



Follow the Money: Krishen Mehta on Capital Flight

Krishen Mehta , Julia Taylor Kennedy

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[Krishen Mehta](#)

JULIA KENNEDY: Welcome to Just Business, a series of interviews on global business ethics.

Today we're talking about capital flight, ways that developing countries lose their wealth. Recent commentators have decried the movement of money from Egypt, Tunisia, Libya, and other countries to Western institutions.

To explain where this money is going I'm joined by Krishen Mehta. He's a former partner with PricewaterhouseCoopers and is now co-chairman of the advisory board of a Washington, D.C.-based think tank called [Global Financial Integrity](#). It's part of the Center for International Policy.

Krishen Mehta, thanks for joining me on Just Business.

KRISHEN MEHTA: Thank you.

JULIA KENNEDY: Let me start by asking a very fundamental question: How does capital flight work? What does it mean and how does it work?

KRISHEN MEHTA: What it means is when developing countries lose their wealth through corruption, money laundering, trade mispricing—where sometimes the elite in the developing countries, the business people working closely with the political establishment, can make special deals with multinational companies to plan certain transactions in a way

that results in a portion of those proceeds ending up in offshore jurisdictions, away from the country of origin.

This capital flight means it's money that would normally have stayed in that country and been subject to income taxes and revenue that the country could use for infrastructure, but it's actually lost. As a result, the countries are poorer because their development capital is lost.

JULIA KENNEDY: Give me an example of a time that this has happened in a developing country so people can put it into context.

KRISHEN MEHTA: Yes. A perfect example is GFI just went to Guatemala a few months ago.

JULIA KENNEDY: GFI, that's Global Financial Integrity?

KRISHEN MEHTA: Correct.

JULIA KENNEDY: That's the think tank that you're related to.

KRISHEN MEHTA: Correct.

We were doing some work with the government of Guatemala at the invitation of Vice President [Rafael Espada](#), who wanted to get a control on this area. We had analyzed prior to this trip the extent of capital outflows from Guatemala. We determined that a very simple way that many Guatemalan companies were not reporting their fair share of revenue to Guatemala was through the underpricing of their exports and the overpricing of their imports. As a result, close to \$1 billion a year was being lost.

Now, this was not just Guatemalan companies who were doing this. For example, the biggest export of Guatemala is bananas. Now, Chiquita and Del Monte are both doing business in Guatemala. They purchase bananas from there, but they resell them to a subsidiary in the Cayman Islands or in Bermuda. They pay a very small markup to the government of Guatemala. It's those companies in the Cayman Islands or Bermuda that then

resell them to the United States or to Europe, and the profits end up in those secrecy jurisdictions. As a result, Guatemala does not get its fair share of revenue because of this pricing arrangement, and even the United States, which is the headquarters of these companies, doesn't get the profits because these profits are then retained in the tax havens.

So capital is lost to developing countries and tax revenue is lost, and even the developed countries that have investments there are not actually paying what we would call a fair share of taxes on these kinds of transactions.

JULIA KENNEDY: So what you're saying is this capital flight allows for the profit margins to be larger, for the companies to retain more of this revenue themselves, right?

KRISHEN MEHTA: Correct. And if it's an American company that has operations in the developing countries and also has subsidiaries in certain tax havens, it ends up enabling them to park a portion of their profits in these jurisdictions, and these are not taxable in the United States until those funds are repatriated. So for a long period of time these funds can continue to stay in those jurisdictions.

A developing country that mainly offers its natural resources as a wealth, that mainly offers its low cost of labor, its plantations, in a way should be the beneficiary of some of these assets, but it ends up losing it.

Let's take the example of Nigeria. Since 1958 when oil and gas was discovered in Nigeria, over \$300 billion has been extracted and sold on the global markets. Now, one would have expected that the standard of living would have risen and per capita income gone up. Unfortunately, in a country of 150 million people, over 70 million still live on less than \$1 or \$2 a day because a significant portion of this wealth from Nigeria's oil and gas has been sheltered abroad by the elite who have made these special deals with the multinational companies and have been able to price these transactions in a way to park a portion of their profits abroad.

Nigeria has had the misfortune of having had certain political leaders who were not very ethical in their stewardship of the country and have paid a price for it. But this is not an uncommon phenomenon in many developing countries where these kinds of transactions have been made.

Commercial tax evasion is the biggest component of this outflow, and this results in depriving the developing countries of a significant amount of tax revenue. In fact, GFI has calculated that close to \$100 billion of tax revenue is lost to these developing countries. Under the [United Nations Millennium Development Goals](#), all that the developing countries need to fight extreme poverty is \$50 billion, but they lose close to \$100 billion.

JULIA KENNEDY: I have so many follow-up questions, I don't even know exactly where to start.

KRISHEN MEHTA: Yes, please.

JULIA KENNEDY: Let's start first with the legality of these types of tax havens, ways of protecting the revenue from the developing country governments. How much of this behavior is legal and extralegal?

KRISHEN MEHTA: Most of it is extralegal. There are actually three components of this outflow.

- One is the corruption by public officials and others, and that is generally about 5 percent of the total.
- Then there is criminal, such as trafficking, counterfeiting, environmental crimes, smuggling, gambling, and so forth, which is about 30 percent.
- The largest component is what we call the commercial component of tax evasion, which is about 65 percent.

So in terms of legality, you would say that if the commercial component was being better managed, if that evasion was not taking place, if this overpricing/underpricing was not taking place, that 65 percent of the wealth that is being lost right now would have been retained in these countries.

Our estimate is that in aggregate GFI estimates that close to \$1 trillion is lost by the developing countries every year, of which 65 percent is relating to commercial tax evasion. The rest, about 35 percent, is on the corruption aspect and the criminal aspect. So if we can capture the legal side, which is 65 percent, a good part of the outflow could be controlled.

JULIA KENNEDY: Why aren't countries closing these loopholes and clamping down on these types of behaviors by corporations?

KRISHEN MEHTA: That's a very good question.

First of all, we have to look at where this money is going. This money is ending up in Western financial institutions the laws of which are kept intentionally vague to continue to allow this inflow to take place. If these institutions were not so much a willing partner in continuing to receive this wealth, some of this wealth would probably be staying in these countries.

Now, another factor in all of this is that the developing countries, along with the business leaders in these countries who have close relationships with the political leaders and who have been able to influence the laws in their countries to keep them as they are, rather than to make them more transparent, to have a stricter regime to prevent this from happening. There is this kind of a nexus in the developing countries which is no different than the nexus we have in the West which keeps the laws as they are, enabling this outflow to take place.

JULIA KENNEDY: **Why do times of crisis spur the flow of money out of developing countries?**

KRISHEN MEHTA: What happens in times of crisis is that there is uncertainty. In these countries, the capital goes to where it will find its safest haven. So when the economic conditions are poor, when there is a lot of mismanagement in some of these countries, money ends up wanting to leave to safer locations.

If those safer locations' laws are such that it continues to welcome it, then the conduit, then the channel, becomes greater.

I think what happens in times of crisis, as we noticed in Libya and Tunisia and in Egypt, is that the public awareness of this issue becomes greater. We certainly heard about how much wealth had been taken out from these countries, partly as a result of the crisis and the uprisings that took place, because that in a way further agitated what the public was aware of.

But the fact is this is a leakage that has constantly taken place for years. We estimate that the aggregate amount of this illicit wealth in the Western financial system is anything in the range of \$10 to \$12 trillion. If the current flow is about \$1 trillion and it has been going on for quite some time, the buildup of this wealth is not insignificant.

JULIA KENNEDY: **So one component that we've been talking about is this flow out of certain developing countries of wealth. Another component that has been in the news here domestically lately is the flow of funds out of developed countries, like the United States, to tax havens. You mentioned the Cayman Islands. Ireland has been another country that has had low corporate taxes, so a lot of corporations are putting offices there, other countries in Europe as well. So this phenomenon isn't just in the developing world, right? Tell me a little bit more about the developed world and how capital revenues are sheltered and how that affects our economies.**

KRISHEN MEHTA: In the Western economies under the current laws as they are structured, a company can have operations in any jurisdiction that they feel is appropriate for their business operations globally. We're dealing with a global economy.

Now, companies, if they wanted to reduce their taxes in the West, for example—let's say a U.S. company wanting to minimize its tax obligations—can make certain business decisions that could result in lowering the tax rate. For example, if some of their research and development was housed in a low-tax jurisdiction, like in Ireland, the Cayman Islands, or Bermuda, if some of their intellectual property could be transferred to those locations, then when the royalties are earned on those assets, they are retained in those countries and the effective rate of these companies is greater from a shareholder perspective. The company is deemed to have a better performance.

Because the U.S. laws are allowing companies to—and this is something that they should not change; I mean, companies should have the right to be anywhere that they want—but because this freedom exists, there is often the opportunity availed of to go to the lowest-tax jurisdiction or go to secrecy jurisdictions where it is practical to continue to have some kind of a business there and as a result park these profits.

Now, under U.S. law these profits are not income in the United States until they are repatriated. So that build-up could continue to take place for years and the current taxability of this could be lost.

Senator [Levin](#) actually proposed change to this provision. He introduced back in 2009 a legislation called the [Stop Tax Haven Abuse Act](#), under which he wanted to make sure that if tax havens were used by American companies they had a business purpose rather than being just used for tax purposes. He introduced that legislation to bring this under control. But then the lobbying against it was also significant and that legislation got sidetracked into other priorities.

In fact, back in 2007 it was Senator Levin, Senator [Obama](#), and Senator [Coleman](#) who introduced the same

legislation, two or three years before. But the Bush Administration at the time did not want to go forward on this.

So off and on there has been legislation introduced. But right now the reality is that low-tax jurisdictions can be used by companies as they wish. If there is a business purpose associated with it and there is economic substance to it, it is totally within the law to do it. But where the business purpose and economic substance become somewhat in the gray area and companies still exploit it, then it becomes egregious and is a kind of practice that needs to be brought into better control.

JULIA KENNEDY: So this is going on in the developed world, it's going on in the developing world. Corporations say they have a responsibility to their shareholders to have the greatest profit margin possible, and so that's how they explain these actions.

What's your opinion? What do you think about their role as corporate citizens? Do they have a stronger responsibility to the society they are working in or to their shareholders? Where does that balance lie?

KRISHEN MEHTA: I think this is a very, very sensitive issue that is now in the public debate quite a bit. There have been a number of articles that have come out about the low effective rates of some of America's most prestigious companies.

The premise of some of these articles is that a company owes it to its shareholders to pay little or no taxes so that more money can be paid out as dividends—what is right for the shareholders is right for the company.

To be honest, I think a more fundamental question is a broader one: Is the society in which the companies operate not one of the shareholders and should receive its share through payment of taxes? Does not the public education system educate the employees that the companies hire? Does not the legal system offer the companies protection on their patents and copyrights? Is not the infrastructure—the roads, the hospitals, the bridges, the transit system—that societies build on tax revenues a necessary ingredient for the companies to operate successfully?

So it's my personal view that society is as much a shareholder as the actual owners. Without it, none of the profits that the companies have would be possible. And I truly believe that companies need to be a little more sensitive to that than they are right now.

Nonpayment of taxes cannot be an end in itself. Now, I know that not all companies are focused on this nonpayment of tax reduction per se, but to the extent that there is an abuse, these kinds of situations need to stop. There must be a business purpose to doing it.

I think the right of the shareholders, the society in which these companies are operating, needs also to be acknowledged as one of the recipients of these returns that the company has.

JULIA KENNEDY: So the question is then how to deploy that. An economist would say, "Well, the companies aren't going to just suddenly say, 'Oh, yeah, society deserves our consideration,' that some external institution has to step in and enforce that." Is that your opinion, or how can this change in priorities be accomplished?

KRISHEN MEHTA: Now that the country is facing a considerable budget crisis—it's not only at the federal level but at the state level—there is a lot of talk taking place, some very good dialogue taking place, on what to do about some of these incentives that exist for companies to take advantage of and revenues to be lost.

One of my heroes—I mentioned Senator Levin's name earlier. He is truly an advocate of bringing more equity to this process. In fact, when he introduced the Stop Tax Haven Abuse Act back in 2009, *The New York Times* had an editorial which said: "\$100 billion that this country could use."

So, in a sense, just revisiting in the elimination of the egregious use of tax havens, which is all that Senator Levin was proposing—not elimination of the use of these havens—congressional researchers had calculated that the United States alone would benefit to the extent of \$100 billion. Now, in the current economic circumstances, where we are looking at every \$30 billion and \$50 billion to bring about budget reconciliations and so forth, this is an important item that needs to be considered.

American banking transparency laws right now need to be also addressed in an important way, because the way that these transparency laws occur, it is not so easy for the federal government, for the state governments, to know who is exactly owning these accounts, who are the true flesh-and-blood owners of these accounts, and to assess proper taxes on the people who receive some of the profits and to include them here.

There should be some kind of exchange-of- information agreements between the United States and the developing countries. Right now, the United States has a lot of wealth from the developing countries on which there is no reporting back as to how much interest was being earned and there is no tax consequence of this wealth being here. As a result, the United States becomes like a tax haven to receive wealth from developing countries. Almost 20 percent of the illicit wealth globally is resident over here. The developing countries also lose their revenue.

JULIA KENNEDY: You've talked a lot about what we can domestically. Why do you see the United States as a key thought leader in this charge?

KRISHEN MEHTA: In a way, the United States being the largest economy in the world, I think we have the opportunity to set a higher standard. It was the United States which implemented the [Foreign Corrupt Practices Act](#) in the [Carter](#) Administration in the 1970s, and it took another 15 or 20 years before the OECD adopted similar provisions, and then a UN Convention on Anti-Corruption was passed. So in a sense we took leadership at that time.

If the largest economy in the world also takes leadership on the issue of tax havens, for example, and even if we are alone in this regard, initially there may be some concern by the American business community that if we do it, then we will be uncompetitive with European companies.

JULIA KENNEDY: Sure, yes.

KRISHEN MEHTA: But eventually pressure will build up on these European companies to enact it also, because this legislation is in as much their interest as it is in ours.

So I think the fact that we are a strong economy, we are leaders, and we represent somewhat of a moral force in this regard—and we have taken steps in the past, and they have been of a leadership nature, we have been a first mover in a sense—that is going to have a dramatic effect, I think, in other countries around the world. Because people will say, "This is something that if the largest economy is willing to do and pay a price initially for doing this, and it's in the global interest for everybody to achieve, then why should we not be a party to it?"

Fortunately, with the G20 meeting on a regular basis and looking at issues of common concern, leadership by any country in this regard is likely to have consequences for all.

JULIA KENNEDY: I'm going to ask you a kind of political question, a U.S. politics question, because there has been so much in the news—we're recording this in April of 2011—and President Obama is now speaking a lot about closing loopholes for corporate taxes. There have also been a lot of headlines about GE's ability to pay very low taxes on its 2010 revenue in the United States. They made something like \$5 billion and are paying 3 percent of that in corporate taxes according to some sources. So there seems to be, as you mentioned, a lot of news around corporate taxes. And yet, a lot of the focus on the budget is on cutting costs rather than trying to corral some of this tax revenue. So do you think those priorities can shift, should shift?

KRISHEN MEHTA: I think if the public truly understood some of the ways in which the United States is losing its current revenue, it will put a lie to much of the austerity talk that we are hearing right now. California is having big problems right now in balancing its budget. All states are going through some crisis.

If there were fundamental reforms that looked not just at the corporate tax rate and reducing it, as some groups are saying, but also letting go of certain opportunities for corporations to defer or avoid income taxes—I think in the final analysis we need to do the cuts that various congressional groups are talking about. We need to look at our effective rate in comparison to other countries'. But that has to be taken in combination with some of the give-aways that we have in the current system.

So if those abilities are somewhat tempered and we are looking at much more substance to this—I give the Obama Administration and Secretary [Geithner](#) a lot of credit. Even though they did not succeed in having Senator Levin's bill go forward with a very key provision in that bill, which was the business purpose and economic substance test, they were able to include that as an amendment in one of the subsequent legislations that happened.

So there are incremental decisions being made of this nature that help both the United States and the developing countries.

Another example I can give you, which affects both sides, East and West, is under the [Dodd-Frank bill](#) there was a provision that was added that allowed—that required actually—companies in the extractive industries, in mining, oil and gas, to report their revenue and taxes in all jurisdictions where they were operating globally. In the past,

they could aggregate them in one location and nobody really knew how much tax was paid or how much revenue was earned. And if you were a member of a civil society in a developing country, you didn't know if Shell operating in your country paid any taxes at all to your country's leadership.

Now, under the Dodd-Frank bill, this will all be public information. So civil society globally will be able to know, at least in the extractive industry, how much was actually earned by these multinational companies in those countries and how much, if any, tax was paid. Because sometimes special deals are made to not pay any taxes by the political and business elites in those countries.

JULIA KENNEDY: What is the incentive for the political and business elite in those countries to cut those kinds of deals?

KRISHEN MEHTA: In a way, they are the new colonialists. We cannot blame the colonial legacy of 50 or 60 years because that time has passed. But we are, unfortunately, dealing with a situation in which many of the countries' leadership has a nexus of business and political leadership that can make contracts on the national resources of these countries with foreign companies and decide how much, if any, would be the benefit of those transactions in the country itself. They give special tax breaks sometimes to attract investments or technology and so on. But often, some of these transactions are structured in a way that a proportionate amount of the revenue is paid to this nexus overseas.

Now, if all of this information is going to be much more public, if civil society will know exactly the revenue that an oil company or mining company was able to extract from the resources it extracted, was able to generate from their country, and they find out that nothing was paid in taxes, they will be enraged and they will ask a lot of questions.

So I think as we get more transparency in the global financial system, as we try to do away with the shadow system that exists, with a system that is convenient for everybody, especially the political leadership and the business leadership in these countries, they will be changed.

JULIA KENNEDY: What makes you so passionate about these issues? You have obviously a lot of expertise in this area as a former partner with PricewaterhouseCoopers. So why have you decided to take this on?

KRISHEN MEHTA: It really is a war against the poor. The inequity that has existed in the past is going to continue unless civil society is informed, asks the right questions of its government, of its business leadership, and asks for more responsibility.

One of my favorite writers is [Blaise Pascal](#), who said that "justice and power must be brought together so that whatever is just may be powerful and whatever is powerful may be just."

We, through NGOs, through civil society, are working in that direction, the direction of balancing the scales of justice.

JULIA KENNEDY: I'm curious. For you personally it would be easy for you to enjoy your retirement, travel when you want. So why have you taken this on? Why is this important to you?

KRISHEN MEHTA: Having come from a developing country and seen the challenges that exist in India, which is my home, having traveled extensively in Asia and other parts of the world, in Central America and so forth, I feel that we need to take some actions now. Our generation has to take some actions now to take corrective steps for the future.

I could certainly make different choices. But this enables me to remain committed to an area that I know with some degree of comfort and to be able to make a contribution. It's really an obligation to the future.

The German theologian [Dietrich Bonhoeffer](#), as you know, is known to have said that "the ultimate test of a modern society is the kind of world we leave for our children." This is really the challenge we face today: Do we want our children to be facing these inequities that exist today, or are there some corrective steps that we can take, even if it's small increments, to bring about the change so that their lives can be better? I think in that sense this exercise is my hope, is my dream.

JULIA KENNEDY: Krishen Mehta, I think so many people would not find taxes so inspiring. But I think you've gotten me on board. So thank you so much for coming and explaining it to me here on Just Business.

KRISHEN MEHTA: Thank you very much, Julia. It's a pleasure to be here.

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