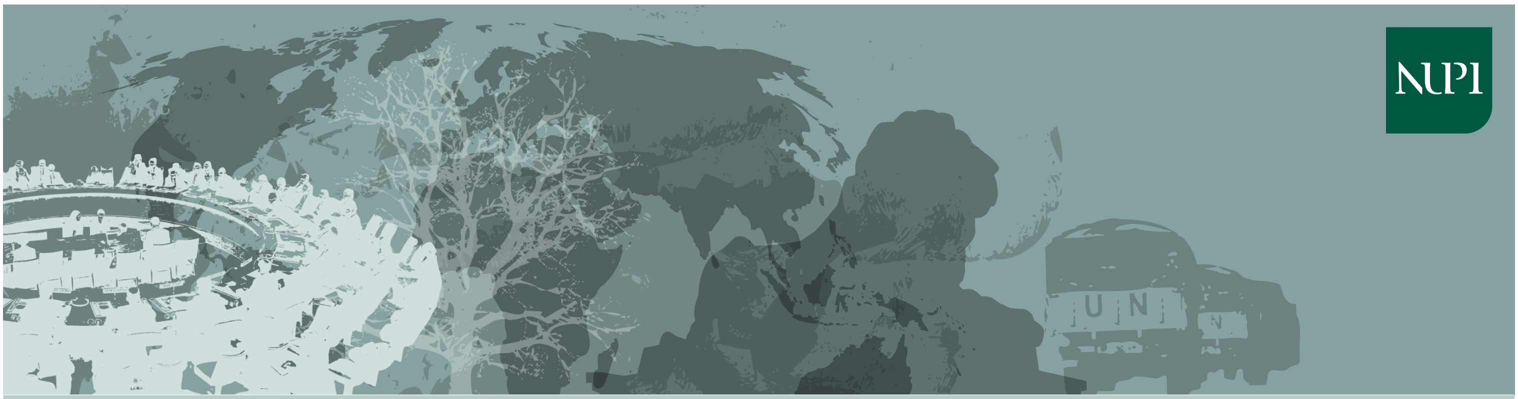

Policy Brief

13 · 2012

New Dependency Relationships

Offshore, Large Banking Conglomerates and Development

Ronen Palan

A theoretical synthesis is emerging in development studies, taxation studies, business and political science that may be described as the new dependency theory. Old dependency theory hypothesised the world capitalist economy was structurally arranged to facilitate a massive transfer capital from developing countries to the developed world. The new dependency theory suggests that the net flow of capital from developing countries has been continuing unabated for the past three decades. In contrast to old dependency theory, the new synthesis stresses that this is not only a problem in developing countries for two reasons. First, the net flow of capital is not necessarily transferred or invested in the developed world. Rather, the transfer of financial resources from developing countries joins a large pool of capital registered in offshore locations. Second, there is evidence that developed countries are subject to net external outflow of capital as well.

The combined transfer of financial assets from low and middle income countries to offshore accounts is estimated currently at approximately US$ 10 trillion (Henri 2012). This figure represents nearly 10 times the annual GDP of the entire African continent. Put differently, for every dollar poor countries received in development assistance, more than twelve dollars are illegally transferred back to rich countries.

For developed countries, the main detrimental impacts of illicit flows are growing income inequalities and a weakening and narrowing of the tax base, as effective (contra nominal) tax rates on corporations and rich individuals decrease. For developing countries, the problems caused by illicit flows are further compounded, and include poor governance, a large black economy, a lack of capital for infrastructural projects, and an over-reliance on aid money that generates deleterious political-economic dynamics. The impact also includes qualitative effects:

- Lack of the negotiated settlements between government and society at the heart of the development of the European democratic state model
- Alternative funding and saving sources to government elites that undermine the need for proper state institutions
- Access to offshore financial centres damages potential for domestic financial development

Main aspects of the new synthesis

- Recent estimates of capital flight and net transfer flow from low and middle income countries
- Understanding of the integrated role of and relationships among offshore financial centres
- Democratic deficit studies in developing countries
- Structural theory of the failed state model.

Capital flight and net transfer from low and middle income countries

It is ironic that one of the earliest versions of the new dependency theory was articulated in a book written largely as an apology for the Swiss banking industry. In the *Gnomes of Zurich*, Fehrenbach (1966) maintained that large capital flows to the secretive Swiss banking system add a layer of stability to an increasingly volatile financial system. Fehrenbach argues that the largest three Swiss banks, UBS, Credit Swiss and Swiss Bank Corporation, accumulated about $500 billion dollars in assets from third world countries by the 1960s, and each opted to re-invest these liabilities largely in the developed world. He cited a figure of 3% of their total assets in third world countries. Fehrenbach showed that the Swiss banking fraternity acted as a conduit for financial flows from developing to developed countries – raising doubts about the conventional wisdom that LDCs were net recipients of capital.

During the 1980s and 1990s, considerable evidence emerged on the deleterious impact of intra-group transfer pricing techniques perpetrated by multinational corporations, particularly in the mining industries of the developing world. The first comprehensive estimates of the scale of the illicit movement across international borders of money 'that is illegally earned, illegally transferred, or illegally utilized' was conducted by Raymond Baker (Baker 2005). Baker's estimated that the global cross border illicit money flows were in the order of $1 to $1.6 trillion annually, and about 70% of all capital flight was conducted via transfer pricing. Of this – $500 to $800 billion a year, or 50% – flows out of developing countries to large offshore financial centres. A related study conducted by Dev and Cartright-Smith (2008) put the figures for illicit financial flows from developing countries slightly higher at between $800 billion and $1 trillion. A follow-up study by Dev and Cartwright-Smith of the total illicit financial outflows from Africa between 1970 to 2010 estimated it to be as high as $1.8 trillion (Dev and Cartwright-Smith 2012). Boyce and Ndikumana reached similar conclusions, claiming that a group of 33 south Saharan countries lost a total of $814 billion dollars (constant 2010 US$) from 1970 to 2010. The authors work on the assumption that flight capital has earned (or could have earned) the modest interest rate measured by the short-term United States Treasury Bill rate. These figures far exceeds the external liabilities of this group of countries of $189 billion (in 2010), making the region a "net creditor" to the rest of the world (Boyce and Mdkiumana 2011; 2012).

The strongest evidence for the new dependency relationships is provided in a recent analysis of the global private financial wealth registered in offshore locations (Henri 2012). Henri estimates that at least $21 to $32 trillion of the global financial assets or about 18% of all financial assets were registered in offshore locations by 2010. $9.3 trillion of this offshore wealth belongs to residents of 139 mainly low-middle income countries. These estimates, he notes, 'underscore how misleading it is to regard countries as "debtors" only by looking at one side of the country balance sheet. Indeed, since the 1970s, with invaluable assistance from the international private banking industry, it appears that private elites in these key developing-world source countries have been able to accumulate at least $7.3 to $9.3 trillion of offshore wealth... compare with these same source-countries' aggregate 2010 gross external debt of $4.08 trillion, and their aggregate net external debt – net of foreign reserves, most of which are invested in First World securities – of minus $2.8 trillion. In total, by way of the offshore system, these "source countries" – including all key developing countries – are net lenders to the tune of $10.1 to $13.1 trillion. By comparison, the real value of these source countries' gross and net external debts – the most they ever borrowed abroad – peaked at $2.25 trillion and $1.43 trillion respectively in 1998, and has been declining ever since' (2012 4-5). The growing evidence is that low and middle income countries are net exporters of capital, not importers of capital.

The International Private Banking Industry

By the 1970s a number of writers noted the large surpluses of capital from OPEC members' countries, the so-called Petrodollars, were deposited in the fledgling unregulated wholesale markets (known as the Euromarkets) that were rising to prominence as a result. Howard Wachtel (Wachtel 1977) calculates that in the three years between 1973 and 1976, OPEC countries accumulated current account surpluses of about $158 billion! The vast majority of these Petrodollars were deposited in U.S. based multinational banks – but not inside the US. They joined the pool of capital, he argued, located in the Euromarkets. Wachtel identified the rise of what was subsequently described as large complex financial institutions (LCFIs) at the heart of the Euromarkets. His analysis highlights easier lending to developing countries in the 1970s, suffering from the double hit of rising oil import costs and shrinking global demand. The seeds of early 1980s crisis were sewn.

The first comprehensive analysis of the rise of the new phenomena of tax havens serving as offshore financial centres (OFCs) provided evidence in support of Wachtel's thesis. Park (1982) presented a picture of an increasingly integrated international wholesale market operating through financial nodes, known as OFCs, spread around all the major commercial centres of the world. The Euromarkets encouraged, he argued, enormous economies of scale in finance by integrating different locales into one market. Many OFCs developed a profile as 'funding' and 'collection centres' to fund Euromarkets operations.

Two subsequent studies of OFCs gave further evidence for further integration of these wholesale markets. In a report commissioned by the Bank of England and published in 2001, Liz Dixon presented evidence for the importance of 'financial intermediation undertaken by entities based in many OFCs [i.e. tax havens, that] is almost entirely 'entrepôt'' (Dixon, 2001, 104). A considerable portion of capital flows between these centres for the reasons that were not entirely clear at the time. The various strands of research addressing the emerging global and offshore financial markets were brought together in a comprehensive IMF study in 2010 exploring the processes that contributed to what is described as international financial interconnectedness. The IMF findings were as follows:

- The architecture of cross-border finance is one of concentration and interconnections. Countries are exposed to certain key money centres or – nodes – common lenders and borrowers—through which the majority of global finance is intermediated. These exposures reflect transactions that occur predominantly through a small, core set of large complex financial institutions (LCFIs).

- LCFIs are systemic players, measured by importance in global book running for bonds, structured finance, U.S. asset backed securities, syndicated loans, equities, and custody asset holders.
- LCFI comprised banks as well as nonbank institutions, such as investment banks, money market funds, and structured investment vehicles (SIVs). The nonbank entities were often linked to banks, including through credit and liquidity enhancement mechanisms.
- Subsequent studies by the Federal Reserve of New York have named this world of complex entities linked to the LCFIs the shadow banking industry, which is larger than the official banking industry.
- The IMF study also showed that the infrastructure of payments and settlements in this integrated offshore wholesale market was also highly concentrated —including CLS (for foreign exchange), DTC (for stocks and bonds), Target II (for domestic and cross-border payments in the Euro area), Clearstream and Euroclear (for securities), and SWIFT (for common messaging across *systems*).

Impact of the New Dependency on Developing Countries

What is the impact of large, net transfer of capital from low and middle income countries to offshore locations? Many developing countries suffer from failing or absent market mechanisms. There is widespread corruption; a black economy that is often larger than the formal sector, tax is generally uncollected. There is a clear link between poverty, illicit financial flows, failed models of government, and an absence of infrastructure, combined with aid dependency.

But there is also a less direct, but possibly more pernicious impact of the net flow of capital exposed by the new dependency theorists. Not only does a functioning tax system raise the necessary revenues for development; it also builds the institutional capacity necessary for long-term development, and encourages consensus and political dialogue between private and public actors (Bräutigam, Fjeldstad, and Moore 2008). More to the point, we also know that much tax evasion is for illicit political elite revenues and that the net flow of capital from low income countries through offshore jurisdictions has a direct and immediate impact on state capacity building.

Conclusion

The new dependency theory implies that there exists an unholy alliance of vested interests that combine the large banking and multinational conglomerates, professional services and small and often weak states known as tax havens. The overall impact of this new dependency is the weakening of the universal tax base in developed countries, manifested in the ongoing shift from direct to indirect taxation, the narrowing of the tax base whereby the poor and the very rich pay comparatively little tax, and growing income gaps in developed countries.

Leading LCFI identified by IMF, 2010

Institution	Country	International Bonds	Structured finance	US ABS	Syndicated loans
JPMorgan Chase	U.S.	1st	2nd	3rd	1st
Barclays Bank PLC	UK	2nd	3rd	1st	15th
Deutsche Bank AG	Germany	3rd	9th	5th	8th
Bank of America	US	4th	4th	2nd	2nd
HSBC	UK	5th	6th		24th
Credit Suisse	Switzerland	6th		7th	18th
Citigroup	US	7th	7th	4th	6th
UBS	Switzerland	8th			
BNP Paribas	France	9th			7th
RBS	UK	10th	5th	6th	12th
Goldman Sachs	US	11th		10th	13th
Morgan Stanley	US	12th		8th	22th
Credit Agricole	France	14th			9th
Lloyd Banking	UK		8th		

Source: (Fund 2010)

The impact of the new dependency on developing countries is a lack of capital for basic infrastructural projects, combined with over-reliance on foreign aid. The new dependency encourages and facilitates alternative sources of income to government and elites, the weakening of political bargains and political processes attendant to universal taxation, and directly contributes to the rise in the phenomenon of fragile states. The new dependency also encourages an extraordinary concentration of resources in the hands of few in the world economy.

Bibliography

Baker, Raymond W. *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-market System*. London: John Wiley and Sons, 2005.

Boyce, James K., and Léonce Ndikumana. *Africa's Odious Debt: How Foreign Loans and Capital Flight Bled a Continent*. London: ZED, 2011.

Boyce, James K., and Leonce Ndikumana. *Capital Flight from African Countries: Estimates, 1970-2010*. Research Report, Univrersity of Massachussettes, Amherst: PERI, 2012.

Brautigam, Deborah, Odd-Helge Fjeldstad, and Mick Moore. T*axation and State Building in Developing Countries*. Cambridge: Cambridge University Press, 2008.

Choi, SR, D Park, and Tschoegl. "Banks and the World's Major Banking Centers." *Review of World Economics* 132, no. 4 (1990): 774-793 .

Dev, Kar, and Devon Cartwright-Smith. *Illicit Financial Flows From Africa: Hidden Resource for Development*. www.gfip.org: Global Financial Integrity, 2012.

Dixon, Liz. "Dixon, LizFinancial Flows Via Offshore Financial Centers." *Financial Stability Review* 10 (2001): 104-115.

Fehrenbach, R.R. *The Gnomes of Zurich*. London : Leslie Frewin , 1966.

Fund, International Monetary. *Understanding Financial Interconnectedness*. Prepared by the Strategy, Policy, and Review Department and the Monetary and Capital Markets Department, in collaboration with the Statistics Department and in consultation with other Departments, IMF, 2010.

He, Dong, and Robert McCauley. "Eurodollar Banking and Currency Internationalisation." *BIS Quarterly Review*, June 2012: 33-47.

Henri, James. "The Price of Offshore Revisited: A Review of Methods and Estimates for 'missing' Global Private Wealth, Income, Inequality, and Lost Taxes." *Tax Avoidance, Corruption and Crisis*, University of Essex, July 5-6. 2012.

Kar, Dev, and Devon Cartwright-Smith. *Illicit Financial Flows from Developing Countries: 2002-2006*. washington D.C.: Global Financial Integrity , 2008.

Turner, Louise. *Multinational Corporations and the Third World*. London: Allen Lane, 1974.

Wachtel, Howard M. *The New Gnomes: Multinational Banks in the Third World*. Washington D.C. : Transnational Institute, 1977.

Y.S., Park. "The Economics of Offshore Financial Centers." *Columbia Journal of World Business* 17, no. 4 (1982): 31-6.

NUPI

Norwegian Institute of International Affairs
P.O. Box 8159 Dep, N-0033 Oslo, Norway
www.nupi.no

This Policy Brief is part of a series of briefs published by the Systems of Tax Evasion and Laundering (STEAL) project. STEAL is funded by the Research Council of Norway (NORGLOBAL, project ES477322), and seeks to identify Global Wealth Chains that are the articulation of organized activities between individuals or international entities, developed countries, developing countries, and tax havens.

About the Author

Professor Ronen Palan (Bsc. Econ, LSE, PhD LSE) is head of the Department of International Politics at the City University, London. His work lies at the intersection between international relations, political economy, political theory, sociology and human geography. He has published extensively on the subject of offshore and tax havens.