

The International Financial System as an Obstacle to Development and Meeting Human Rights Obligations

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In 1997, a financial crisis began spreading throughout Southeast Asia, eventually engulfing Korea, making it an East Asian crisis.

The region of East Asia was and continues to be considered the region of successful globalizers. Because they were successful, East Asian countries could not be blamed for bad policies unlike other regions.

But the blame coming from Western countries on corruption and family-centred capitalism in East Asia was a way to hide the true causes, the instability in financial system.

The Asian crisis was a dress rehearsal for the current global economic crisis. This crisis is the culmination of years of elimination of controls on international private capital movements. This, despite the early warning from the East Asian crisis itself, such as the failure of Long Term Capital Management in 1998, which required the resolution of \$1.2 trillion in financial claims for one company alone.

The ongoing global economic crisis has exposed the treacherous features of the international financial system. The current crisis originates from the developed countries and continues to threaten global economic recovery for all. The source of the current financial problems cannot be blamed on the corruption and inefficiency in the developing countries. Systemic reforms are required. Because of the entrenched commercial interests that are advantaged by the current financial rules and arrangements, the international community must also overcome crises in politics, policy and morality to undertake systemic reforms.

Current financial rules are inimical for prospects for economic development in poor countries because volatile and large private financial flows restrict the policy space of developing countries governments in promoting long-term investment to diversify their economies. The global system is configured to encourage competition among nations over trade and for private investment even though private investment is highly unstable and unable to provide the scale of resources needed for development. In the context of this competition, developing country governments are able to mobilize resources for their own development from their own domestic economies.

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2. Financial regulation

The biggest irony of all is that the era of deregulated financial markets has not been associated with greater investment levels as a proportion of GDP worldwide. It has only resulted only greater instability in capital flows and more difficulty for developing countries to maintain steady growth rates, build their own enterprises and government capabilities.

What will financial regulation entail?

First, for developing countries, the restoration of the power of individual countries to regulate external capital account flows is a necessary reform to making sure that private capital flows can be harnessed to economic development, instead of playing the role of creating unstable economic conditions and restricting government policy space.

Studies suggest that volatility of international cyclical movements represent the most important source of macroeconomic instability in developing countries.

Countries should be able to impose conditions on the banking system on how much foreign exposure they will undertake because such borrowings ultimately become the responsibility of governments when debt crisis break out.

Because of these volatile movements, countries are unable to control their exchange rates to protect employment from job losses. The monetary policy is severely restricted. Tax systems are afraid to raise tax rates to raise sufficient revenues from domestic financial activities because of the possibility that residents will move their income offshore if taxes are too high.

There is the additional problem that countries have been signing **bilateral investment treaties** which allow private financial companies to sue governments directly, if they increase regulation or impose new taxes.

Investor-state disputes provide a very special kind of international status to private companies to sue developing country governments, who are too poor to keep up with most of the costs of the litigation, to be able to defend themselves well. Even the WTO does not have this system; in the WTO, if a private company has a complaint against a developing country it has to convince its own government to file a dispute against the developing country. Under BITS, secret arbitration proceedings can award billions of dollars of damages by direct action.

Second, there is a need for advanced economies from which the volatile capital movements emanate to properly regulate their own domestic financial markets. This will also require cooperation on the part of international organizations to make sure that these regulations are put in place and to provide assistance to developing countries, where needed, on how to maintain effective controls on volatile private capital flows.

3. International cooperation in domestic resource mobilization

Investment is necessary for development. Making sure that domestic resources are mobilized for domestic investment, instead of frittered overseas or squandered in consumption by the rich requires that developing countries (1) have a fiscal system that can collect taxes and channel these to long-term investment and (2) domestic financial to support long-term investment.

The international financial system is however unfriendly, if not undermining, of the need mobilize long-term investment in developing countries.

There is competition internationally for financial investment through policies which lower tax rates, provide strong protections for investors even when these involve the sacrifice of state social and environmental objectives and human rights obligations, facilitate secrecy of identity of investors (facilitating capital flight) and reduced regulation. This results in countries undermining each other's tax systems. From the point of view of most developing countries, it is developed country financial markets that the greatest destination of the movement of domestic resources out of the country.

Development of the domestic financial system is also undermined by the entry of foreign banking companies, often given national treatment. These banks can move their resources very quickly out of the country and, impelled by strong trends towards short-termism in rich countries have little interest or energy in lending long-term to domestic companies. Foreign banks tend to skim the richest deposits, depriving the domestic private bank of resources they might have lent to local enterprises.

3.1 including concerted efforts against tax evasion and for greater international tax cooperation;

In developing countries, the government's critical developmental role is circumscribed by its ability to raise revenues to fund social programs and catalyze investment. In fact, many social programs, such as in health and education in poorer countries, while being part of the government's human rights obligations, are also investments in improving productivity and provisioning of modern forms of employment.

Many developing countries have highly unequal income distributions and must find means of raising revenues from trade and sales taxes which are taxes in which the poor contribute a greater proportion of their income than the rich or from the wealthy and foreign investors. The competition from other tax jurisdictions offering lower taxes and anonymity seriously undermines the tax base of many developing countries.

The Tax Justice Network recently commissioned a study that estimates that at the end of 2010 at least \$21 trillion of unreported private financial wealth owned by wealthy individuals and corporations are deposited in tax havens. This stock of wealth beyond the reach of tax authorities is equivalent to the annual product of the US and Japanese economies. High net worth individuals could actually be hiding \$32 trillion in financial assets.

While developing countries have the image of debtors, this image does not take into account the fact they have residents who are investing wealth gathered from the domestic economy outside the country. For example, at the end of 2010, middle income developing countries (the group of countries with the highest per capita incomes among developing countries) had an estimated external debt of \$4.1 trillion. However, their governments held external assets in the form of international reserves and their wealthy individuals had deposits overseas. The Tax Justice Study study suggests that netting these two stocks actually turns middle income developing countries into net creditors at the level of between \$10.1 to 13.1 trillion dollars. We of course know that when these countries fall victim to debt crises, the collection of debt payments fall on the government and the incomes of the poor.

Multinational companies are the biggest supporters of tax havens because these facilitate their ability to move their profits to the lowest tax jurisdictions. One suggestion to mitigate this problem is to institute country-by-country reporting on the part of these kinds of companies. This will require them to open to public scrutiny the social and tax impact of

their international activities. It will then be possible to gauge to what extent their operations are truly at the service of society, as has been claimed.

Even *The Economist*, a magazine known for its conservatism and disdain for government taxation and regulation, ran a piece in May 2012 why there might be important good reasons to being taxing “capital” (meaning wealth). The argument is that it is not true that all government spending is wasteful. On the other hand

While it is unlikely that a global taxation regime will happen soon, what can be sought is increased and increasing cooperation among countries in tax and revenue collection in the practices of exchanging information on the assets of each others’ citizens kept in their jurisdiction and in assisting each other in collecting tax debts. What is needed to shift to a regime away from tax competition to one of tax cooperation.

The Tax Justice Network identifies some policies that must be avoided in order to move away from a mode of tax competition. These include offering incentives to encourage the artificial relocation of transactions to a territory. Often this means that companies incorporate a “dummy” office in a jurisdiction, which own the entity which actually undertakes its operations in another territory to take advantage of the lower taxes afforded to the dummy office. Other practices include refusal to recognize tax evasion as a crime, encouraging the non-taxation of capital, and the refusal to share tax information.

Governance reform in international financial and trade rules

In human rights terms, the international economic system can be seen to manifest extensive violations the principle of discrimination. Its rules discriminate against small national companies and citizens and favors large companies and those individuals with the resources and the control of resources that other against other individuals and communities. This international minority is privileged by freedom from regulation and social obligation. Progress in these suggestions requires fundamental reforms in global governance.

In thinking about governance reform reform, there are two things that need to be addressed. First, there is a need to change the overall framework behind the system. Second, there is a need to progressively eliminate the discriminatory features which characterizes the current system of international economic governance.

The overall framework of the current international system pits country against country to compete for export markets and foreign investment. Instead of pitting countries against each other, the approach should be to require the international private sector to contribute positively to development efforts and compete for access to markets and resources based on their capacity to contribute positively toward social objectives. Such an approach takes the claims of most large private conglomerates at their face value – that their operations are directed to providing a positive contribution to society. Regulating capital flows and investment overturns the current system to one in which the private sector compete within its ranks for the right to move their operations and their resources where they can promise to contribute.

Removing those features that actually force countries to compete with each other will have to start with reforming the voting weights and voice of developing countries in organizations – such as the IMF – which implicitly have the mandate to set and enforce rules and to allocate international public resources. Economically powerful countries, from whence large international companies emanate, do not mind intercountry competition

where they think their superior size and capabilities will be to their advantage. Aside from advantages in competition, they also believe they can bend the rules and their enforcement to avoid penalties should they violate them. One specific arena where this is being debated and decided right now is actually voting weights in the IMF itself.

In fact, one principle that can prove useful is to think about reforming the voting procedures and the staff rules in these organizations to make them better reflect their public purpose of serving the populations of the world and ensuring the effectiveness of the international economy. One direct way to do this – and this was part of the design of the post World War II governance system but never seriously practiced – is to require all international organizations to account for their operations and be subject to audit by the United Nations. Assessing these operations in the framework of human rights commitments of member countries is also an activity which we are seeing more of.

Second, the rules must be changed so that powerful countries take into account the impact of their policies on other countries. One simple example is the international system's dependence on the dollar, the national currency of the US. This turns other countries hostage to the national political events in the US. When the US sought to fight inflation in the late 1970s by raising interest rates, one important impact was the debt crisis of 1982 which economically ruined many developing countries. In the current period, when Europe and the US are undertaking quantitative easing, the provisions of international liquidity are leading to currency appreciations in developing countries making their domestic economies less competitive. These actions increase the danger of a bigger crisis in the coming years.

Governance reforms are critical to the long-term problem of the financial system as an obstacle to development and meeting states' human rights obligations. Without governance reforms, the international financial system will lead the global economy to periodic crises, such as the current one which is unresolved, which could get larger and larger.