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Charity Registration Number: 208223

## Transcript

# Fragile States, Capital Flight and Tax Havens

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25 September 2013

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### **John Christensen:**

Good evening everyone. Welcome to this event on 'Fragile States, Capital Flight and Tax Havens'. Before we start, just a couple of housekeeping points. We can note that this is an open event – the Chatham House Rule doesn't apply and you might be quoted. And I understand this event is also being recorded, so if you have any objections please let us know.

My name is John Christensen and I'm director of Tax Justice Network, which is a network which has a particular focus on the issues we're addressing this afternoon: capital flight and tax havens. With me we have a very distinguished panel, and I'll introduce them to you in a few minutes time. I'm delighted that we have this panel with us. The panellists will speak for approximately seven or eight minutes each and then we'll open up the discussion on the floor.

Our speaking order this evening: Ronen Palan will speak first, followed by Ginny Hill, followed by Stefan Dercon. I'll introduce Ronen first. Ronen is professor of international political economy at City University London. His study, which I've been musing over for many years – his earlier study – he describes it as intersecting between international relations, political economy, political theory, sociology and human geography. Sounds like a good excuse for dipping into everything and trying to understand what's going on across the world. But his theoretical work, and this is where our paths have crossed now for over 12 years, is on the role of tax havens in the global economy and how they have played a very important part in shaping what we know as globalization, and in attracting capital uphill from south to north – rather than sending capital downhill from north to south, as market liberalization theory would suggest should happen.

So Ronen is going to speak first, then Ginny is going to come in. Ginny is associate fellow here in the Middle East and North Africa section at Chatham House, on the Middle East and North Africa Programme. She is the founder and runs the Yemen Forum. Her book, *Yemen: The Road to Chaos*, – says it all, doesn't it? – provides what I think is the essential background to that country's Arab Spring uprising. Ginny is a former journalist and filmmaker. She has reported extensively for Al Jazeera, BBC, Channel 4 News and ITV.

By no means least, Professor Stefan Dercon from DFID, chief economist at DFID, and professor of development and economics at the University of Oxford, associated to the Department of International Development and the Centre for the Study of African Economies. He's worked extensively in Africa and India, and at DFID he has the role of focusing on how to improve the quality of development policy design.

I'm hoping we're going to hear from our speakers – not necessarily completely conflicting positions – but we'll hear different positions which will help to shape a very lively debate. Without further ado, Ronen, would you like to open up, please?

### **Ronen Palan:**

Thank you very much, John. Luckily I've got only seven minutes so I can concentrate on generalities, describing the role of the offshore world and its relationship with development in a very broad sense.

I think my first point is that we tend to envision the world as divided between large continental economies – the United States, or perhaps even America, Europe, Asia, the rising Asia – and so on and so forth – and Africa. But in fact there is another continent out there, if you look at the data, and that continent is called the offshore world. It's the size of a continent in the sense that when we look at the estimated figures of assets that are registered through this world of offshore, we are looking at figures now of \$25–30 trillion. So this is a very large economic, in a sense, continent. That's changed completely, I think, the way we should think about financial trade, finance, wealth and the way the world economy operates. It operates through this particular world called the offshore world.

The figure of \$25–30 trillion is not my figure – I don't know how to count to three. It's a figure that a friend of ours called Jim Henry, who was chief economist at McKinsey, came up with on the basis of various triangulations of different data. That's the figure that many people, for example the Tax Justice Network, believe is probably closer to the truth than the other figures.

What does it mean? The figure that he came up with is \$25–30 trillion. Out of this, more than \$9 trillion, he estimates, have escaped countries which are called middle and low-income countries. So actually most of the funds from the offshore world are from what you may call the north. But there are serious figures also from developing countries: \$9.5–10 trillion is serious money.

Other research shows that, for example, sub-Saharan Africa – and there were two separate researches that showed that in the last 30 years, sub-Saharan Africa has collectively lost about \$1 trillion in money. That in fact sub-Saharan Africa is losing capital, not gaining capital – is in fact funding the world out there. The same evidence appears in other countries as well. So that is very significant. What does it mean that so much money effectively is directed from developing countries to developed? Most obviously, these countries are

starved of necessary resources. I think that's what most people focus on. It's expensive to run a modern state – it's very expensive. States that are particularly successful in today's world – and these are states that are successful in terms of GDP per capita and so on and so forth – are extremely expensive. That's why actually taxation is quite high in this country. Many of these countries that we call 'fragile states', of course, lack basic capital – money simply for investment. They rely on investment from the World Bank, they rely on help. But in fact, and that's the paradox, they are capital exporters at the same time. So we have a serious problem.

But that's a quantitative problem – which is very serious and I don't want to understate it, but it's only part of the issue that these countries actually encounter. The other problem, and it's difficult to quantify, is qualitative. That's to do with the nature of the relationship between government and the people within these countries that evolves under conditions where so much money, so many resources, are being taken out of these countries. When we talk about developing countries, it's really a matter of, what are the resources? If we have raw materials – a country which is rich in raw materials – there will be a lot of capital flight; countries that are poor, there will be less. But most of them, all of them, are losing money.

When the elite in these countries have the ability to take so much money out when their wealth, when their future, when their business propositions are basically linked to a world out there running through offshore, they don't need to negotiate with their own population. The negotiation with the population takes the form of what we call patrimonial relationships: those people who want to be part of that particular business have to find more personal relationships, based on either personal relationships or ethnic relationship – relationship to a particular group or people in power. What we don't have is the emergence of what we saw in Europe, which took a long time, through negotiation between government and people: the development of institutions – the development of those institutions of governance that we associate with developing countries that have been very successful.

The third aspect is also more pernicious, and that aspect is that in many countries when they are facing or engaging with a very viable, sophisticated commercial centre like Cayman Islands or Singapore, say – near Thailand – what you find is, in a case like Thailand, it has difficulties developing its own financial centre. It relies on Singapore. As a result, it's very difficult to raise money in Thailand, or in many of these countries. It's very difficult. They always have to go through offshore. Middle-sized businesses, small businesses, have difficulties raising funds. There's no money in these

countries. They have to raise funds normally through personal relationships, personal contacts. Again, it reinforces the patrimonial system.

I want to talk about the solution but I don't think I have time for that, do I? I have. Of course the offshore world and tax havens are now very – there is much talk about them. But the proposals now being discussed, and I think many of them are quite serious, will not address the issue of development. The reasons are two. The proposals being now proposed are basically for countries, say like Britain or France, to be able to engage with the countries or jurisdictions, like Cayman Islands and others, in order to find information about certain companies. So it's between states. It's an inter-state relationship. That's what, for example, the OECD is proposing. That's one principle that's being set on the table. The problem with the countries – and you'll hear about Yemen in a moment – is the government is very unlikely to investigate itself. So the system of regulation that now is being proposed based on intergovernmental relations is not going to work.

The second principle that now I think is becoming even more significant, I call it the NIMBY principle: not in my backyard. Basically, the United States, Europe and Japan are saying: you can set up companies, you can move to offshore or wherever you like, but not in my backyard. If you want to invest in the United States or Europe, you have to follow my own rules. Or China – China, of course, does that. But I'm afraid developing countries will not have the power to impose that particular principle of NIMBY.

So they are left between the cracks, and I think the situation that they are facing is quite grim at the moment. I tend to be an optimist, generally speaking, but from this perspective the situation does not look particularly promising.

### **John Christensen:**

Thanks, Ronen. It's interesting, until very recently China was seen as an outlier, not engaging in this. Just this month China has now signed up to many of the processes, including automatic information exchange. So China is joining the OECD community, is very much interested in protecting its own backyard, but no sign whatsoever of engagement with developing countries. That's a good opportunity now to turn to the particular situation of Yemen and its problem with capital flight.

### **Ginny Hill:**

Thank you. I'll start by just giving a little bit of detail about human development indicators in Yemen and the structure of politics, and then I'll talk about the transition that Yemen is going through as a result of the Arab Spring uprising. I'll try to link it in to what we just heard from Ronen about patterns of capital flight and the impact that they have on state-building processes.

Yemen is the poorest country in the Middle East. Yemenis, especially Yemeni children, are among the hungriest people in the world: nearly half the population don't have enough food to eat, according to the latest statistics from the World Food Program. Yemen is highly dependent on oil, but oil is running out. The country went past peak oil in 2002 and it's now producing less than half of what it was producing in 2002. At the moment there is no viable alternative to fill the gap in the state budget.

Before the Arab Spring uprising in 2011 there was a civil war that had been going on for six years in the north. There was a southern separatist movement and Al-Qaeda in the Arabian Peninsula was considered to be one of the greatest threats to national security in the United States and other Western democracies.

Yemen has a very weak state structure and a highly factionalized elite. The army was not really run as a state institution at all – it was run as a series of personal fiefdoms. In 2011, when young people came onto the streets in Yemen to protest against corruption, the army divided and the regime basically – the elite families divided between themselves. One group came to protect the protest camp and tried to position themselves as defenders of the revolution. Essentially the uprising provided a catalyst that created a split inside the regime that was on the horizon already before the uprising.

That uneasy truce between rival elite factions has been holding since 2011 as a result of international mediation. The international community – particularly the UN, the British government, the US, the EU – have been trying to bring new political actors in Yemen into the political framework, under their supervision. That means women, young people – some of them marginalized political groups and identity groups that really didn't have very much access to the patterns of patronage that Ronen had described in his own presentation. We also see a caretaker president who is trying to oversee military restructuring in an attempt to bring the army under state control for the first time in Yemen's history, and a national dialogue which is the most inclusive body in Yemen's history – as I said, with young people and youth

taking part in the discussions. When the national dialogue reaches its conclusion, hopefully in a matter of weeks, the country is going to go through a process of constitutional reform before moving toward elections. In theory, that transition period was only meant to take two years and the elections would happen in February 2014. It looks like the transitional period is going to be extended.

But the crucial thing to understand is that although there's this enormous potential now for progressive change in Yemen's formal political structures, when you look at Yemen's political economy you see a rather different picture altogether. Under Ali Abdullah Saleh, who was president in Yemen for over 30 years, the political economy was built around an elite group of army commanders, tribal leaders, elite political figures and business people. This group was held together through marriage and patronage. Around 10 key families and business groups controlled more than 80 per cent of Yemen's imports, manufacturing, processing, banking, telecoms, and transport. Pretty much the commodity chain that keeps Yemeni households in food, water and gas is really controlled by this small group of families. This informal network which constituted the regime was much more powerful than formal government structures before the uprising in 2011.

When the protesters came onto the streets and the elite divided, these different factions and different family groups drew on their own personal resources in order to confront one another and in order to provide resources for their own supporters on the streets and within the political structure. But they kind of hit stalemate before the end of the year because they were quite evenly matched and they were starting to run out of money. In accepting the terms of the transition deal, including immunity for the former president, they basically came to an agreement amongst themselves that they would initially preserve their common advantage, at least, whilst the longer-term discussions were going on about the structure of the state and formal political change.

Our research shows that so far the sub-structure of the old regime really remains largely in place, with all evidence pointing to a kind of rebalancing of resources within the elite rather than any radical change or redistribution. It seems to me that Yemen's future depends very much on whether or not these elite rivals and these groups of rival families and business interests are more concerned about the threat posed to one another than they are about redistributing wealth, responding to popular anger and creating a fairer, more sustainable system that can survive the transition to a post-oil economy.

I'll just talk very briefly about the efforts of Western governments to support reform in Yemen over the last 10 years. There has been quite a concerted push, and the British government has played a really strong role in this, in trying to rectify some of the structural economic flaws that might put the economy on a more sustainable path. But in Yemen, as elsewhere, there's a tendency to view corruption and fragility in local terms, and sometimes regional terms. The remedies tend to be highly technocratic. But governance reform in Yemen and in other fragile states is a highly political process, and successive efforts to promote reform in Yemen have foundered on this question of elite incentives, and the absence of elite incentives to carry out these painful political reforms that would make life much harder in the short term for ordinary Yemenis – food prices would rise, and especially diesel prices would rise – but it would also have an impact on the patronage structures that are really holding things together in the absence of a formal state.

But the other factor to bear in mind is that not enough attention really has been paid, in my mind, to the interplay between domestic and international factors that have incentivized corruption in Yemen. Much of what passed for political activity in Yemen under the former president really constituted a squabble between these rival factions for a greater share of the economy. The goal of that competition was profit, but the profit didn't stay in Yemen. These different elite families and groups have their own private banking channels and they were using these banking channels to transfer large amounts of money out of the country into much safer jurisdictions, some of which may have been tax havens. The impact that this has had on the strength of state institutions, the governance environment and the security conditions in Yemen – it has undermined those crucial domestic tax revenues that would be used to build the state. So we see a really destructive cycle where weak institutions, weak property rights and low growth are providing a push factor which is encouraging people to send capital out of the country into a safer environment, but it's also perpetuating those problems in their own right.

Yemen was fifth amongst least-developed countries in the 1990s and 2000s for rates of capital flight. Really that competition began to intensify between elite factions in the late 2000s, and during the 2011 uprising our research shows that possibly billions of dollars were transferred out of the country. That was accentuated by the threat of sanctions which came from the UN Security Council, in an attempt to cease the fighting between these groups and reach a political solution.



To my mind, if these pull factors remain in place and if the structure of the political economy is not changed, new faces in government and even potentially new state structures are unlikely to alter the basic rules of the game of Yemen's political economy. To that sense, Yemen potentially is a case study for a systemic problem. The 2011 uprising saw youth activists come out onto the streets in their thousands, in a rebellion on the part of an entire generation – which is what it seemed at times – against political and economic corruption at the highest levels, and a mass outpouring of frustration that was caused by decades of unaccountable rule and economic marginalization. We've all seen this pattern elsewhere across the Middle East and North Africa during the Arab Spring, but it's also a pattern common to people who are working in fragile states.

Beyond that, it shares some characteristics with the activists in the Western Occupy movement actually, because it all comes down to the relationship between the markets and the state. I would like to argue that Yemen's uprising forms part of that global discussion about political representation and market forces in the wake of the global financial crisis.

### **John Christensen:**

Thank you. Stefan, do you recognize this position? How does DFID see these fragilities? It sounds to me like we have an extreme case here of the resource curse at its most harmful.

### **Stefan Dercon:**

Thank you. I'm going to make some, while trying to do my best to not agree with the two previous speakers – there is of course quite a lot you can agree with but I think in terms of leading to what do we do about it and how will change come about, I think I will actually differ here in terms of the views I am having. I'll be very careful: I'll make sure that I'm very clear of when I'm drifting into a more personal view of me as an academic from where the government may be or where it's going.

The relationship between illicit flows, capital flight and development is quite a tricky one, especially the relationship between capital flight and development. The point I will want to make is that capital flight is a symptom, not a cause. We have to be very careful that when we try to look for remedies that we think carefully through what it means to be a symptom – are we just treating the

symptoms or are we fundamentally dealing with some of the causes around it?

There was a time, when I was educated as an economist, that capital flight was also talked about all the time as the reason why, for example, Latin America wasn't functioning. Fundamentally, it was all a way of arguing against capital account liberalization and free flows of capital, and in fact arguments were all the time made about capital controls as the real thing – because that will make development take place. It's quite an interesting thing because we've moved a long way. We've moved a long way where there's actually a relative consensus that fundamentally the capital account – we need to be very careful about movements in and out of countries that probably – and even almost up to the IMF there will be voices – not necessarily everybody but voices – recognizing that certain types of quick movements of capital over borders are probably not very good for economies in the world economy. Think of deposit flows, people moving very quickly money around, as we've learned probably in the Asian crisis. That can't be very good. But at the same time, coming to a stronger conviction that actually flows of capital through investment and repatriation of profit are probably something – it's not the best idea to try to stop this. If we look at structures of African economies, we want to be a bit careful. I'm saying this from an economic point of view, not necessarily from a political economy point of view and whatever.

But the debate has moved to something else – to tax havens, to these kind of places – and certainly more about, can they cross the borders but where are they going to? That's quite an interesting thing which probably gets already closer – that indeed there is probably a more fundamental problem, not so much with controls on borders – because that actually will help and can be positive for countries, and blocking that will throw away the baby with the bathwater, that you actually focus on that.

I will add a sentence here. To many of our surprise, the UK government has taken on as the theme of the G8 – and I will be very honest about it. We're in DFID. Some people – and I dare to mention names of people like Paul Collier – got actually under the skin of leading politicians and talked about it: what could we do as the G8? The topic – and I remember a couple of years ago when it was put to me, I said the UK will never go for this – trade transparency and taxation.

**John Christensen:**

Why not?

**Stefan Dercon:**

Because you would have thought that's actually a very sensitive battle, a very tricky battle, a very messy battle. It's not about just two people go and tango, it's a really not very attractive Morris dance that would have to be played with lots of players. So you get in a very strange thing. Indeed, I will be saying – and I will be saying also as an official within government now – I'm surprised how far we got. I think there's been a remarkable sense that actually the debate has been open – we can have a debate and it's not anymore whether we should start thinking about it but how and how far will we go. I think we could be sceptical but there is definitely a sense of the progress we've seen, that certain elements are now and can be discussed. Indeed, tax havens can be discussed, we can talk about it.

In fact, some of the things that are in the communiqué of the G8 meetings actually are quite striking, by emphasizing the sharing of information but also looking for facilities and ways. Which means, in practice, if you are a government official like me, that actually you have to take steps to see how far you can get with it, including getting developing countries in. In practical terms, start working with HMRC to try and actually get certain things moving in countries – which, to be honest, five years ago would never be thought about. Similarly, on transparency initiatives, the kind of pressure to go well beyond the Bribery Act and actually looking for transparency and forcing firms to go further – partly shaming firms to do this, partly pushing them and showing them it's in their self-interest to do so – that's something right.

So I think there's a whole series of things that are quite positive steps. I think we can clearly go further, and many of us would like to go further, but that's there.

But now I come to the final point. How does this solve the case study? How does this solve something? What traction will we get in terms of places like Yemen? I would actually argue that it will have more traction in the Mozambiques of the world, in the Tanzanias of the world, where the murky world we are dealing with is slightly less murky, than actually going to some of the kind of really extreme rent-seeking states – states organized around rent-seeking, as we would have in Yemen. Then we have to be very careful. When we go in more degrees of fragility, this is not going to solve fragility. Tax havens are not going to solve this. If we think of what are the binding

constraints – I spent a summer in Congo, in DRC; there were always houses in Brussels to be bought. You don't need tax havens to get the houses in Brussels to be bought. You will always be able to get licit, if that's the word, flows to get out. The state that is the state you describe, that is organized around rent-seeking, will have ways of organizing legal rent-seeking. In fact there is a huge amount of legal rent-seeking taking place, organized by the most fragile states.

So just focusing simply on solving the legality of these flows, so basically changing the pull factor, I'm actually quite convinced this is not where the solution lies. The solution lies in the ugly fight, the really difficult fight in development: engaging with these countries and – even if for 10 years we don't get very far – to try to look for better and better ways of doing it, and keep on doing it. Because fundamentally, capital will keep on flying from these places as long as capital has no reason to stay. The key point here is: that's where the cause is. The capital is going because it's not in anyone's interest to invest it in Yemen. The investment climate and political economy are such that actually productive investments don't make any sense. Then we go – and there's the political economy interaction between the economy and the politics and the rent-seeking structure – that's the only thing. As long as that doesn't start changing, we won't get anywhere.

There are countries, Latin American countries, where people thought a curse was there – there are changes happening. In fact there are more and more reasons for capital to stay in Latin America. That is not the debate we are having anymore, like we had in the 1980s, about Latin America. Similarly, there are African countries where the investment opportunities are rising because the investment climates are improving, where bit by bit political economy and transparency start increasing inside a country. We can have five elections that are run smoothly in Ghana; the result is actually it's quite an attractive place to invest in, and actually we start getting these things.

That is the fight and I think that is the binding constraint. I would say we keep on working on some of these pull factors but we have to be realistic to get some of these places sorted out. The solution lies to a strong extent also in whatever we can achieve in these places. It will be an ugly fight but it's a fight worth fighting.