

RGNUL- IPAN WORKING PAPER SERIES

VOLUME - 3

YEAR- 2015- 2016



CALL FOR SUBMISSIONS

(With attached Concept Note)

TOPIC FOR SUBMISSIONS:

MEASURES FOR TAMING BLACK MONEY: LESSONS FOR INDIA



ABOUT US

“International Policy Analysis Network” (IPAN), Asia’s first youth-led public policy think tank had initiated an Annual Working Paper Series in association with School of Agriculture Law and Economics (SALE), Rajiv Gandhi National University of Law, Punjab in the year 2012.

The research theme for the previous (2014) edition of this series was “WTO and Farm Subsidies: The Road towards a Permanent Solution”. Students, academicians and Ph.D scholars from across the country submitted their papers on the issue and selected papers were published in the form of a book which was made available for free download for wide dissemination.

This year the topic for discussion relates Cross Country Legislation for Taming Black Money. Papers should address some specific social, political, economic or cultural aspect of this issue, and papers with detailed solutions are encouraged. Foreign contributors are especially encouraged to submit their contributions which discuss their own country’s stand and the economic background which necessitates such a stand. Papers can be submitted by students at all levels, research scholars, academicians and professionals interested in the subject.

This series for 2015-2016 might culminate into an international seminar or a book release. Contributions selected by a peer review panel will be notified about their prospective presentation/publication by **June 30, 2016**.



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SUBMISSION GUIDELINES:

Contributors are encouraged to submit papers that address the various solutions to the deadlock. Papers which explain about the various economic problems of nations which lead to the current deadlock are invited. We also welcome any other innovative papers on issues which relate directly to the topic.

Contributors are highly encouraged to go through the detailed Concept Note attached with this call for papers. They should bear in mind when they are preparing their paper that it will be available online for public reading.

The deadline for submissions is April 30, 2016.

Papers should conform to the following format:

1. 3000-5000 words (excluding bibliography, including footnotes).
2. 150-200 words abstract.
3. Headings and sub-headings are encouraged.
4. Chicago Manual of Citation should be strictly adhered to.
5. Papers should be submitted in Microsoft Word (.doc or .docx) format.
6. Graphs, pictures and tables should be included as appropriate in the same file as the paper.
7. Plagiarism would be strictly checked and would lead to disqualification of submission.
8. The Font for the main body should be Times New Roman with 12 pt size and foot notes should be in 10 pt size. Headings and sub-headings should also be in 12 pt size.
9. Line spacing should be 1.5 throughout the document except footnotes which should be single spaced.
10. Selected papers would be published in the form of a book and a free copy would be provided to each paper contributor.
11. All papers should be accompanied by a cover letter containing the Name, Mobile No., E-mail and Communication address of all the researchers.



12. For any additional qualifications, the RGNUL IPAN working paper Team can be contacted at sale.rgnul@gmail.com.

The paper should be sent by email to: sale.rgnul@gmail.com

(With the subject line as “SUBMISSION_BLACK MONEY WORKING PAPER”)

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THE 3RD RGNUL- IPAN WORKING PAPER SERIES



**MEASURES FOR TAMING BLACK MONEY: LESSONS FOR
INDIA**

CONCEPT NOTE

MEASURES FOR TAMING BLACK MONEY: LESSONS FOR INDIA*

PROLOGUE:

The contemporary economies functioning in an era of economic liberation and mutual interdependence primarily operate with an objective of promoting their own interests. On one hand, these economies, cooperate with one another for increasing the volume of their trade and promoting their economic development and on the other, they reveal disparities as well, especially when it comes to fostering their economic objectives. In this regard, it is more often observed that the developed nations that have large economic prowess begin to dominate over and exploit the developing nations in an urge to surpass one another. This mad race for minting more money for their economies at times, leads to an outflow of money through trade and commerce in an unparalleled manner.¹ But sometimes, this capital flight is accompanied by nefarious practices that help in siphoning off the money of one country unscrupulously to another without even letting the host nation know.² At times, the major aim of this kind of a fraudulent practice is to evade taxes and conceal the true income from the public authorities. Subsequently, the countries world over developed cognizance of this kind of a hideous practice of the resourceful people in stashing their wealth far away in distant accounts, where it remains out of the reach of the local government.

As a destination for earthing the unaccounted money, the banks of Europe, especially those of Switzerland and Norway gained popularity and came to be called Tax Havens where the wealthy but corrupt people all over the world could store their wealth away from the sight of their tax officials. Such devious practice of concealing the economic resources gave rise to Black Money all over. The World Economic Outlook 2005 defines Black Money as that portion of the revenue which is hidden from the account of the government and as the amassing of this kind of wealth gained momentum, the governments of the countries realized the need to restrict such massive illicit capital outflow. Consequently, the governments of different countries realized the need to make concerted efforts to curb such practices; so that the large sum of money that could be significantly utilized for financing economic development, could be contained within the domestic territory of the concerned nation itself.

* Research Assistants, SALE-IPAN, RGNUL.

¹ Thomas V. McClendon, (2013) *The South Africa Reader: History, Culture and Politics*, pp 103

² Tom Burgis, (2015) *The Looting Machine: The Systematic Theft of Africa's Resources*, pp 328

The present paper is an attempt to draw a comparative analysis of the various legislations formulated by the governments of some developing countries and also aims to take an insight on the impact of these legislations on curbing the menace of Black Money in their economies.

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The present paper is an attempt to draw a comparative analysis of the various legislations formulated by the governments of some developing countries and also aims to take an insight on the impact of these legislations on curbing the menace of Black Money in their economies.

1. BLACK MONEY AND SOUTH AFRICA

The economy of South Africa shares its history with that of India since both the economies had been subjected to imperial dominion for centuries together. Ever since South Africa gained independence in 1961 and emerged as the Republic of South Africa, it has been making persistent efforts to develop its industrial as well as its agricultural sector because the colonialists had completely drained the South African economy of its rich gold and diamond resources. However, over the last few decades, commendable progress has been observed in the South African economy especially by way of the development of iron and steel plants that have been set up through foreign collaborations. Moreover, the service sector has also seen a steady progress and as a result, South Africa has now emerged as one of the most preferred destinations for foreign investment. Nevertheless, such rapid strides being made for the overall development of all the sectors has also led to the evolution of Black Money therein. The huge profits that were accrued to the corporate entities were concealed from the tax authorities and were deposited in the Tax Havens and this menace has been observed to magnify since the year 2000 when Foreign Direct Investment was at its peak in the South African economy. The civilian and the non- governmental organizations at large baffled the state authority through their aggressive campaigns. Realizing the gravity of the situation, the government of South Africa passed some laws so as to scrutinize the outflow of capital resources and curtail its illegal movement beyond the national barriers. In a move to discourage the defaulters from evading tax obligations, the Prevention and Combating of Corrupt Practices Act was passed in 2004 and Section 22 of the new law provides for initiation of legal proceedings against an individual who is found suspicious of such act of impropriety. The law makes it mandatory for the individuals or corporations making transaction of more than One Lakh Rands to a foreign bank to inform the authority of the same.⁵ Moreover, the Act also made it imperative to disclose the source of income as well in case the transactions to be made with foreign banks were of a larger volume. The most significant contribution of the Act was that it encompassed the concept of extrajudicial

⁵ Recheal Mc Donolds, (2014) *Prevention and Combating of Corrupt Activities Act, 2004: Critical Analysis*, Journal of Pretoria, Vol. 24, No. 26.

jurisdiction which was more pertinent for the fact that such a provision could leave scope for the decree of the court to be effective even in cases which fell beyond the local jurisdiction of the court.

Nonetheless, the Act was perceived to be a game changer because One Lakh Rands was not such a huge sum to be diverted to a foreign bank without the permission of the authorities.⁶ Unfortunately the Act proved ineffective due to faulty implementation and more so because the executing officials, who had been entrusted with the responsibility to implement the Act, were themselves corrupt so much so that they deliberately delayed the proceedings of the case, giving sufficient time to the culprit to escape. Besides, the courts too had been showing laxity by way of dismissing and adjourning the cases on insignificant grounds. Moreover, the pace at which the cases are decided under the Act too is not very appreciable; it generally takes about five years for a case registered under the Prevention of Corrupt Activities Act to complete. This is sufficient enough an instance to connote the efficacy of the law for preventing Black Money in the South African economy.

Although the Republic of South Africa has passed the Act with a noble intent yet the law needs to be strictly enforced to become an effective deterrent against Black Money. In furtherance of this objective and to make the law more effective, the maximum period of punishment needs to be enhanced from 3 years to 10 years and emphasis needs to be laid on imprisonment rather than imposition of fine. Moreover, special courts need to be established under the domain of the Act so as to pace up the process of prosecution. The government needs to adopt a zero tolerance approach towards the delinquents. Besides, there is also a dire need for the government to enter into agreements with the banks of Switzerland, Thailand etc. so that the crucial information can be shared and the stashed money can be unearthed. In this regard, South Africa needs to toe the lines of US and India and use its diplomatic arrangements to obtain the necessary details pertaining to the transactions carried out with the Tax Havens. Only if adequate emphasis is laid on the advice of the civilian organizations that the government can work with a renewed commitment to eliminate Black Money from its economy.

⁶ Freidinend Rooseu, (ed.) (2015) *Global Tax Heavens and the Worst Victims*, The Deccan Herald, Hyderabad

2. BLACK MONEY AND RUSSIA

The disintegration of the socialist structure of the former Soviet Union into the Russian Federation in 1991, called for economic reforms which were introduced with an objective of driving the Soviet economy towards a liberal and a capitalist set-up. However, the lack of a proper legal framework and planning mechanism for restructuring the economic system rendered the Russian economy as an easy target for illegal capital flight.⁷ This outflow of capital transfers was primarily the outcome of the tax policy which was perceived to be 'confiscatory' in nature, apprehensions of the failure of the capitalist model, widespread corruption and non cooperative attitude of the public towards the regulation of the banking system.⁸ The illicit capital transfers from the Russian economy were generated because of under-statement of the export earnings, over-reporting of import payments, fake records of import advances, withdrawal of state control from trading activities in the economy, dollarization of the economy and levying of high tax rates. Moreover, since the public at large had started losing faith in the Russian Ruble, the mechanism of transfer of the currency caused capital resources to outflow in huge volume especially during the financial crisis of August 1998, when the domestic banks had begun to hide their money. Corruption bred into the system when the Russian exporters started under-invoicing their exports and received kickbacks from the European importers who transferred the money into the European bank accounts of such exporters. Moreover, some Russian companies had even set up their subsidiary companies in Europe which used to buy their own exports at low prices thus generating large revenue outside their own country. The Central Bank of Russia estimated that during 1994 to 1998, about 54.2 billion dollars had moved out of the Russian territory in the form of illicit capital outflows.⁹

To curb the menace of Black Money from its economy, Russia adopted a four-pronged process that aims at curtailing the outflow of illicit transfers.

- i. The first category of Macroeconomic policy is targeted to regularly review the tax structure so that there is minimum tax evasion and more compliance. This has helped the underground economy (Black Money) in Russia to shrink to a great extent.

⁷ A. Shazeeda, (1998) *A Gateway for Money Laundering? Financial Liberalization in Developing and Transitional Economies*, Journal of Money laundering Control, Vol. 1, No. 4, pp 326-328

⁸ R G. Gidadhubli and Rama Sampath Kumar, (1999) *Causes and Consequences of Money Laundering in Russia*, Economic and Political Weekly, Vol. 34, No. 4, pp 3396

⁹ International Monetary Fund, (1999) *Russian Federation: Recent Economic Developments*, IMF Staff Country Report No. 99/100, September, Washington, D.C., p.104

- ii. The policy of improving governance through enhanced sense of accountability, absence of violence, regulatory quality, control over corruption and implementing the rule of law provides a clear indication that the law machinery in Russia will enforce the laws in a timely and a more fair and transparent manner.
- iii. Technical assistance is sought by the Russian customs administration from the IMF and other international bodies for the purpose of obtaining clearances, reducing the time and costs involved in clearances, avoiding duplication of activities or inducing harmony in those automated systems which have no communication with each other. Such a process of obtaining technical assistance is also expected to reduce the penetration of the shadow economy by way of mis-invoicing external trade.
- iv. The foreign trade invoices from Russia now call for a legally binding declaration to be made by the traders i.e. both, from the exporters and the importers, affirming that they have not mispriced or manipulated the trade activity and that they conform to the anti-money laundering law and also to the regulations pertaining to banking and exchange control activities of the economy.¹⁰

However still, the reports of Global Financial Integrity (GFI) indicate huge outbound transfers of liquidity through the illegal and unregulated channel so much so that Russia ranks at the top in the world with respect to the estimated quantum of black money. Illegal capital outflows worth nearly 123 billion US dollars have been reported to be made from Russia between 2003 and 2012.¹¹ To this, it is suggested that to enhance transparency and accountability, Russia must formulate such banking laws that deter the opening of accounts in banks or insurance companies without the knowledge of the specific parties owning the accounts. It should be mandatory for the concerned parties making large transactions with the Tax Havens to seek approval from the Central Bank before actually transferring the funds.

There must be a provision for the individual tax payers in Russia to choose between the Double Tax Avoidance Agreement and the national tax laws because the Double Taxation system primarily triggers tax evasion and promotes the generation of Black Money.

The auditor's of the high net worth companies or individuals must be held responsible for noting the transactions with the tax havens. There must be developed a mechanism for Automatic Exchange of Information regarding the different sources of income that accrues to

¹⁰ Dev Kar and Sarah Freitas, (2013) *Russia: Illicit Financial Flows and the Role of the Underground Economy*, Global Financial Integrity

¹¹ *India Third on Black Money List: Report*, The Hindu, December 26, 2014

an individual especially from the foreign countries and also to keep a check on whether an individual has reported his foreign income accurately.

3. BLACK MONEY AND CHINA

Illegal capital flight from China has been seen to be caused by factors like increasing current account surplus that results from the significant volume of exports incurred by the country; wide spread inflation and under-valuation of the Chinese Yuan (induced by the trade surplus); structural factors that lead to non-inclusive growth hence increasing the number of 'High Net Worth Individuals' who further siphon off their illegally amassed wealth to the outside world; increased degree of open trade which facilitates the traders to mis-invoice the volume of trade and exploit the customs regulatory system to their benefit. The extent of illegal capital outflows is also effected by the complexity of determination of origin of exports when trade is carried out from China-Hong Kong region. Generally, the exports of China which proceed through Hong Kong are registered by the importers as being originated from Hong Kong whereas China enlists them in its own record, thus causing an overstatement and also a greater illegal outflow of capital funds. The Chinese traders and firms have also discovered a novel, though complex channel of converting their illicit wealth into licit. When Chinese economy offers high tax rebates, the exporters reduce the volume of under-invoiced exports and then stash it in foreign avenues. Subsequently, they round-trip the same money in the form of FDI in China and earn tax incentives on one hand and launder their ill-earned wealth on the other. This round tripping of FDI is generally done on a mutual basis between Mainland China and Hong Kong since they are each other's largest foreign direct investors.

However, although the Chinese government has introduced the Foreign Exchange Control Regulations to regulate the use of foreign exchange, yet it has been observed that there is a parallel economy being driven by the illegal use of foreign currency which is completely overlooked by the government. This also partly indicates that though the government does not openly support the generation of black money, yet it continues to accept the existence and movement of the illicit wealth through a parallel channel in China. Apparently, the government deliberately does not want to make efforts to remove the black money from the system because it is very well aware of the concealed merits of such illicit capital. In fact, the Chinese consumers, as backed by the traditional set up procure the imports as well as Foreign Exchange Certificates without using the official foreign exchange reserves of the country.

This goes a long way in saving China's forex reserves since maintaining large gold and foreign exchange reserves has always been a major agenda on the priority list of the Chinese government.

4. BLACK MONEY AND INDIA

Black money is a significant problem of the Indian Economy which transcends the borders and has now become a global predicament. It is a key obstacle in the growth and development of our nation. A series of movements have been initiated by social activists such as Anna Hazare and Baba Ramdev to make the nation realize the quantum of the problem and its repercussions with respect to the development of our nation. Total illegal financial flows in India account for US \$ 344 billion from 2002-2011.¹² According to the 3rd Swiss National Bank Report published in the year 2012 India has the topmost position vis-à-vis black money deposits amounting to a total of \$ 1,456 billion.

An analysis of the definition of Black Money is pivotal in deciding the techniques and channels through which the funds of the nation can be brought back. Transparency International, a leading global Non-Governmental Organization dedicated to the cause of international ethics and promoting transparency in the economic dealings across the globe, has defined Black money as *'the portion of the revenues accrued or income earned by the individuals or the corporations, the proceeds of which are hidden from the government in order to avoid the tax obligations.'*¹³ The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 has classified Black Money into 'Undisclosed asset located outside India' and 'Undisclosed foreign income and asset'.

Black Money in India is generated through two principal sources- Firstly, through activities which are not legally recognized, such as crime and corruption; secondly, through activities which are legally recognized but not accounted for leading to an evasion of tax. The unholy link between politicians, bureaucrats and business men acts as a catalyst in the generation of black economy in India. Efforts have been made by successive governments to acquire the illegally stashed Black Money from foreign banks. Indian government wants nations like Malaysia and Switzerland (which serve as a popular destination for tax evaders) to disclose the name of those Indians who are evading tax back home. A list of tax offenders can be

¹² *Illicit Financial Flows from Developing Countries: 2002-2011*, Global Financial Integrity Report, December 2013

¹³ B.V. Kumar, (2nd ed. 2014) *The Dark Side of Black Money: An Insight into the World of Financial Secrecy and Tax Havens*, Konark Publishers Pvt. Ltd., New Delhi, pp 212

obtained by the Union Government through diplomatic partnerships with such tax heavens which will serve as a critical linchpin in helping the nation bring back the money.

A number of administrative and legislative policies have been formulated by the Government to counter the problem of Black Money ubiquitous in various sectors of Indian Economy. Administrative agencies, regulatory authorities and coordinating agencies have been setup to tackle the generation of Black Money through the process of scrutiny and assessment.

The legislative policies formulated by the Government include the Prevention of Money Laundering Act enacted in the year 2005 as a core measure to curb and control the problem of money laundering. The Act makes it mandatory for financial institutions and banking companies to maintain a record of all suspicious transactions, all cross border wire transactions over rupees 5 lakhs, all transactions over 10 lakh rupees and all transactions of sale of immovable properties of the value of rupees 50 lakhs or more.¹⁴ The Act provides for a rigorous imprisonment of 3 to 7 years,¹⁵ and also allows for the appropriation of both movable and immovable property.

Further, the legislature introduced the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act in the year 2015 to tackle the problem of Black Money stashed abroad. The Act provides for a voluntary declaration of the undisclosed assets and payment of tax on the same. It provides for a rigorous imprisonment upto 10 years and calls for a penalty equal to three times of the tax evasion amount. The said Act also provides for One Time Compliance window thereby giving people who possess undeclared assets abroad an opportunity to declare and regularise the same.

The aforementioned two legislations operate in cohesion towards combating possession of black money and money laundering. On paper, they seem to be efficacious but what is imperative with regard to such legislations is their proper implementation. In case of the Black Money Act, around 4000 crore rupees were disclosed within the compliance window, thereby attracting around 2500 crore rupees as tax on such undisclosed assets. However, this is only a miniscule amount in comparison to the total amount of illicit funds stashed abroad. Further, the complex judicial and political structure coupled with the evil of corruption acts as a hindrance in countering the issue of Black Money for the benefit of people. The other

¹⁴ Section 12, Prevention of Money Laundering Act, 2002

¹⁵ *Id.*, Section 4

hindrances in capturing black money include lack of suitable infrastructure, inadequacy of the training staff to scrutinize black money and inefficiency of the administrative agencies.¹⁶

In order to curb the problem of Black Money, the money regime of the country needs to be streamlined and the loopholes in the administrative and legislative policy of the Government need to be plugged in. White Paper on Black Money, a Report by the Ministry of Finance published in the year 2012 suggests that a comprehensive blend of distinct strategies carried on with patience & perseverance by the Government and implementation of the same by the respective agencies in a structured manner will ensure the repatriation of Black Money. Supreme Court's decision in the case of Ram Jethmalani v. Union of India,¹⁷ should be followed and stringent steps such as creation of High Level Committee and investigation by Special Investigation Team should be adopted to bring back Black Money back for the welfare of our nation.

5. CONCLUSION

The problem of illicit capital outflows is not peculiar to one country alone; it has engulfed in itself almost the entire world. However, taming the black money of the countries cannot be solely possible on the basis of formulation of specific domestic anti-money laundering laws. The shadow economies world over, need to be subjected to stringent regulatory mechanisms in order to instill greater accountability with regards to the volume and nature of transactions carried out across the borders. The furtherance of this objective calls for concerted efforts between the host countries and the administration of the tax havens so that an automatic mechanism of exchange of information pertaining to the account holders is enabled, the requisite data is shared with the financial institutions to establish greater standards of transparency with regards to the transactions made by the multinationals and the unregulated capital transfers across the borders can be deterred.

Black money or the illegally occupied or kept money or near money assets constitutes one of the gravest economic loophole faced not just by India, but by most of the nations of today's world. In light of rising allegations of corruption and increasing leakages from the economy, curbing the menace of black money is the need of the hour. Albeit steps been recently taken by the government to tackle the problem, India has a long path to forge to contain such illicit leakages which cripple the economic financial structure of the nation.

¹⁶ *A Study on Widening of Tax Base and Tackling Black Money*, Federation of Indian Chambers of Commerce and Industry Report, February 2015

¹⁷ Ram Jethmalani and Ors. v. Union of India, Writ Petition (Civil) No. 176 of 2009



The problem is India is peculiar because the regulatory authorities and the government has to balance two delicate and conflicting interests, i.e. the object of curbing black money and the object of facilitating ease of going business, of which simplicity and lower taxation is a basic tenant. Indian tax authorities cannot ruthlessly scrutinize or impose taxation under the garb of prevention of black money as that would directly impact the allure of investing in India, both by domestic as well as international players.

The Concept note lays down the problem of black money comprehensively from an international perspective and calls for healthy discussion on drawing learnings from around the globe for taming this problem domestically. Therefore, Working Paper Series attempts to attain focused research on the relevance of Black Money laws in curbing the menace in India in light of current economic, geopolitical and developmental factors.