad structure may actually increase tax and even lead the promoters into criminal liability.

Some jurisdictions require a public record of the details of the shareholders to be maintained. In such cases, nominees or trustees will frequently hold the shares allowing the beneficial owner to retain anonymity.

Where we are not providing directors the client may choose to have mail directed to his own address but this is rarely advisable as the connection between the client and the company will be revealed and it is sometimes not convenient for a client to receive mail issuing out of a recognised offshore financial centre. For these reasons we offer to provide re-mailing and other office services out of the jurisdiction of incorporation or out of one of our other Group offices located in Hong Kong, London or elsewhere. When we receive mail we will re-package it into a plain envelope and can arrange for it to be posted, according to your instructions, directly from the place of receipt or via one of our onshore offices to ensure that correspondence is not received at your home address bearing an offshore postmark and the name of your company. In this way confidentiality which would be lost if mail was received directly can be maintained. Faxes, e-mails and telephone calls can be dealt with according to agreement to further ensure confidentiality.

Sovereign frequently provides directors who reside and meet offshore. This prevents a company being considered as resident in the high tax country where the owners reside. These directors will, after careful consideration, normally carry out the wishes of the ultimate owner but, if the tax status of the company is not to be prejudiced, those directors must be capable of demonstrating that they exercise independent mind and management.

Offshore Fox, another well-visited website,⁵⁸ is less circumspect in its advice and states:

It will be of interest to many that jurisynergy [a technique of using structures that combine the useful legal features of several jurisdictions] makes financial anonymity wholly possible by carefully constructing an entity from a number of different parts (aspects) of relevant jurisdictions. Little-known facts concerning bank secrecy laws and customs in certain banking centres, as well as fiscal loopholes existent in wholly unlikely – and therefore very low profile – jurisdictions can be amalgamated to form the desired result.

1. Utilise differences in regulatory systems – regulatory arbitrage – to achieve a given result: privacy, anonymity, low tax, no tax or whatever.

2. Disguise or obscure the fact that the structure was designed for the purpose mentioned in (1) above. It is crucial that the visible portion of the structure – that which may be open to scrutiny – be formed in a low profile (i.e. non-traditional offshore haven) jurisdiction.

3. Be structured in such a way as to allow the maximum amount of flexibility to integrate any new regulatory opportunities that may arise which contribute towards the attainment of (1) above in the event of better conditions becoming available, or as a result of regulatory changes adversely affecting the structure's primary purpose. Jurisynergy-compliant structures offer what a traditional offshore fit-all solution cannot. They do not stand out as being primarily for the purpose for which they are intended, and as such will not attract the undue scrutiny of any prying authority or a paranoid bank officer. They are flexible enough to withstand the continuously changing regulatory map and use this for both beneficial and defensive means. It is interesting to note the existence of grey-area "transfer pricing" schemes, specifically serving those who seek to transfer funds offshore in silence. This is an area that has grown rapidly in response to client demand.

Reading these solicitations, it is not difficult to see how blatant the 'pull factors' for capital flight can be.

7. How big a problem is capital flight?

According to Raymond Baker, a widely respected expert, developing countries lose US\$500-800 billion in untaxed money that leaves their economies unrecorded every year.⁵⁹ This flight of capital is a multiple of the US\$104 billion that developing countries currently receive in aid. As becomes clear later in this section, annual capital flight exceeding 5 per cent of GDP is common for a number of developing countries. Clearly, capital flight is undermining and overwhelming the various inflows of aid and investment in many of these.

Tax losses on money that has leaked out as capital flight are worth hundreds of billions of dollars. This is money that could easily be used by developing country governments to provide essential services to their citizens in the form of basic healthcare, education and clean drinking water. Clearly capital flight and the tax evasion associated with it are severely impeding development and, unless checked, will soon prevent even the modest millennium development goals from being met.

By definition, quantitative information on this subject is hard to acquire, and different estimators use different methodologies. The estimates below are not strictly comparable, but together they serve to give the best snapshot we could create of the magnitude of the problem.

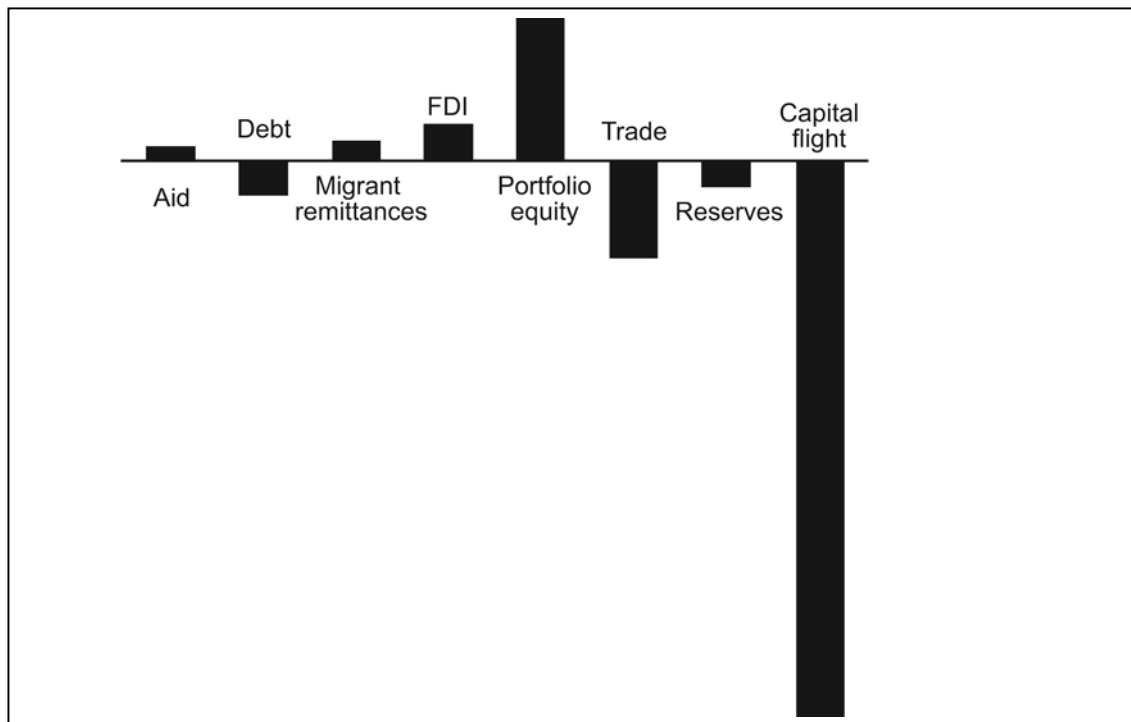
7.1 Estimates of annual capital flight

To get an idea of the sheer magnitude of capital flight, especially when compared with other forms of inflow and outflow, we use the estimates of academic expert Gerald Epstein on South Africa as an example. Although the figures may appear extreme, South Africa is by no means alone in suffering leakages of this magnitude. This is a crisis that is shared by many other developing countries in all income categories.

During the 20 years from 1980-2000 the extent of accumulated capital flight (sum of annual flows) from South Africa was 36 per cent of the value of productive capital (cumulative gross fixed capital formation) for the same period. During the last 13 years of apartheid, average annual capital flight was 5.4 per cent of GDP. In the post-apartheid period it rose to 9.2 per cent a year, resulting in an average of 6.6 per cent a year over the 1980-2000 period.⁶⁰

Graph 1 sums up the main external financial flows in and out of post-apartheid South Africa between 1994 and 2003. Net outflows were as high as US\$94.2 billion – more than 7 per cent of cumulative GDP over the same period.⁶¹ This clearly illustrates the overall message of this briefing: if rich countries are serious about tackling poverty they need to act immediately and decisively to reverse the direction of capital and resource flows and allow developing countries to retain and build their own domestic resources – supplementing them with aid where necessary. This is the only way to attain sustainable development.⁶²

Graph 1: Major sources of external finance inflow and outflow for South Africa between 1994 and 2003 (US\$ billion)



To show that South Africa's shocking level of capital flight is not an anomaly, we consider a few more examples:

- Capital flight out of China between 1990 and 1998 is estimated to be about US\$580 billion, an average of about 10.2 per cent of Chinese GDP every year in the period.
- Thailand has a capital flight stock in excess of US\$155 billion⁶³ accumulated over just 20 years from 1980 to 2000.⁶⁴
- Indonesia has leaked more than US\$221 billion of funds which are now worth well over US\$353 billion.⁶⁵
- *Goskomstat* (now known as the Federal Statistics Service) estimated that between 1990 and 1995 alone, up to US\$400 billion of capital may have been taken out of Russia and sent to the US, UK, Cyprus, Switzerland, the Netherlands and Denmark.⁶⁶

7.2 Estimates of capital flight stock

When capital flees a developing country, it is usually deposited in a bank and then invested to generate profit for its owners. Much of it ends up being invested in real estate, equity and bond markets and hedge funds. Because it has been invested for profit, the amount of private wealth held is likely to increase over time. Also, every year more capital that has fled developing countries gets added to the existing amounts that are held offshore.

For both of these reasons, the amount of flight capital held offshore is likely to increase over time. This constitutes the stock of capital and is likely to be a significant multiple of the annual flight of capital from a country.

One estimate of the stock of capital flight comes from the Tax Justice Network, who calculated the amount of funds held by individuals in tax havens that are undeclared in their country of residence to be in excess of US\$11.5 trillion.⁶⁷ However, this figure is known to be a significant underestimate of the total stock of capital flight from developing countries as it does not include the wealth of individuals held outside the country of origin and outside tax havens. Nor does it include the capital flight that comes about as a consequence of the actions of multinationals, which is likely to be significantly greater than this money. Finally, the figures are incomplete for both high-net-worth individuals⁶⁸ and they do not account for the wealth of non-high-net-worth individuals who are likely to be more numerous, though the wealth they hold will also be lower.

Another estimate of wealth held offshore comes from Baker (see Table 3),⁶⁹ and includes a breakdown of the continent of origin: the amount is well in excess of US\$8,000 billion, a significant chunk of which comes from Africa, Asia, Latin America and the Middle East. Again, though, it should be noted that the figures do not include non-financial assets such as real estate or tangible assets such as works of arts and boats, so are likely to be a highly conservative estimate.

Table 3: Offshore holdings of high-net-worth individuals (US\$ trillions)

Area	Total holding (US\$)	% offshore	amount offshore (US\$)
N America	7.4	34	2.5
Europe	8.8	31	2.7
Asia	5.7	30	1.7
Latin America	3.6	31	1.1
Middle East	1.1	27	0.3
Africa	0.6	33	0.2
Total world	27.2	31	8.5

Source: Raymond Baker *Capitalism's Achilles Heel*, 2005 using Merrill Lynch/Cap Gemini Ernst & Young World Wealth reports

A report by the UN Industrial Development Organization (UNIDO) has indicated that the private assets of Nigerians in the UK alone stand at over US\$20 billion, while overall, more than US\$107 billion or 70 per cent of Nigeria's private savings are stashed abroad.⁷⁰

In fact, much of Africa's ill-gotten wealth is stashed abroad. The UN Economic Commission for Africa (UNECA)'s 1999 *Economic Report on Africa* stated that roughly 80 cents of every dollar that flowed into Africa from foreign loans flowed back out as capital flight.⁷¹ Foreign exchange made available by new borrowing is transferred aboard illicitly through unscrupulous wire transfers or the over-invoicing of imports, etc. This does not mean that the borrowed money itself flows out immediately, though that can happen when the abuse is especially egregious – as in the case of

Mobutu who, when he was the dictator of the Congo, ordered the central bank to transfer hundreds of millions of dollars lent by the IMF to his personal accounts.⁷²

Boyce and Ndikumama estimated that, between 1970 and 1996, total capital flight from a group of 30 sub-Saharan African countries (excluding South Africa) amounted to US\$187 billion, and that:

...adding imputed interest earnings, the stock of Africa's capital flight stood at US\$274 billion, a sum equivalent to 145% of the debts owed by those countries [in 2001], just as the home governments grapple with the problem of capital inadequacy and the dearth of long-term investment funds. In other words, sub-Saharan Africa is a net creditor to the rest of the world: its external assets exceed its external debts. The difference is that the assets are private and the debts public.⁷³

These assets, which are held offshore, constitute capital flight: during the decades in question, it was illegal for the citizens of most African countries to hold wealth abroad.

During the international debt crisis of the 1980s, private assets held abroad belonging to citizens of some Latin American and African countries were equal to, or even greater than, the size of the country's external official debt. These individuals were creditors to the world economy at the very moment their countries were experiencing debt crises.⁷⁴

Table 4 collates capital flight stock estimates from a number of academic studies to illustrate the magnitude and significance of the problem. While the methodology used in various studies is not the same, the figures are comparable at an 'order of magnitude' level. The estimates show that annual capital flight figures exceed 5 per cent of GDP for a number of developing countries, and highlight the pernicious and widespread existence of the problem of capital leakage, which affects developing countries at all levels of income in all geographical locations.

It is important to keep in mind, however, that these estimates are likely to be highly conservative and that the real figures for capital flight from Africa (and other regions) are likely to be significantly higher (see Box 8).

Why these numbers are likely to be significant underestimates⁷⁵

The studies used to estimate the numbers for capital flight [from Africa] are all likely to have a strong bias towards underestimation because [they]:

- (i) omitted a serious analysis of BoP [balance of payment] errors and omissions from 1970 onwards
- (ii) fail[ed] to adjust nominal dollars into equivalent recent dollars
- (iii) all are focused exclusively on sub-Saharan Africa (capital flight from Morocco, Egypt, Tunisia and Libya is very large as well)
- (iv) all omitted the large kickbacks from infrastructure and defence supply contracts that finance a significant proportion of capital flight (e.g. the corruption element in a single water project – i.e. the Lesotho Highlands Water project was estimated to be about \$300 million or around 15% of total project cost, whereas estimates for kickbacks under power and water and road/rail

- construction projects across [sub-Saharan Africa] usually range between 25-40% of total contract cost)
- (v) most omitted altogether the capital flight figures from Zaire/Congo (which are probably twice as large as Nigeria's as almost everything extracted there finds its way out via capital flight) since official figures were unavailable
 - (vi) also omitted capital flight figures from Angola between 1970-95 for the same reasons.

Table 4: Capital flight from developing countries (1972-2002)

Country	Period/year of calculation	Stock of capital flight (US\$ billions)	Stock/GDP (GNI) (%)	Source
South Africa	1980-2000	370	285	Esptein et al
Nigeria	1970-1996	129.7	367	Ndikumana and Boyce
Angola	1985-1996	20.4	268	Ndikumana and Boyce
Burundi	1985-1996	1	109	Ndikumana and Boyce
Cameroon	1970-1996	16.9	186	Ndikumana and Boyce
Cote d'Ivoire	1970-1996	34.8	325	Ndikumana and Boyce
Ethiopia	1970-1996	8	134	Ndikumana and Boyce
Mauritania	1973-1995	1.8	167	Ndikumana and Boyce
Mozambique	1982-1996	6.2	218	Ndikumana and Boyce
Rwanda	1970-1996	3.5	250	Ndikumana and Boyce
Sierra Leone	1970-1995	2.3	257	Ndikumana and Boyce
Zambia	1970-1991	13.1	355	Ndikumana and Boyce
Russia	1992-1997	158	40	Konstantin Loukine
Argentina	2002	115.3	122	Florian Kaufmann
Venezuela	1990-1998	45.6	52	Niels Hermes
Chile	1990-1998	27.8	36	Niels Hermes
Philippines	1970-2002	77	95	Esptein et al
Thailand	1970-2002	71	57	Esptein et al
Indonesia	1970-2002	221	114	Esptein et al
China	1990-1999	580.4	54	Esptein et al

8. What can be done to stop capital flight?

In 2005, the UK admirably led efforts to put development, debt cancellation and increased aid flows on the agenda of the G8. Though some progress was achieved, Christian Aid has advocated that the UK can and should do much more on both fronts.⁷⁶

However, the UK and other rich countries have up to now ignored the key role capital flight has played in undermining efforts to finance development. In fact, capital leakages are undermining UK and other rich-country efforts to increase aid flows and cancel debt in various parts of the world, especially Africa.

Among rich countries, the UK has a special responsibility to raise and tackle the issue of capital flight because more than most other countries, the UK and its institutions sit right at the heart of the complex web of structures and actors who facilitate the illicit leakage of capital from the poor developing world. UK crown dependencies such as Jersey, Guernsey and the Isle of Man are well-known tax havens, as are overseas territories such as the Cayman Islands and the British Virgin Islands. Also, UK banks,

accountancy firms and multinationals are involved in the practices described in this briefing as much as those from any other country.

The issues have been addressed to some extent in various international initiatives and agreements – for example the 1998 OECD Proposals on Harmful Tax Practices and the 2005 EU Savings Tax Directive – but these are very partial in what they cover, and the former has not been fully implemented. The EU Savings Directive requires automatic exchange of tax information for individuals – a good precedent – but also needs to apply to companies and be extended to tax havens outside Europe.

The bribery aspects of capital flight have been addressed by the UN Convention on Corruption and the OECD Bribery Convention. Again, these have not been fully implemented. The Commission for Africa report⁷⁷ asks western governments to inform their African counterparts of ‘suspicious’ transactions associated with corruption, and the UN World Summit in September 2005 stated that ‘We resolve...to support efforts to reduce capital flight and measures to curb the illicit transfer of funds.’

9. Conclusion and recommendations

Christian Aid views capital flight as nothing short of a crime against society because it diverts hundreds of billions of dollars away from essential, life-saving expenditure on health and other services, undermines the development process and stops our fellow citizens in the poor world from determining their own fate. It is also anti-democratic and undermines respect for the rule of law.

In order to address the serious development challenges posed by capital flight, we recommend that:

1. The UK government show more political commitment

We recommend that the UK champion tackling the twin problems of illicit capital flight and associated tax evasion in international and national forums on development. A first tangible step would be for the UK to take this issue up alongside the debt, aid, trade and climate change discussions that take place at forums such as the G8. The UK also needs to push for the international finance institutions, the UN, the EU, the OECD and other international institutions to explicitly factor capital flight into their analysis of development policy and take urgent steps to fight it.

We recommend that DFID immediately commission independent research into the seriousness and magnitude of these problems, with a special emphasis on the role played by the UK and UK-based institutions in facilitating capital flight and tax evasion from the developing world.

2. The international community adopt a standard that would require MNCs’ operations to be transparent

At the moment, companies are not required to report enough detail about their operations, their tax payments and even their ownership to enable governments to claim the tax that is fairly due. The UK should support the adoption by the International Accounting Standards Board of the accounting standard proposed by the Tax Justice Network. Under this standard, MNCs will be obliged to reveal the scale of economic activity, profits and taxes paid in each jurisdiction where they

operate. This information clearly already exists in their internal records, so it would only be a matter of making it public. It will help make it easier to identify the use of dubious transfer pricing practices, allowing the relevant authorities to take appropriate action against offenders. Such a standard will also expose the widespread use of tax havens.

3. The international community tackle tax havens

The key to tackling tax havens is to ensure that all countries require their financial institutions to reveal information to tax authorities, and that such information is exchanged between countries. International agreement is needed on the following recommendations, but the UK can also act unilaterally in its own right, and put pressure on its crown dependencies and overseas territories to act:

- **Increase banking transparency:** All countries need to modify banking laws and practices to increase banking transparency. This would give tax authorities access to the data they need to ensure that taxation liabilities are correctly reported and assessed. Banks and other financial institutions should be required to disclose all the income they pay to their customers (both individuals and company) to the governments of their country of residence. This would include interest, dividends, royalties, license fees and other income. The banks should make this disclosure in response to any enquiry from a country, without requiring proof of possible wrong-doing.
- **Automatic information exchange:** All banks and other financial institutions should be required to exchange information on all sorts of income earned in their country, with the government of the income earner's country of residence. This would enable the country of residence to levy appropriate taxes from the country in which the income was earned. This requirement should extend to trusts whose beneficiaries reside in territories other than where the trust is administered, and to private limited companies where a majority of the beneficial shareholders live in a country other than that in which the company is incorporated. For this to happen, trusts and companies would need to file information on their income and ownership with the territories in which they are registered, which is rarely the case at present.

4. Countries take legal action on capital flight

The handling of the proceeds of capital flight, and aiding and facilitating capital flight, should be made a crime with strict penalties that might include suspending a bank's banking licence and revoking accountants', lawyers' and other professionals' licence to practice. Criminal penalties should also be considered in the most egregious cases of abuse.

5. Countries ensure that existing flown capital is repatriated

A huge stock of capital and stolen assets is currently deposited and invested in UK (and other western country) financial institutions. It is imperative that governments act to return this wealth which rightfully belongs to the citizens of developing countries – especially in the context of the urgency of meeting the MDGs and triggering a process of sustainable development. The UK has been very slow to act, for example, on returning the stolen money stashed in UK banks by the Abacha family.

A system must be put in place – as called for both by the Commission for Africa report and the UN Convention on Corruption (UNCAC) – to ensure that all assets held by UK banks are scrutinised for origin, and that information on those found to be owned by developing country residents is conveyed to the respective governments. This should ideally be part of a broader international initiative, but the UK can also act unilaterally. UK financial institutions should be given a time limit to disclose the relevant information, cooperate in the repatriation of these assets or face prosecution. The UN Convention on Corruption, which the UK has recently signed, specifically calls for states to commit to asset repatriation.

6. All countries tackle mis-invoicing

Automatic exchange of import-export and taxation-relevant information, the maintenance of automated databases and providing technical assistance and expertise to developing country governments – specifically customs, revenue and bank supervisory authorities – would go a long way in tackling the enormous challenge posed by mis-invoicing.

Countries must adopt legal measures to limit the falsification of trade prices. Signatures could be used on a document stating that the price is the real price; the document could then be backed by inspection and price-verification and buttressed with severe penalties for any violations.

Custom authorities need training in techniques to help them detect mis-invoicing. These include: statistical tools; pre-checking information on invoices before the goods arrive in port; quicker and more efficient data exchange between developing and developed countries; focusing on the channels and goods most likely to be used for capital flight; and severe penalties for any infringement. Mis-invoicing specialist Simon Pak underscores the need for computerised assistance in order to be able to efficiently and cost-effectively scan the huge amounts of trade entering and leaving a country daily⁷⁸. The increased trade in services does, however, pose a severe limitation to this approach.

Both in the interest of efficiency and to help check mis-invoicing, an international system of tracking goods containers worldwide and seizing goods that do not match the documents should also be considered.

7. International efforts to tackle bribery be improved

The UK is a signatory of both the OECD Bribery Convention and the UN Convention on Corruption, both of which are designed to prevent bribery. However, the OECD Convention needs to be better enforced, and the UNCAC needs a better monitoring mechanism if it is to be implemented properly.⁷⁹

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- ³ Jeffrey Sachs et al, *What It Will Take to Meet the Millennium Development Goals*, Sustainable Development International, 2005.
- ⁴ Commission for Africa, *Our Common Interest*, March 2005.
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- ⁷ According to Jack Blum, the renowned US attorney who led the US senate investigation into the BCCI bank collapse and who is considered to be an international expert on capital flight.
- ⁸ James Boyce and Léonce Ndikumana, 'Is Africa a net creditor? New estimates of capital flight from severely indebted Sub-Saharan African countries, 1970-1996', *Journal of Development Studies*, 38(2) (2001) pp 27-56.
- ⁹ This is technically known as the residual in the balance of payments (BoP) account.
- ¹⁰ While money lost through legitimate means also constitutes a loss for the country, it is outside the scope of this paper.
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- ¹² Ibid.
- ¹³ Ibid.
- ¹⁴ Christian Aid UK, *A Rich Seam: Who Benefits from the Rising Commodity Prices?*, 2007.
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- ¹⁷ Raymond Baker, *Capitalism's Achilles Heel*, 2005.
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- ²⁴ Ibid.
- ²⁵ J D Gramlich and J E Wheeler, 'How Chevron, Texaco and Indonesian government structured transactions to avoid billions in US income tax', *Accounting Horizons*, Vol 17(3) (2003) pp 107-122.
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- ²⁸ See Section 3 on mis-invoicing of trade transactions
- ²⁹ Raymond Baker, *Capitalism's Achilles Heel*, 2005.
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- ³¹ 'Microsoft to hide Irish tax haven data of subsidiaries that have saved it billions of dollars in US taxes', *Finfacts Ireland Business News*, 9 March 2006; 'American ingenuity, Irish residence', *New York Times*, 17 November 2005; Neil Callanan, 'Top 100 companies make €20bn', *Irish Sunday Business*, 18 December 2005; Wearing of the Green: Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe, *The Wall Street Journal*, Nov 7, 2005; Microsoft Unit in Ireland Tops List, *The Wall Street Journal*, Dec 20, 2005; Plan Would End Use of Tax Havens for Patents, *The Wall Street Journal*, Feb 8, 2006
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- ⁶³ This figure includes imputed interest costs (as opposed to the figure in the lower table [what lower table? if you mean table below, specify table number], which does not).
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- ⁷⁸ Christensen J, Kapoor S, Murphy R, Pak S & Spencer D, *Closing the Floodgates*, Tax Justice Network, 2007
- ⁷⁹ For more detail on these, see the forthcoming Christian Aid briefing on corruption, 2007.