

Black Stain over India

By: Javid A. Chowdhury

1. Introduction

- 1.1 In the run-up to the recent general elections a political controversy erupted relating to 'back money' stashed away in foreign banking havens. In the heat of that political juncture, the issue degenerated into a slanging match as to which political formation had encouraged 'black money' by turning a blind eye to this category of economic crime. Actually, the course that the events took proved a serious disservice to an issue that is of the highest importance to the socio-economic well-being of the country. The large and all pervasive presence of 'black money'- whether within the business processes in the country, or as illicit funds stashed away in safe havens abroad - has an extremely damaging impact on the economic health of the country. Raising such issues in sensational terms on the eve of elections devalues the seriousness of the issue and taints it as partisan in the eyes of the common citizenry. The problems caused by illicit funds, both within and outside the country, are enormous in scale, and the truth is that, every government in the past, regardless of its political colour, has closed its eyes to it. However, with the elections behind us, this paper can now objectively examine the following principal features of the critical issue: the volume of illicit funds, both within and outside the country; the underlying factors causing the generation of such funds; the impact of the parallel economy on the legal economy; and some suggestions relating to broad policy measures that would tend to moderate the scope for creation of illicit funds in the course of the business operations in the country.
- 1.2 The danger to the national economy from the huge quantum of illicit funds in circulation, and the impact this has in distorting the normal functioning of the legal economy, has not originated from some recent development. This is a tainted legacy from the past decades, stretching back to independence. For a variety of reasons, in the early years after independence, a vast panoply of controls and restrictions regulated the industrial and business activity in the country. Some critics may even assert that this was the result of bureaucratic obduracy, but we believe that an objective overview would lead to a conclusion that there were many compelling and constraining circumstances that necessitated such restrictions. The country survived despite many constraints - a very small industrial base, inadequate agricultural production, miniscule public infra-structure, a critically adverse balance of payments position, and the presence of a huge section of the population living in indigence, below human subsistence level. In those circumstances, a policy of prioritising use of both the limited foreign exchange and domestic credit inevitably had to be resorted to.
- 1.3 For the first four-and-a-half decades after independence, the economy was characterized by high direct and indirect tax rates and stringent control over the consumption of foreign exchange, both on current and capital accounts. The tax base being very narrow, the irreducible revenue requirements for discharging the minimal responsibilities of governance necessitated high taxation levels. Also at that stage, with wide disparities between income/wealth levels across the population profile, high direct tax levels were considered unavoidable by the government of the day, on equity considerations. As a result of these tax policy features, from the viewpoint of the business community, the industrial and trade activities were considerably strapped. In those days, the dominant political ideology was of 'welfare socialism.' Individual industrialists and business men nursed an insecurity, fearing

that governments may nationalize/appropriate private assets at any time in furtherance of its public policy. As a safety net against such a contingency, the business community had a strong propensity to conceal income and wealth. With such a business attitude, over time, a large corpus of illicit funds accumulated in the country, as also in safe havens abroad. Since it did not make sense to keep the funds idle, by stashing them away below the mattress, these illicit funds gradually entered the cycle of production by partially providing the capital resources and working capital for the ongoing industrial and business activities.

2. Size of the Domestic Parallel Economy

- 2.1 As is understandable, the estimate of black money in the domestic economy has never been very accurate. A study of the National Institute of Public Finance and Policy in 1985 estimated the share of black money as 20% of the GDP. On a later date, the Indira Gandhi Institute of Development Report - 1999-2000 - again estimated the black money economy to be 20% of the GDP. Assuming that the share of black money in the economy is unchanged, the current estimate of aggregate black money would be Rs. 10.0 lakh crores. This would be about 33% in excess of the annual central budget. Even if 10% of this could be netted by the tax enforcement agencies, tax recovery would improve by 2% of the GDP.
- 2.2 With the growth of the economy, 'black money' gradually came to provide a significant portion of the funds utilised for domestic manufacturing/business activities. The use of this money in the economy had its advantages and disadvantages – the process of negotiating funds by business entrepreneurs was hassle-free, though the business operations were based on trust and carried their attendant risks, which made such funds much more expensive.
- 2.3 The financial insecurity encountered by Indian businessmen was a psychological load for them. Sub-consciously, they felt that their assets would only be secure if held in safe havens abroad. As a result, there was a marked propensity to keep large amounts of funds in Swiss Banks and other foreign safe havens. Such foreign deposits fetched little return, if any; yet, the business community was willing to idle their funds for their sense of security. In circumstances in which the business community did not find the national business environment conducive to their aspirations, a parallel economy of illicit funds developed in the country. An idea of the magnitude of the foreign funds held by Indians can be obtained from the Report of the Swiss Banking Association - 2006 - which revealed that Indian nationals held assets totaling US\$ 1456 billion in Swiss Banks, an amount that exceeded the combined holdings of all other countries of the world. Also, this aggregate holding would be over six times our national foreign debt. While the Indian holdings are no doubt enormous for a developing country, it would be necessary to qualify that all these assets are not illicit assets – the Indian diaspora has thrived abroad, and some part of the assets would be legally held assets. However, the quantum of these funds does raise some uneasiness in our minds. Switzerland is not a very significant industrial country – their industries are limited to dairying, confectionary, pharmaceutical drugs, machine tools and watch and clock-making. Also, Switzerland is not the country in which many Indians would have earned their fortunes. In this background, the presence of such huge Indian-owned funds in Switzerland should be of professional interest to the enforcement authorities of fiscal laws!
- 2.4 With time, the size of the parallel domestic economy grew to enormous proportions. As is understandable, it is not easy to get a very accurate fix on the size of this parallel economy. The attempts made in the past – National Institute of Public Finance and Policy and Indira

Gandhi Institute of Development Research Studies – mentioned earlier, are based on macro conceptual models, and with computational methodologies that rely on several assumptions. However, accuracy in such an estimate is not of vital importance for practical policy formulation. Any exercise for estimating the size of the domestic parallel economy yields such a gigantic figure, that, even after all possible normalization and moderation, the irreducible number that remains, makes it plain that the problem is one of the most daunting ones faced by the government. Quite often, the discussion on the issue of the parallel economy gets bogged down in a debate over the accuracy of the methodology of computation of the estimate of the 'black money'. To our mind, this is a futile debate – no serious exercise has ever yielded a low figure that suggests that the problem is not a serious one. A useful discussion could begin with the acceptance that the scale of the parallel economy is a gigantic one, and move on to examine the possible measures that can be undertaken to create an economic environment that ensures better compliance of fiscal laws and foreign exchange regulations, so as to reduce the fresh generation of 'black money'.

- 2.5 The recent discussion in the media, relating to illicit foreign funds had not specifically covered the illicit domestic funds; however, with these two flows of illicit funds being symbiotically linked, many of the observations applicable to illicit foreign funds would *mutatis mutandis* apply to the domestic parallel economy.

3. Outflow of Illicit Funds

3.1 The parallel domestic economy fuels the flow of illicit funds out of the country. To understand the transactional mechanism involved in holding illicit funds abroad, it would be useful to examine the issues thrown up in the recent discussion in the media. Our observations are based on the Report released in December, 2008 by Global Financial Integrity, titled: 'Illicit Financial Flows from Developing Countries: 2002-2006,' authored by Dev Kar and Devon Cartwright Smith. Using global trade statistics, and subjecting them to a computational process under methodologies widely used by economists, the authors have come to certain significant conclusions. They have computed two contributory streams of illicit foreign fund flows from developing countries using global trade statistics and have used two types of methodologies: (i) the World Bank Residual Model, computing the difference between the inflow of capital funds and the use of funds in the country, the difference in the two numbers representing the quantum of capital diverted as illicit funds abroad; and (ii), The Trade Mis-invoicing Model for quantifying the volume of fraud through fabrication of trade documents – under-invoicing of imports and over-invoicing of exports. The total of these two computed figures gives the magnitude of the illicit fund flow put away in foreign safe havens. The figures obtained through such an exercise in GFI's Report have been normalized/moderated, to exclude any effect on account of non-typical features in the statistics used, and also to exclude some large illicit transactions that may have be of a 'one-off' nature. Based on these two methodologies, GFI's Report gives the average, annual, normalized estimate of illicit fund flows out of developing countries as US\$ 612 billion per year during the period 2002-06. The same estimate on the non-normalised basis is US\$ 716 billion. These two figures mark the upper and lower limits of the range of estimates obtained through the methodologies used. In other words, it can be said that the irreducible estimate of illicit fund flows out of developing countries would be of the order of US\$ 612 billion. The study indicates that the volume of illicit flow of funds has grown at 18.2% over the study period 2002-06. The estimate of the flow of illicit funds from developing countries in the last year of the study – year 2006 - was US\$859 billion on the normalized basis and US\$ 1060

billion on the non-normalised basis. Other studies have estimated that about half the illicit financial flows from developing countries originate in Asia. The broad source of these illicit money flows are as under: (i) bribery and misappropriation by government officials – 3%; (ii) criminal funds – 30-35%; and (iii) tax-evaded funds – 60-65%.

- 3.2 At the disaggregated level for India, the estimate of average annual illicit outflow of funds in the period 2002-06 was US\$ 22.7-27.3 billion; the estimate for the final year of the study – year 2006 - was US\$ 44.6 billion. India ranks fifth amongst the countries in Asia for outflow of illicit funds. The region is lead by China, and followed by Saudi Arabia, Mexico and Russia, in that order. In Indian currency, we come to the mind-boggling conclusion that, at the lower end of the estimate the average, annual illicit out flow of funds from the country in the period 2002-06, was of the order of Rs.1, 10, 000 crores, which is 2.3 % of the country's GDP, or 15% of the annual central budget. At this stage it, would be necessary to acknowledge and clarify a seeming anomaly in the statistics. The estimate of annual outflow of funds from India is more than the estimated black money generated in a year. It needs to be noted that the outflow of illicit funds would be from the pool of black money accumulated from the beginning of such transactions, and not merely from the black money generated in a particular year. The extant direct tax concessions for export earnings in the IT sector could be driving outflows of illicit funds from the accumulated black money. Also the possible margin of error in the estimates contributes to some extent to the seeming anomaly.
- 3.3 A further comment appears to be necessary to demonstrate that GFI's estimate of outflow of illicit funds is not exaggerated. A very common way of acquiring illicit foreign exchange is through hawala transactions for converting domestic black money into illicit foreign assets. These transactions can never be captured by GFIs study because hawala transactions are not recorded anywhere in the government system. A US state department study has estimated the outflow of funds from India through hawala as US\$ 13-17 billion per year. As has been narrated in an earlier part of this paper, a considerable portion of the illicit foreign funds, in due course, re-enters the domestic economy. However, much of these flows are highly footloose, and are always seeking opportunities for short term, speculative profits. Most of such illicit funds would not re-enter sectors of economy that are considered desirable for the development of the country, as reflected in its macro-level monetary and fiscal policies. Such illicit funds invariably go into speculative areas – realty, secondary stock market, commodity trading, entertainment industry, road transport sector, retail consumer goods, etc. Large quanta of the illicit foreign funds are also brought back into the country for use in heinous criminal and anti-national activities. The illicit funds located both within the country and in foreign countries, are always available for use in heinous activities – arms trade, narcotics smuggling, trafficking in women and children, gambling, terrorism, etc. – which are high profit activities. The facilitation of such activities through illicit funds, both domestic and foreign, poses a serious hazard to the social stability and sovereignty of the country.
- 3.4 Some researchers have criticized the methodology used in the GFI's study. It is critiqued that this only attempts to capture the outflow of funds and does not take into account the compensatory inflows. Such an argument is only an obfuscation of the nature of the phenomenon. Illicit outflow and inflow of funds are both harmful as they bypass all the regulations that have been put in place in furtherance of public interest. As a matter of fact, if the domestic black money enjoys the additional facility of easy conversion into illicit foreign funds, its muscle power for damaging the real economy, is enhanced. The symbiotic

relationship between the illicit foreign funds and the domestic 'black money' makes the parallel economy a very powerful system. With the easy fungibility of illicit domestic funds and illicit foreign funds, the parallel economy acquires the principal features of a sovereign state – freedom to escape from all taxes, effective exemption from cross-border capital movement restrictions, exemption from the other policy directions set by the government to turn the economy in a desired direction, etc. In other words, the parallel economy becomes a state within the Indian state.

- 3.5 The actual process through which the illicit funds are transferred abroad varies from country to country depending on the immediate economic circumstances prevailing. In India, in the post-reforms period the underlying economic parameters have altered significantly. Both direct and indirect tax rates have come down considerably and are comparable with many developed countries. In the last decade-and-a-half, the country has seen a reduced propensity to under-invoice imports in order to reduce the burden of customs duty, thereby reducing the landed costs of imports. However, during the very same period there is a marked increase in propensity to over-invoice the exports. This is because, for some time now, profits earned through hundred percent export-oriented units in SEZs / EPZs / EOUs / FTZ / STPIs have been fully deductible under Sec. 10A and 10B of the Income Tax Act from corporate tax for ten years after commissioning. The deduction is applicable to manufactured products as well as software IT products and services – the deduction has been available for manufactured products from 1981 and for software products from 1994. This concession has last been extended up to FY 2010-11. The provision from income deduction has become a major escape route for black money. To maximize gains from this opportunity, corporate entities convert domestic black money through the *hawala* route, into illicit funds abroad. Such illicit foreign funds are then used to make good the difference between the over-invoiced price and the real market price of the exported product. It needs to be pointed out that such a malpractice is particularly risk-free for software and gems & jewelry exports – most IT products are custom-made for a particular user taking into account the specific organizational circumstances and the objectives to be achieved; and, gems and jewelry are also difficult to value as much depends on intangibles and the aesthetic sensibility of the purchaser. There is, therefore, no free and competitive market where the price of such products is determined through competition between different purchasers; the price is fixed through a two-party negotiation, depending on what the purchaser is willing to pay for the perceived gains from the product. In this situation, it is near impossible for any enforcement authority to establish that an exported IT product is over-invoiced. The product can be exported with impunity at an outrageous documented price and the enhanced export earnings can enter the accounts of the exporting entity as tax-free, lawful earnings. Thus, over-invoicing of tax-exempt export earnings, with the support of *hawala* transactions, provides a risk-free route for laundering domestic black money. It is because of these circumstances that, despite low levels of direct and indirect taxes, even today, the *hawala* market is thriving, and the premium on *hawala* foreign exchange continues to rule high at about 8-10%. India has made a mark in the global IT sector and the contribution of this sector to export earnings is expected to be significant. However, the share of the sector in export earnings has reached a scale where doubts regarding its authenticity would not be unreasonable – for the year 2006-07, NASSCOM has estimated that the IT industry's export earning was US\$ 48 billion, which would be 38% of the export earnings in that year; also, the services sector has exceeded 50% of the total GDP of the country. The scale of these revenues would be an indicator of over-invoicing of the exports from this sector. The evidence uncovered through investigations through the recent Satyam Scam strengthens

such suspicions – the large-scale padding of turnover/profits through software exports shown in the account books of the company, could only have been carried out through the ‘round-tripping’ money-laundering methodology described above.

3.6 The circumstances relating to black money generation in the Indian economy today are somewhat different to that in other developing countries. Typically, developing countries face a resource crunch and have to maintain high direct and indirect tax rates in order to meet irreducible revenue requirements. This was India’s condition in the early years after independence. In this situation, the flow of illicit funds out of many developing countries is through under-invoicing of imports and over-invoicing of exports. Where necessary, illicit foreign exchange obtained through the *hawala* route, facilitates the under-invoicing of imports. This is the model of generation of illicit foreign funds that has formed the basis of GFI’s study. The large number of ‘round-tripping’ export transactions, which are occurring in the country today, would not be captured in the exercise carried out in GFI’s study of illicit fund flows from typical developing countries. In other words, the actual average flow of illicit funds out of India currently would be much in excess of US\$ 44.6 billion in year 2006 as estimated by the GFI, if the outflow of funds through *hawala* is also taken into account. *Hawala* transactions do not in any form enter the trade records and, therefore, are not captured in the exercise.

4. The Universe of the Parallel Economy

4.1 At this stage it would be useful to demarcate the contours of the parallel Indian economy in its entirety. It is widely perceived that domestic illicit funds have an all-pervasive presence in the economy. The two studies carried out by reputed research institutions, even though dated, clearly show that. Most of the illicit funds are employed in various types of commercial and industrial activities in violation of the national fiscal laws; some of these are also employed in serious criminal activities. Depending on the needs of individual business entities, such funds can be moved to foreign tax havens at short notice through the *hawala* route, and may be stashed away there. Some of the illicit funds held in foreign banking institutions are utilised to obtain laundered rupee funds in India, while the rest are retained in secret accounts as a safety net against untoward developments in the Indian economy that may have an adverse impact on their business. The illicit foreign funds that are laundered and brought into the country may serve as the promoter’s equity contribution for launching new business ventures. Domestic black money is also widely used as a part of the working capital in Indian business. The manner in which the illicit funds are flowing in and out makes a mockery of the fiscal laws of the country. The ease with which black money can be converted into white, is an irresistible temptation to the business class to wantonly violate fiscal laws. In the current situation the parallel economy enjoys a seamless fungibility between domestic black money and illicit foreign assets. As a result, the parallel economy has acquired a muscle with which it can operate with complete impunity in violation of the fiscal and foreign exchange laws of the country.

4.2 If this tendency persists, even with a high rate of growth, budgetary resources in the country will always be under strain. The resources required to discharge the role of the state in respect of the disadvantaged – access to minimal nutrition, free/inexpensive primary education, access to basic healthcare, access to a basic shelter, etc. - would never be available. Currently, the gross abuse of fiscal laws is the driving force of the parallel economy. In earlier days, it was expected that, with the lowering of rates to moderate levels,

the parallel economy would shrink. This has not come about. The current economic environment creates an atmosphere conducive for the coexistence of illicit domestic and foreign funds. The unchecked growth of the parallel economy is seriously debilitating the legal economy which is expected to drive the realization of the principal social goals of the country.

4.3 The modus operandi for laundering illicit domestic funds has been significantly in use since the nineties, the early days of liberalization. The nineties saw a spectacular increase in export remittances, and a consequential dramatic improvement in the balance of payments. Some of this was, no doubt, on account of increased production of goods and services, triggered off by the easing of controls and increase in incentives to the entrepreneurs. However, a significant part of the increase in export earnings was the result of the 'round-tripping', and the resultant laundering of illicit domestic funds. I know from the time when I was the Enforcement Director, in charge of the foreign exchange regulations, that there was ample evidence to indicate the wide-spread prevalence of such transactions in the early nineties. During that period, the Directorate had estimated, on a set of very conservative assumptions, and using back-of-the-envelope calculations, that the inflated export earnings, facilitated by hawala-routed foreign funds, could not be less than US\$ 1 billion - an amount that was not small by the standards of the export trade of those days. The open invitation to avail of this form of money laundering continues even today on account of the continuing tax exemption granted to export earnings of the IT and gem and jewelry sectors and from SEZs/EPZs/FTXs/EOWs/STPIs. The bed-rock of the current neoliberal economic policy is the principle that no special concessions/relaxations should be given to any particular area or sector of activity. Consistent with that, all concessions and tax exemptions need to be withdrawn, so that all investment decisions are taken on the basis of unhampered market forces. Based on this dictum, subsidies in various sectors benefitting individuals - petroleum products, food grains through the public distribution system, higher professional education, agriculture power tariff, fertilizer price, etc - have been removed, or reduced, over the last decade and a half. Yet, ironically, almost over the entire period of economic reforms, corporate tax exemption has been extended to export earnings of IT sector. In the early days of liberalization, our balance of payments position was so precarious that we were often forced to close our eyes to the violation of the tax/foreign exchange laws by way of over-invoicing of exports. However, this cannot be allowed to continue indefinitely. In the existing situation, the two types of illicit funds - domestic and foreign - are fully inter-convertible. In the circumstances that prevail, fiscal law authorities are waging an impossible battle to enforce the laws in the country. The business sector will only turn to activities in the legal sector when it becomes inconvenient for them to operate in the parallel economy. While the parallel economy will never cease to exist entirely - it is known to exist to some extent even in the first world economies (Italy, France, UK, etc) - but with the withdrawal of the incentive for export earnings, that invites abuse, there would be more pressure on the business sector to operate in the legal economy. In the totality of the circumstances described, the government should seek the earliest opportunity to remove the corporate tax exemption on IT exports. Corporate interest, with its overweening persuasive influence, always seems to get such concessions extended indefinitely. Very recently this concession was extended up to FY 2010-11. Conceptually, no other exemption/subsidy provision causes as much harm to the enforcement of fiscal laws, as the tax exemption available to export earnings in the IT and gems and jewelry sector. We know that if the concession is withdrawn today, in the midst of the global economic down-turn, there would be a howl of protest from the business community. Export earnings have come down drastically in the last six months. However, as

soon as this adverse situation eases, at the first opportunity, the anomaly should be removed so that the extreme ease of operating illegally in the parallel economy stands significantly diminished. Only when this is brought about, the fiscal authorities would have a fair opportunity to bring pressure on the parallel economy. While we may turn a blind eye to the over-invoiced export earnings in periods of dire difficulty, the fact cannot be ignored that this is indirectly encouraging the violation of fiscal laws to the damage of the legal economy. It is only when the laundering of black money becomes difficult, the legal economy would be able to dominate the scene in the country, and the government would acquire the capacity of directing the economy in a desired manner under its macro-level policies.

- 4.4 The foreign exchange transactions today are regulated under the Foreign Exchange Management Act, 1999 (FEMA). Prior to the enactment of this statute the transactions were regulated under the Foreign Exchange Regulation Act, 1973 (FERA). The new enactment marks a very significant dilution of the laws relating to foreign exchange transactions. Under FEMA, transgressions of the foreign exchange regulations are treated as fiscal offences, and not as economic crimes as under the erstwhile FERA. These transgressions are now non-cognisable and bailable. Investigating powers are limited to those available to income tax law enforcers under the Code of Civil Procedure. Various provisions that strengthened the hands of the investigator under FERA have been withdrawn: (i) independent powers to summon, search and seize evidence and property; (ii) independent power to arrest; (iii) presumption as to authenticity and correctness of records and property seized; (iv) burden of proof resting on the accused; and (v) stringent penalties, including a minimum sentence. In its totality, FEMA has been completely defanged. The possibility of the ED regulating the ongoing foreign exchange transactions is near nil now. Even in the rare case where the violation is established, the provision for compounding the offence makes the penalty entirely painless.
- 4.5 A new law – The Prevention of Money Laundering Act, 1999 – has given the enforcement authorities stronger powers for regulating certain elements of the parallel economy. The Prevention of Money Laundering Act is applicable to certain scheduled offences under the Indian Penal Code (murder, causing grievous hurt, kidnapping for ransom, counterfeiting of currency notes, forgery of securities, etc), Narcotic Drugs and Psychotropic Substances Act, Wild Life (Protection) Act, Immoral Traffic (Prevention) Act, Prevention of Corruption Act and Arms Act. Investigation of offences coming under these laws are also likely to get much more assistance from international banks.
- 4.6 However, the statutory backing available under the Prevention of Money Laundering Act is in no way adequate to meet the threat of the parallel economy. First and foremost, the quantum of money laundering linked to the statutes listed in the Prevention of Money Laundering Act is insignificant compared to the volume of the parallel economy. The social damage through these scheduled crimes – Indian Penal Code (waging war against the country, counterfeiting of currency notes); Wild Life (Protection) Act; Immoral Traffic (Prevention) Act – is enormous, but actually they involve relatively paltry amounts of illicit funds. Well-informed estimates of the funds from the parallel economy used in the 1993 Bombay blasts would not put the figure at more than ten lakh rupees; estimates of the fund requirements for the terrorist attacks in Delhi, Jaipur, Hyderabad, Malegaon and Varanasi suggest small fund requirements. Most of the volume of the parallel economy is through tax-evaded funds, which have the fungibility to effortlessly turn into resources for the most heinous crimes. Most of the funds in the parallel economy start off as tax-evaded funds; later, some part of the tax-evaded funds go into financing heinous crimes. In that perspective, domestic black money needs to be treated

more seriously than as a mere civil dispute between the government and the individual. The dilution of transgressions of foreign exchange regulations to that of civil offences, in our view, trivializes the issue. Taking into account the universe of the parallel economy (both illicit domestic funds and foreign fund flows), and the enormous dangers to society arising there from, we are of the considered view that the powers of the investigators under FEMA should be largely identical to those under the Prevention of Money Laundering Act. Conceptually, all transgressions of foreign exchange regulations, begin as tax-evaded funds and at some stage or the other, end up as the input for money laundering. By making foreign exchange violations a mere fiscal offence, we are only hobbling the law enforcers in their attempt to control money laundering. Foreign exchange violations are the first stage of the process of money laundering – we should not delude ourselves into believing that there are some benign forms of money laundering that deserve a milder enforcement statute.

5. The Damage to the Real Economy

5.1 It is the easy availability of illicit funds that is giving rise to many of the unhealthy features of the economy. For example, the secondary equity markets have always been very volatile, often for no identifiable reason. Many of the spikes and dips in the stock market indices seem unrelated to the economic conditions in the domestic or international markets. For example, the latest slump in the secondary equity market – from a level of 21, 500 in September, 2008 to 9000 in March, 2009- is not adequately explained by the prevailing conditions. As a matter of fact, many commentators on the stock market saw little fundamental basis for the bull frenzy that drove the sensdex up to 21, 500 by September, 2008. Also, considering that India is not so closely coupled with the international markets, and that the domestic demand creates a large market pool by itself, even after the global financial down-turn, there was little reason to justify a plunge in the stock market index to below 9000 by March, 2009. The only plausible reason for the volatility in the stock market is that the stock market is excessively dominated by speculative foreign funds. Large fund flows have been reported in the secondary equity market through 'participatory notes' and by investment of FII's registered in havens with low taxes and enjoying the protection of 'Double Taxation Avoidance Agreement' (DTAA). There is good reason to believe that a large portion of such funds is 'hot money'. In the modality of investment through 'participatory notes', the identity of the beneficial owner is undisclosed. The DTAA is a bilateral agreement that protects an investor from double taxation – first in the country where the profit (or interest, dividend, royalties and technical fees) is made, and there after in the country of residence of the investor. Conceptually, this provision is made to encourage cross investment between two countries, by avoiding the risk of double taxation. In other words, in the case of the DTAA with Mauritius, this is meant to catalyse Mauritian interest in investing in India, and vice versa. It has been observed that large scale capital flows from Mauritius has been in the form of FII flows into the secondary equity market. The investors are shell companies with only a pro forma registration in Mauritius. Under Mauritian law, any company registered in Mauritius is deemed to be resident there – no other evidence of working presence is required. The beneficial holdings are of legal entities located in other countries, and the Mauritian company that invests in the secondary market does not disclose the identity of the beneficial holdings. Under Indian taxation law, the shell company is first taxable in the country of its registration i.e. Mauritius. There is no capital gains tax in Mauritius, and consequently the Mauritius-registered shell companies are free of all taxes on their capital gains. The benefit of avoidance of capital gains goes to the faceless beneficial investors located in all parts of the globe. In result, we get no investment from legal entities substantively located in Mauritius, for promoting which

the DTAA was signed. Currently, over 43% of the FII coming into the country is routed through Mauritius. The funds are actually originating from other first world countries, many of which have their own DTAA's with India. However, many of these first world countries also have some level of capital gains tax, which would become leviable if the transaction was made with India directly by the investor in the first world country. In other words, Mauritius is merely utilised as a by-pass route. The use of this method by international investors is called 'treaty shopping'. The legality of a DTAA with Mauritius, that is openly used in this fashion, was challenged judicially. Finally, the Supreme Court ruled that the Central Government had the authority to enter into international agreements in its best judgment, and that the exercise of the power was not a justiciable issue. The Apex Court has given a ruling and it is only left to us to submit to that judicial ruling. However, the issue is not limited to the legal one of the Central Government having the constitutional authority to enter into a bi-lateral agreement with another country. Everything that is legal is not carried out by the state – for the state to take a proactive initiative, the action should be in public interest. In the circumstances of the DTAA, it is manifest that no public interest is served in allowing capital flows through the gaping hole that exists in the agreement with Mauritius. Or, if it is asserted that the government does consider it in public interest to have the DTAA with Mauritius in its present form, then the question immediately arises as to why a similar provision is not provided in the DTAA's with first world countries. The DTAA with Mauritius has benefitted no one; that is to say, no one other than kith and kin! If similar DTAA's were entered into with leading first world countries, they may not prove to be as tolerant of disguised money as Mauritius is!

- 5.2 There would be no reason for the financial sector to devise an opaque investment through PN/DTAA if the beneficial interest had nothing to conceal. Also, the DTAA is being used by FII funds to move through countries that have stringent secrecy laws. India has DTAA's with several countries, but it is the one with Mauritius that is preferred by many of the FIIs investing in the secondary equity market. Countries with stringent secrecy laws, and low or nil taxation, are the ones which are preferred. Transactions through such routes are the ones found convenient by the beneficial owners of 'hot money'. In this backdrop, there is reason to believe that a considerable portion of the funds coming into the secondary equity market is 'hot money'.
- 5.3 Such funds are in the nature of 'footloose' funds, which pose a serious threat to the stability of the economy and the sovereignty of the country. The funds are of a speculative nature and can be withdrawn in one sweep from the market. In the context of the global financial downturn, though the Indian economy was not directly hit, FIIs, as a result of their global liquidity requirements, withdrew heavily from the Indian secondary equity market. Also, these funds are often used by market speculators for making short-term killings through orchestrated manipulation of the market, and insider trading. These funds never plan a strategy of reaping long-term benefits through the productivity gains from investment in the country. The various policy initiatives adopted in the financial sector by the government had several stated objectives, one major one being that of widening and deepening the equity market, so as to make it more attractive and accessible to the domestic retail investor. The nature of the funds that have been coming into the secondary equity market, as also the manner in which they have been utilized, has not improved the nature of the secondary market from the point of view of the domestic retail investor. In the cataclysmic gyrations of the secondary equity market, the common retail investor has gone into his shell out of sheer fright. In fact, for the domestic retail investor, the market remains as illiquid as before. Sharp volatility in the stock market, even in an ascending phase, is no indication of its sound health.

6. Abuse of the Banking System by Global Banks

- 6.1 The tracking down of illicit foreign funds requires the cooperation of foreign countries. This has been totally missing in the past; in fact, countries like Switzerland and some seventy other tax havens over the globe, have openly colluded with the wrong-doers in protecting illicit foreign funds. It is specious to argue that secrecy of bank records is an inherent element of the privacy of an individual. It is understandable that everyone's bank records cannot be put in the public domain, and a situation cannot be created where mischief-mongers can set off on 'fishing expeditions' to dig out illegalities against their chosen targets. Undoubtedly, the country demanding information must have some preliminary evidence (not necessarily legally admissible evidence, or clinching evidence), before it can justifiably ask the concerned foreign bank to cooperate in the investigation. However, the position currently taken by Switzerland and other tax havens is that, the offence being investigated in India should amount to a criminal one in their country (as distinct from a fiscal offence), before they are prepared to extend cooperation.
- 6.2 The attitude of the governments of the tax havens in the past has been utterly cynical. These countries would never permit business activities that generate illicit funds in their own economy, but they are prepared to commercially deal with illicit funds originating from the developing countries, on the specious plea of an individual's 'banking privacy.' However, with increasing global financial integration, and the cataclysmic global events of the recent past, it has become clear to all, that such abuse will not be tolerated indefinitely by the global community. The attitude of the first world countries - to cooperation in investigations of the parallel economies of developing countries - is bound to change. The first shock was the 9/11 terrorist attack in New York in Sept., 2001. Several groups of conspirators had drawn up elaborate plans over an extended period, and had been financed by their principal handlers through the banking channels. Despite the strong private lobby championing banking secrecy, even the US government had to move for opening-up the secrecy laws. The second temblor that hit the developed world was the sudden melt-down of western banking institutions in September, 2008. Even the stoutest neoliberals realized that they had allowed anarchy to take root in the banking sector to a dangerous degree. The banks created countless opaque and complex instruments which attractively camouflaged weak housing loan securities. The aggregate value of these instruments was humongous, but the banking world was careful not to mention the risks involved in these. The absence of any monitoring or supervision was considered a virtue in this set-up. The edifice of housing securities had no structural reinforcement by way of regulatory oversight. Once this tall, fraudulent banking system crumbled, the powers that be in USA and Europe, realized with a shock, the degree of anarchy they had been promoting.
- 6.3 Now, the demand for monitoring/regulation of the global financial system is being voiced increasingly by first world countries and the multi-lateral forums. The OECD has pressed for greater cooperation between countries in the course of financial investigations, and has also advocated the lifting of banking secrecy laws in tax havens. The OECD has developed a code of tax standards internationally acceptable to rein in money laundering. At a meeting of the Finance Ministers of the G-20, including India, this code of standards was endorsed in Berlin in year 2004. OECD and G-20 countries are pressurizing the delinquent countries like Switzerland, with threats of black listing to enforce relaxation of their secrecy provisions. In a recent development, the US government has succeeded in forcing the UBS, Switzerland, a leading international bank, to revealing the particulars of some of their citizens holding secret

bank accounts. Recently, in the G-20 meeting held in London in April, 2009, several first world leaders (France and Germany were most vociferous) highlighted the urgent need to lift the veil of secrecy currently cast over financial transactions in tax havens. The time is now ripe for developing countries that have suffered as a result of such shady financial institutions, to collectively put their strength together to bring about a change in international banking practices.

6.4 In the past, the demand made by the developing countries, for lifting of the veil of secrecy in banking transactions, has been weak and only pro forma. Regrettably, many of the regimes in newly independent countries during the last half of the twentieth century have themselves been beneficiaries of secret bank accounts. In India, from time to time, the gravity of the issue has been highlighted, but without any sustained effort. Many cases uncovering large illegal assets have hit the headlines. Some have even been investigated with a degree of success, but have invariably been derailed before reaching judicial finality. India, as a country, is still to demonstrate that it has the political will to tame the demon of black money. Regrettably, whenever it comes to the point of biting the bullet, in matters relating to the parallel economy, our country has held back. India and China are emerging world economic powers, who can move strongly against the international illicit economy. In the sharing of benefits from the illicit black economy, the developed countries are the financial beneficiaries, while the developing countries are the losers. The developing countries – particularly India and China, could legitimately press for transparency in the global banking system. Banks from the first world are very eager to enter India and set up retail branches and other business centres. While giving such permission, a key condition could be that the foreign bank, on request, will extend cooperation, without demur, in any investigation relating to the parallel economy in India. The international community, in order to bring about the integration of the global financial system, could legitimately insist on cooperation, without demur, in the investigation of offences under national economic laws. If the developed countries expect cooperation from the developing countries in integration of the global financial system, they cannot at the same time, defend secrecy in transactions that go against the fundamental principles of integration of the global financial system. Insistence on cooperation in offences relating to the parallel economy must be the key bargaining chip for developing countries, like India, in their negotiations with the first world for reforms in the global financial sector.

7. Challenging Black Money through National and International Law

7.1 With the increasing anxiety about the danger from clandestine funds, the global community drew up a convention for regulating the conduct of, and cooperation between, countries– the UN Convention against Corruption (UNCAC -2003). 140 countries of the globe have signed the Convention and 125 of them have ratified it. India, regrettably, has signed, but not ratified, the Convention. It is obvious that if we want global cooperation in this area, we have to demonstrate the seriousness of our intent. In today's world, China and India are seen as the two emerging powers that have to be globally reckoned with. In an earlier part of this paper we have noted that Asia contributes about 50% of the illicit flow of funds out of developing countries, and China and India, in that order, are the two largest contributors in Asia. China faces a threat from its parallel economy that is no less serious than that faced in India. If these two countries jointly assume the leadership of the developing world, the first world roadblocks to open bank investigations, are likely to yield. The integrated global economy that the first world so much wants, cannot be created without including India and China. We can certainly argue with impact that the integrated global economy cannot be allowed to

retain features that disable the governments of developing countries from discharging their sovereign functions. As a first step in this direction, and in order to establish our bonafide, India should ratify the UNCAC without further loss of time.

7.2 Cooperation of the international banks would always be easier if the outflow of illicit funds is linked to some heinous crime. The Prevention of Money Laundering Act is an economic law for offences linked with heinous crimes like trafficking in women and children, narcotics smuggling, terrorism, arms trafficking, counterfeiting of currency, etc. The Act gives the investigating agency enhanced powers for enforcing of this law. Black money transactions and illicit foreign funds used in such crimes can be investigated under the enhanced powers. Conceptually, these would be the types of offences in which international banks would find it impossible too deny assistance. It is a common experience that, when a black money scam/hawala scam is uncovered, the funds are found to be involved in a large array of clandestine activities. A hawala centre is in the nature of an illegal, retail bank- some of it is used in other heinous crimes, while some may go into the production cycle of the parallel economy. It would be in our tactical interest if we give higher importance to investigation of the links with heinous crimes listed in the Prevention of Money Laundering Act. Even if one link is established with a heinous crime, the case for asking for bank details of all the individuals thrown up in that investigation would be strengthened. One example would clarify this point. The infamous Jain Hawala Case dominated the headlines in the first five years of the nineties. The documents unearthed incriminated many public personalities from the political arena, bureaucracy, industrialists, participants in the hawala business, and terrorists. Early in the investigation a terrorist link was established. A student from JNU had received some twenty lakh rupees, which were passed on to a terrorist outfit operating in J&K. The investigation into this strand of transaction was quickly tied up, and in the ensuing case the court convicted the student. This was found to be the only link with a terrorist organization that was discovered in the investigation; some other recipients of the hawala money were ministers and bureaucrats, who it was suspected were given funds on a quid pro basis; and still other recipients were politicians and bureaucrats who were out of power, and who, as we could surmise, had been given payments as investments in goodwill for future favours. For both the above-mentioned categories it was difficult to obtain evidence, particularly for the latter category, where the transaction was in the nature of an investment in goodwill. However, tactically, if we had pushed forward the terrorist case, in preference over the other types of crimes, it would have been difficult for any bank to deny information. For any significant case involving black money, at least one or two strands of it would lead to suspected crimes of the category listed in the Prevention of Money Laundering Act. Pursuit of these strands can be adopted as our preferred strategy where ever possible. The strands of investigation leading to any of the listed heinous crimes could be spotlighted in preference to the other strands linked to fiscal offences, when seeking assistance from foreign banks.

7.3 Government has for too long allowed the impression to grow that economic laws were to be tolerated in their own place, but they must never be allowed to retard growth. Laws relating to economic laws were found to be necessary, but only just so. In the course of its implementation the economic tsars found many occasions and reasons to go soft on it, in the interest of 'growth'. The rationale for 'Rule of Law' is obvious, but the intellectual elite so often find sound reason to brush it away. In this situation, even at the risk of stating the obvious, we would very briefly set out the situation where we feel law must be enforced without equivocation. Obviously, the need for economic laws has to be balanced with other priorities of society. Also, economic laws are meant to serve as deterrents and are not designed to

uncover and punish every case of violation. While the provisions of the law should be unambiguous in what it wants to stamp out, it cannot be so restrictive as to strangle all the activities of the ordinary world. The letter of our economic law should balance our various priorities – precise provisions for categories of economic activities barred in public interest; adequate and appropriate investigative powers considering the nature of the offences; balanced penal provisions commensurate to the damage caused by such actions to community interest; and the resolve of the community that the restrictions in the statute are honourable and defensible in public interest. Once the democratic polity has, through its working processes, satisfied itself that the economic law is justified, enforcing it should be a matter of duty. Unfortunately, in the reforms period, this is not the signal sent out by the government in respect of its economic laws. Many of the reforms samurai have openly mocked such laws. The impression was given that the laws had to be tolerated as a grudging gesture to past beliefs. The politico-cum-bureaucratic class has treated economic legislation as inferior legislation, best by-passed in the drive of development. Recalling my tenure as an economic law enforcer, in the face of all the flak one received from the economic tsars, one was often left wondering whether we at all held the legal mandate of the State for enforcing the economic laws. In such a climate of social values one can hardly expect diligent and committed enforcement of the economic laws.

7.4 It has earlier been mentioned that the funds in the parallel economy all begin their journey as tax-evaded funds. Therefore, the most effective method to stem the flow of funds would be to tighten up enforcement at that stage of the initial generation of illicit funds. Unfortunately, the general devaluation in the importance of enforcement of economic laws has weakened the enforcement of tax laws also. It has become fashionable to bad-mouth law enforcement in the commercial and industrial sector. Going by conventional wisdom, the lowering of the tax tariff framework in the last two decades, evasion should have come down drastically. While tax revenues have been growing, this is the result of the increased growth rate of the economy. There is persisting evidence that evasion is still continuing on a huge scale, thereby bloating the parallel domestic economy. The developed countries have relatively low tax levels, but they enforce them rigorously. Only selected cases are pursued and every tax filer is not harassed. However, even in a country like America, if you appear on the radar of the IRS, you are in for a harrowing time – in that system, the enforcement authorities don't take up a case for detailed scrutiny without good reason, but once having taken it up, they do not let the tax-filer off on the basis of flimsy explanations. In India the Income tax authorities need to improve their credibility and need to acquire a reputation where they are held in awe by the citizenry. The supply side of the parallel economy is determined by the efficiency of the income tax authorities in enforcing their law. Once tax-evaded money has been created, it becomes very much more difficult to track it in its further journey in the parallel economy. In this backdrop it would be apparent that the most effective way of shrinking the size of the parallel economy would be to encourage the revenue authorities to enforce the laws strictly and to maximise the revenue, thus reducing the volume of the stream of black money.

7.5 Consistent with this attitude to economic laws, over time, the laws themselves have been diluted till they are merely a token expression of intent. The Foreign Exchange Management Act, a key statutory instrument to tackle black economy, has become an un-implementable statute. An offence of the foreign exchange regulations has become a fiscal offence, in all features similar to an income tax law violation. The problems faced in investigation of foreign exchange regulations are infinitely more than those faced in offences relating to evasion of the income tax law. Black money generated in the course of clandestine production of goods

and services in the country does leave some evidentiary trail. In the case of production, raw material is purchased from somewhere, electricity is consumed in the course of production, manufactured goods are stored somewhere, money obtained through the sale of the goods is kept somewhere. All these items of evidence give the income tax law enforcers some space to investigate in. On the other hand, in the case of foreign exchange regulation violations, the evidence, if any, is out of reach in some foreign country. The law to investigate illicit foreign fund flows needs to give the investigators powers in excess of the powers available under normal economic law, despite the attendant risk that some part of it may, in some instances, be abused by the law enforcer. The rigour of the law has to be linked to the damage to the community through the offence, and the difficulty in bringing it to book – possible abuse of the enhanced powers has to be met through supervisory control. In this perspective, the package of powers given to the investigators under the Prevention of Money Laundering Act for the scheduled offences, with some balanced modifications, need to be extended to violations of the foreign exchange regulations. While the scheduled offences under the Prevention of Money Laundering Act are socially abhorrent and deserving of a stringent statute, we would be grossly underestimating the social damage caused by the parallel economy, if we left the powers under FEMA at the token level at which they exist today. The parallel economy (including illicit foreign fund flows) pose the gravest threat to our vision of India – one in which the democracy is founded on broad-based egalitarianism, where law is enacted as a balanced product for enhancing public interest, and where the resultant rule of law is held sacred as a secular bible. The runaway parallel economy that we encounter today is, in a way, hijacking the pattern of national development and is denying the country the socio-economic structure that it has democratically decided.

8. The Dharma of the Law Enforcers

- 8.1 There is a wide-spread perception in the country that investigating agencies (CBI, Enforcement Directorate, Investigative Wing of CBDT, Directorate of Revenue Intelligence) often intentionally compromise even strong cases. On reflection, I cannot recall many mega-scams relating to economic laws that have been taken to a conclusion, and where the perpetrators have been brought to book. The one partial exception may be the Securities Scam of the early 1990s. Even there, while the cases filed by the CBI and the ED, may be reasonably strong, as they rely on the regularly maintained books of account of banks, they are still in the courts. Only in one case has the conviction and sentence been conformed at the final level of the Supreme Court, and even there the sentence is only for six months. In the nearly two decades that have gone by, many of the perpetrators of this mega-scam have passed away, thus freeing themselves from the jurisdiction of the secular laws of the country.
- 8.2 From the evidence that is thrown up by the media from time to time, there is little doubt that many cases are compromised by the investigating agencies by intentionally taking the investigation in a direction which is a dead end. In several cases, the investigative drama is enacted more at the stage of the interlocutory proceedings, than in substantial investigation. In many prominent cases the drama has been over the remand/bail proceedings. While it is true that custodial interrogation is useful in some cases, the frenzy which is whipped up around it is mere sensationalism. Any seasoned criminal during custodial investigation will only give information which, though sensational, will not implicate him seriously. Of course, the period of police custody does give a chance to the investigating team to fabricate a purported confession of the accused! However, that is of little use in the trial, as the confession is not admissible evidence in a trial, unless admitted by the accused in court. This

is the reason why, in so many cases, there are dramatic announcements of confessions by the accused in police custody, but eventually the accused is set free by the court in the trial. Actually, the strategy of playing up the drama at the early investigative stage, and diverting attention away from the substantial and incontrovertible documentary evidence, is a standard operating practice for helping the accused.

8.3 The Bofors guns case has provided titillation to our newspaper readers for a quarter of a century now. Much is made of the fact that some foreign nationals have to be interrogated, and they are avoiding appearance before the investigating authorities. The media has widely reported, and it is known to be true, that despite all efforts of the investigating agency to drag their feet, some reliable documentary evidence has reached the CBI! It is quite likely that this evidence does not reveal the entire chain of the conspiracy. However, to the extent of the ex-facie evidence it provides, a case can be filed against those mentioned in the documents. Instead, we are continually entertained to a *nautanki*, where the absconding individual is pursued in Malaysia without success, and thereafter pursued in Argentina, again without success. And, at the end of all this, it is concluded that, without the presence of the accused, no case can be made out, and therefore the investigation should be closed. The evidence authenticated and provided by the Swiss investigating authorities, appears to be good prima facie evidence, on the basis of which a case can be filed in court even without the interrogation of the absconding accused.

8.4 The recent sensational case relating to the Pune-based stud farm-owner, Hasan Ali Khan, is a good illustration of how an investigation can be deflected and irretrievably damaged. In the course of Income Tax Department investigation into this person's illicit transactions, evidence was uncovered of massive holdings of illicit funds in UBS, a Swiss Bank. In December, 2006 the account had a balance of US \$ 8 billion which has been fully drained out by now. The volume of the transactions detected is reported to be Rs. 36, 000 crores. After some investigation, the Income Tax Department has served a demand of Rs. 71,849 crores on Hasan Ali Khan. Proceedings under FEMA are also underway. From all evidence in the public domain, Hasan Ali Khan is a mega – hawala dealer who maintained custody of his clients' assets in his foreign accounts till such time his clients made arrangements to take custody of their assets. Reliable sources give a few names of those whose assets are mentioned in the documents – the variety of the public personalities mentioned confirms that black money is a wide-spread national disease. The named individuals are not confined to one caste religion, language, state or political identity, and provide good evidence that the blight of black money is an all-pervasive, secular disease. To make an income tax demand of Rs. 71, 849 crores against Hasan Ali Khan, or to pursue some trifling case under FEMA and end the investigation there, would only bring the case to a premature closure. As has been mentioned earlier, Hasan Ali Khan is a big time hawala dealer – but his total identifiable assets cannot be more than a few hundred crore rupees; and, the Income Tax demand beyond that will only have to be written off. The large players in black money must have used Hasan Ali Khan's services, and these are the ones who would have acquired these assets in violation of various substantive economic statutes – Prevention of Corruption Act; Prevention of Money Laundering Act; Income Tax Act; Customs Act; Foreign Exchange Management Act and the former Foreign Exchange Regulation Act; Reserve Bank of India Act, etc. Investigations have reportedly thrown up evidence of a large inflow of funds in to the account from Adnan Khassogi, the infamous arms dealer of the nineties. The link of these funds with heinous crime (arms running) covered by the Prevention of Money Laundering Act gives the investigators an immediate opportunity to seek the cooperation of the foreign bank involved.

Treating this case as merely one of concealed income on the part of Hasan Ali Khan is to trivialize it. It is impossible to conceive of so much concealed income coming from benign, domestic business activities of Hasan Ali Khan. Already the investigating agency has discredited itself by transmitting documents to the Swiss authorities, which the latter has declared as forged. Could the premier investigating agency of the country have done this through an inadvertent error, or was this a ruse to play for time? The obvious line of action at this stage is for the Income Tax department to share the evidence with the other sister investigating agencies to ascertain how the money was generated, and to identify the specific criminal laws that have been violated. It is only when the investigation is carried forward to its logical conclusion that we would have made a major dent on the parallel economy. Also, at the end of the exercise, public life in the country would be much cleaner. The penalties provided in the economic laws of the country are not intended to raise revenue, but to act as a deterrent against the future commissioning of criminal acts. Therefore, it is critical to reach the entities where the illicit funds were generated and indict those who generated the funds.

- 8.5 The convolutions that the investigating agency has been through in these two cited cases are good evidence to show that it was never keen to pursue the investigation. The investigation agencies of the government – both CBI and ED – sorely need an image make-over. Sporadic announcements of economic criminals being brought to book will not convince anyone, least of all foreign banks that are looking for any excuse to avoid disclosure of their clients' accounts.
- 8.6 Discussions about the agencies that deal with economic crimes have often highlighted the need for greater sharing of information between them. This advice is a double-edged sword. All investigating/intelligence agencies suffer greatly because of porosity of their system and frequent leakage of critical operational information. Times without number, cases under investigation by an agency have been compromised by a crucial leak. The danger of this increases manifold if information is routinely shared between the different agencies. Sleuthing is often a solitary exercise. Good sleuths are very cagey – they have their own clandestine channels of information, and their own assessment as to who can deliver what, and when. A competent and motivated sleuth would not like his line of investigation to be second-guessed by anyone in another agency. Sharing of information across the board would go against the grain of the old pros. It is recognized that any economic crime may transgress several laws enforced by different agencies. Information would have to be transferred from the agency that makes the first discovery to the others, but that call must be taken at an appropriate time at a very high level in the originating agency, perhaps even at the highest level. Only such a procedure will ensure that investigations in different agencies do not stand compromised as a result of an independent move by a sister agency. Of course, if this is to work effectively, the heads of the agencies would have to exercise the highest order of objectivity when taking the crucial call.
- 8.7 Seeing the dismal past record of our investigating/intelligence agencies, several well-meaning individuals and institutions have suggested that the answer lies in designing a transparent system of making appointments to the heads of these agencies, and of providing a fixed and reasonable tenure to each appointee. From time to time, voices have also been raised by public personalities that the investigating organizations should be entirely independent i.e. not answerable to any wing of government. It is our view that none of these suggestions will improve matters by themselves. The appointments are generally made through screening processes by individuals holding the highest position in public affairs (in

some cases through a committee including the leader of the opposition in Parliament, in order to ensure bipartisan objectivity). These procedures have been in force for several years now, but with little impact. It has often been seen that a certain type of individual, who, in objective terms, is not suitable for holding a high public responsibility, easily obtains bi-partisan support – after all, all political parties feel they may need special consideration at some time or the other! Also, the fixed tenure has not in most cases elicited an attitude of independence and objectivity on the part of the appointee. In the culture that prevails in the bureaucracy, officers require not just security in this tenure, but also invest in goodwill for the post-retirement tenure! The new procedures introduced may become effective in future when the culture of public accountability in the country is of a different qualitative standard. The suggestion, that the heads of such institutions should be entirely independent, and should not be under the authority of any wing of government, also requires a good look in the practical setting. This, again, is a suggestion that will work when public probity and accountability is the prevailing ambient atmosphere in the country. In the situation that exists today, the wrong appointee put in position, without any answerability to any one, would become a raving tyrant. If one reflects on the personalities of the past (of course, they cannot be mentioned by name!), one would recall several Chiefs of CBI/IB/ED, who would be appropriate subjects of enquiry by the very institutions they headed! In the flawed society that we live in, it would be prudent to subject all our institutions to checks and balances and parliamentary accountability, despite our past disappointment with the processes of parliamentary accountability.

9. Summation

9.1 This paper has attempted to define the contours of the parallel economy. It has set out the historical background in which the parallel economy gained strength. It has demonstrated the mutually supportive inter-relationship, and easy mutual convertibility between illicit domestic funds and illicit foreign holdings. Monetary estimates of the domestic parallel economy, the illicit foreign holdings and the volume of hawala transactions have been given. The paper attempts to identify the fiscal environment that encourages and facilitates the creation of illicit foreign assets. It also gives examples of business activities that are particularly conducive to generation of illicit funds. The existing laws for controlling illegal economic activity – FEMA, Prevention of Money Laundering Act and the Income Tax Act – have been examined in the context of their effectiveness in controlling illegal economic activity. The deleterious impact of ‘hot money’ on important segments of the economy through PNs, DTAAAs and unfiltered FII investments has been described. The role of the international tax havens in protecting hot money has been described and the possibility of moderating this through international cooperation highlighted. The paper has also identified possible government initiatives that could shrink the parallel economy and moderate the illicit foreign holdings. To wrap up, the following major suggestions have been listed:

- (i) Withdrawal of Income Tax exemption under Sec. 10A and 10B currently available to IT exports and other exports from EEZs.
- (ii) Insistence on transparency in the beneficial ownership while allowing transactions in PNs; and limiting concessions under DTAAAs to legal entities substantively located in the countries entering into the DTAA.
- (iii) Renegotiation of the existing DTAAAs so as to ensure the cooperation of the contracting party during investigations into fiscal offences in India.
- (iv) Taking the leadership of the group of developing countries, particularly in partnership with China, in demanding transparency in financial transactions in foreign countries, in the

course of investigation of domestic fiscal offences. The negotiations under WTO for globalization of the financial sector should be used as a lever to ensure the setting up of modalities to obtain access to, and cooperation from, foreign financial institutions in the matter of fiscal investigations. Also, when foreign financial institutions apply for setting up branches to operate in India, these permissions should only be given subject to their commitment to cooperate in any of their global branches, in the course of an investigation of fiscal offences in India.

- (v) Immediate ratification of the United Nations Convention against Corruption by India. This will demonstrate our country's serious intent and bonafides.
- (vi) Strengthening of the provisions under FEMA on the lines of those provided in the Prevention of Money Laundering Act. Only this will enable the enforcement agencies to effectively challenge the creation of illicit foreign assets.
- (vii) Political and administrative commitment to the firm enforcement of all domestic economic laws.
