

## Reverse Capital Flight to Pakistan: Analysis of Evidence

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Capital flight from Pakistan has remained one of the major concerns of policy makers, mainly because of the nature of private capital outflows; that is, whereas private citizens hold a large amount of foreign assets, the country's burden of foreign debt continues to grow. Capital flight over and above normal levels raises serious concerns. Capital flight induces foreign donors to demand repatriation of private capital held abroad in return for their support. Previous studies have largely ignored the fact that illegal capital flow is a two way phenomenon. Private citizens' foreign capital is brought into the country when time is opportune. Using the measure of trade misinvoicing, this paper finds that between 1972 and 2013 the (net) reverse capital flight in Pakistan was of the order of about \$30 billion. To explain this phenomenon, the paper examines the evolution of Pakistan's exchange and trade control regimes in four phases. It is found that reversed capital flight increased during liberal regimes when both current and capital accounts were liberalised, meaning that in the absence of strong regulatory bodies, private citizens could manipulate trade and exchange laws. The paper offers some specific policy recommendations to restrict cross-border movement of capital through illegal channels.

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### 1. INTRODUCTION

Capital flight from Pakistan has been one of the main concerns for planners and policy-makers. Their worries come from the "paradoxical" nature of private capital outflows: private citizens hold large foreign assets while the country is in crisis burdened under growing foreign debt. Any abnormal capital flight when the position of foreign exchange reserves is unstable raises serious concerns for national welfare loss.<sup>1</sup> Evidence on capital flight often induces foreign donors to impose conditions for repatriation of private capital held abroad.

The impetus for capital flight from a country represents a demand for foreign exchange that arises due to portfolio reasons, excessive taxation, expectations of a major exchange rate realignment, macroeconomic (large fiscal and current account deficit) and political instability, and, of course, various foreign pull factors. Illegal outflow of capital

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<sup>1</sup>Interestingly, whereas capital flight activates idle capital, it also deteriorates income distribution in the country. Moreover, it deprives the government of tax revenues and foreign exchange earnings via workers' remittances that are leaked to fund both way movement of illegal capital.

is often channelled through remittances transferred by such means as Hundi/Hawala system, export under-invoicing, import over-invoicing, and smuggling of precious metals, antiques, etc.

Interestingly, illegal (unrecorded) capital flow is a two-way phenomenon. The capital held abroad by private citizens is brought into the country at opportune times. Policy-makers have only recently taken notice of this problem and decided to reverse capital flight that might be taking place through workers' remittances. Reverse capital flight takes place when imports are under-invoiced and exports are over-invoiced. What are the reasons for reverse capital flight? The answer is three-fold. First, it helps whitening the black money that earlier flew from the country. Second, it facilitates evasion of taxes on imports, and realises superfluous rebates and refunds on exports. Third, it assists in the circumvention of non-tariff measures (NTMs) on imports.

Given the nature of trade misinvoicing in Pakistan, it is permitting the two way movement of illegal capital. In this situation an adjustment of unrecorded private capital flows (arising from short-term capital movements or on payments flows that do not show directly in the recorded statistics) with capital flows arising from trade misinvoicing becomes essential to have a complete account of illegal capital flows in Pakistan.

Previous studies [Khan (1993) and Sarmad and Mahmood (1993)] focus only on the problem of capital flight from Pakistan, while Mahmood and Nazli (1999), covering the period 1972 to 1994, find evidence of reverse capital flight to Pakistan but stop short of analysing the phenomenon due to changes in trade and exchange control regimes.<sup>2</sup> The present paper shows that private citizens' motives in evading trade taxes and circumventing trade controls are to build foreign assets in Pakistan. Thus, net reverse capital flight is indeed taking place instead of net capital flight from the country.

Why does reverse capital flight take place? This is mainly because most of the reverse capital ends up in the informal part of the economy, where the owners of illegal capital easily avoid domestic taxes. Owners of this capital under-invoice import of goods with high customs duties to bring back their illegal capital. For this purpose, they use their foreign based capital or foreign exchange bought through Hundi/Hawala companies. To further hide their illegal capital from the radar of domestic tax authorities, they invest the capital, brought home in the guise of imported goods, in the informal sector. Interestingly, this happens despite the fact that owners of illegal capital can easily bring back the capital by remitting through the formal banking channels. This is so because by bringing back the illegal capital through under-invoiced imports they are not only able to evade import taxes but can also keep the illegal capital hidden from authorities by investing it in the informal sector.

Concomitantly, Section 111(4) of the Income Tax Ordinance, 2001, provides immunity from probe to foreign remittances coming through formal banking channels. This in effect encourages money laundering and round-tripping. It works like a permanent amnesty scheme to bring back capital residing outside the country. Since no questions are asked about the source of capital and no taxes are imposed, reverse capital

<sup>2</sup>It is important to note that with trade liberalisation, in the absence of effective regulatory institutions, opportunities to misinvoice trade increases, which accommodate two ways illegal capital flows. It may be noticed that the arrest of some owners of the foreign exchange companies in 2008 corroborate the view that the central bank's policy on capital account liberalisation is not implemented in letters and spirit, and thus other means, including trade account, are being utilised to illegally transfer capital across borders.

inflow through remittances is mostly used in the formal economy or kept in foreign currency accounts. One reason for the recent surge in remittances, largely believed to be the reverse capital, is the adoption of stringent money laundering laws and regulations by the international community.

The paper covers the period 1972 to 2013. During this period Pakistan passed through different exchange rate regimes including fixed exchange rate, managed floating exchange rate, multiple exchange rate, dirty float and flexible exchange rate. On the trade policy front, during this period Pakistan implemented various reform programmes, in particular the drastic cut in tariff rates and NTMs, and incentives for export promotion. Moreover, Pakistan allowed full convertibility on the current account along with partial convertibility on the capital account.<sup>3</sup> It would be useful to analyse the illicit capital flows by using the latest available data, in terms of the link between capital flight and shifts in exchange rate and trade policy regimes.

The rest of the paper is divided into seven sections. Section 2 provides an overview of exchange rate and trade regimes in Pakistan. Section 3 discusses the methodology to identify and measure the size of trade misinvoicing. The approaches to estimate capital flight are discussed in Section 4. Section 5 provides the adjustment mechanism of illegal capital flows with trade misinvoicing. Section 6 reports data and data sources. Estimates of illicit capital flows and discussion on the findings are reported in Section 7. Finally, Section 8 concludes the paper and offers some policy recommendations.

## 2. EXCHANGE RATE AND TRADE REGIMES

To explain the trends in illicit capital flows, it would be useful to demarcate in an analytically meaningful manner the evolution of Pakistan's exchange and trade control regimes. In this context, we delineate four phases:

### 2.1. Phase I (1972-1981): Fixed Exchange Rate Regime and Partial Lifting of Trade Controls

During this phase, Pakistan maintained the fixed exchange rate policy. On 11th May 1972, the Pakistani currency was devalued by 56 percent, which was appreciated by 11 percent in February 1973 soon after the US dollar was devalued by 10 percent. The exchange rate fixed in 1973 was maintained upto 7th January 1982. Upon devaluation of the currency, the trade control system was overhauled on the lines recommended by the International Monetary Fund (IMF). The export bonus scheme that introduced a multiple exchange rate system throughout the 1960s was abolished, tariffs were reduced on intermediate and capital goods, and the degree of *cascading* in the tariff structure was lowered. With the exception of tax rebates and export financing, all export subsidies were withdrawn. Instead, export duties were introduced on a number of intermediate inputs to promote high value added industries. These were eliminated subsequently, however. In

<sup>3</sup>The very fact that trade misinvoicing takes place in Pakistan, to move capital in and out of the country, explains that the capital account *de facto* is not fully convertible. Thus, those who wish to take their money out or bring in get indulged into trade misinvoicing activities because of certain controls that are still in place on the movement of capital.

addition to these policy measures, the import licensing system was simplified; all the permissible imports were placed either on the “Free List” or the “Tied List”. During this phase both current and capital accounts remained substantially restricted.

The impact of these liberalisation measures on the economy was short lived due to rising domestic inflation. The rupee once again became overvalued, especially after the appreciation of the US dollar to which the currency was pegged. Instead of devaluation of the rupee, the government preferred to use export subsidies and quantitative restrictions on imports to manage the trade balance. Licensing procedures were tightened again. Differential import duty rates were imposed for commercial and industrial users. All of these measures further increased the anti-export bias in government policies.

## **2.2. Phase II (1982-1998): Managed Floating Exchange Rate and Liberalisation Initiatives**

The government fine-tuned the overvaluation of the currency by adopting the managed floating exchange rate on 8th January 1982 and linking the currency to a basket of 16 currencies of its major trading partners. The value of the currency started declining after the adoption of the new exchange rate regime. Since 1991, some new measures to reform the exchange and payments system were introduced that included: (i) resident Pakistanis were allowed to maintain foreign currency accounts like non-residents to attract funds held abroad by private citizens, legally or illegally; (ii) restrictions on holding foreign currency and on foreign exchange allowances for travel were removed; and (iii) rules governing private sector’s foreign borrowing were liberalised, especially where no government guarantee was required. In addition, a host of other restrictions on foreign payments were removed (e.g., for the purpose of education, royalty payment, foreign advertisement, and professional institutions’ membership).

During this phase the import tariff structure was significantly rationalised: maximum tariff rate declined from 350 percent in 1982 to 45 percent in 1998. Import licensing was eliminated with the exception of a small number of items remaining on the negative and restricted lists; these were further reduced gradually. Non-tariff barriers were reduced except for security, health, religious and reciprocity reasons. Some new export promotion measures were also introduced such as: (i) streamlining of schemes of duty-drawbacks, bonded warehousing and export credit; (ii) garment units in export processing zones were allowed to buy textile export quotas from the Pakistani market; (iii) foreign companies were allowed to export goods; and (iv) improvements were made in the institutional arrangements for quality control, marketing and training of skilled manpower.

In 1994, full convertibility of Pak-Rupee was introduced for current account transactions as part of the trade liberalisation programme, while a cautious approach was adopted for the convertibility of the capital account. The central bank implemented partial convertibility of the capital account by allowing foreign exchange companies to operate in Pakistan and the corporate sector to obtain foreign equity. Pak-Rupee was also made fully convertible for some capital account transactions, e.g., foreign portfolio investment in the country. Aside from allowing 100 percent foreign equity participation, no restrictions were in place on the repatriation of capital, profits, royalty, etc.

### **2.3. Phase III (July 1998-July 2000): Multiple Exchange Rate and Dirty Float Regimes**

This phase was marked with political instability in the country and economic sanctions by western countries against the nuclear test by Pakistan. The government froze the foreign currency accounts in order to preserve its official foreign exchange reserves. These steps eroded the confidence of the private sector. Whatever gains had been made on the current and capital accounts through liberalisation in the earlier periods were virtually reversed. To counter the crisis, government adopted the system of multiple exchange rates consisting of an official rate (pegged to US dollar), a floating inter-bank rate (FIBR), and a composite rate (combining official and FIBR rates). On May 1999, Pakistan adopted the system of dirty floating exchange rate and the currency was pegged to the US dollar by removing the multiple exchange rate system. The exchange rate was then defended within narrow bands (margins) till July 2000.

Despite economic and political difficulties, Pakistan resisted the protectionist pressure from domestic interest groups and continued with market-based reforms, including a more liberal policy for imports and foreign investment. Besides, the maximum tariff rate came down to 30 percent from 45 percent in 1998. The scope of export prohibitions was reduced and export subsidies were linked with export-performance.

### **2.4. Phase IV (July 2000-2013): Flexible Exchange Rate Regime and Trade Liberalisation**

Since 20th July 2000, Pakistan has been following a flexible exchange rate regime. Nevertheless, the *de jure* exchange rate arrangement is managed float without fixing pre-determined paths for the exchange rate. The central bank's interventions are limited to moderating and preventing excessive fluctuations in the exchange rate. The central bank intervenes in the market using the US dollar. Foreign exchange controls and restrictions are now minimal. Current account transactions are now unrestricted except for occasionally imposed limits on advance payments for some imports. Foreign investors can now freely bring in and take out their capital, profits, dividends, royalties, etc. IMF (2010) classifies Pakistan's exchange rate regime as a *de facto* conventional peg to the US dollar within a narrow band.

Pakistan has reduced tariff rates across the board. Between 2003 and 2007, the maximum tariff rate was 25 percent. However, due to rising trade deficit, the maximum tariff was raised to 35 percent in 2008. In the 2012-2013 budget, the government reduced maximum tariff rate to 30 percent and simplified the tariff structure by reducing the number of tariff slabs from 8 to 7. Quantitative restrictions and other direct state interventions relating to trade have been drastically reduced. Ordinary customs duties are now the primary trade policy instrument along with some NTMs that range from price controls to exchange and finance controls, quantity controls, and monopolistic and technical measures. Many of the statutory regulatory orders (SROs) providing discretionary exemptions to firms and industries are still in force making the trade regime more complicated.

The government has introduced the Strategic Trade Policy Framework (2009-2012). It includes measures such as: financing of export firms at fixed interests for a short to medium term, creation of a fund to hedge markup rate hikes, provision of insurance cover for visiting buyers, facilitation of export firms in foreign markets, arranging warehousing facilities abroad, providing support for compliance certification, compensating inland freight charges, funding technology, skills and management upgradation for value added products, supporting brand promotion and compliance with safety standards, clustering development, reducing cost of doing business, etc.

### 3. TRADE MISINVOICING

An importer is tempted to under-invoice imports if import duties and rents on quantitatively restricted imports are higher than the premium on the exchange rate in the open (or black) market that he has to purchase to pay foreign sellers in full. When there are no foreign exchange controls but trade barriers do exist, then clearly there is an incentive to under-invoice imports [Mahmood (1997)]. There is, however, some risk attached both to under-invoicing of imports and engaging in illegal foreign exchange transactions. Thus, under-invoicing will not occur unless the difference between import tariff equivalent and premium on foreign exchange in the open market is greater than the evaluated risk factor of being caught by law enforcing agencies [Bhagwati (1964)]. The importer who practices under invoicing brings capital to the country (the reverse capital flight) and draws benefit from this transaction. It is quite likely that if this perceived benefit is added to the saving of import duties due to import under-invoicing then the above differential further rises. Capital is brought into the country but by by-passing official foreign exchange reserves.

One can also explain over-invoicing of imports that takes place simultaneously. This is used to take capital out of the country. In this case, the importer is willing to pay higher customs duties to take out its capital, normally the 'black money', outside the country to safe havens, to whiten it at a later date. With the resultant higher average import tax earning rate it transmits false signals about the trade policy being more protectionist or restrictive whereas in fact it is not.

Likewise, under-invoicing of exports is practised to take black money outside the country. By under-invoicing, the exporter is willing to surrender the benefit of export subsidy if it is available or avoid export tax if there is any. This practice deprives the government of foreign exchange earnings.

Some exporters also resort to export over-invoicing to illegitimately benefit from export subsidies and to make reverse capital flight possible to whiten the black money taken out of the country at some earlier date. If the exporters do not have black money outside the country then they buy it from the Hundi/Hawala ("correspondent") exchange companies based in foreign countries. In this case exporters compare the differential between the subsidy rate and the perceived benefit from reverse capital with the premium on foreign exchange paid on capital purchased from the Hundi/Hawala traders in the open market; if the differential is greater than the evaluated risk factor of being caught, then the exporter will over-invoice. In this case government receives additional foreign exchange earnings but loses on account of extra export subsidies it pays for over-invoiced exports.

#### 4. ILLICIT CAPITAL MOVEMENTS

Two approaches to measure illicit capital movements are available in the literature: direct and indirect. The direct approach uses information obtained from the balance of payments accounts. This approach identifies capital flight as short-term capital outflows, and considers it as a response of private citizens to investment risks in the country. Usually, these funds promptly respond to political or financial crisis and expectations about more restrictions on capital account or devaluation of the home currency.

Cuddington (1986) using the direct approach, defines capital flight as a short-term (speculative) reaction of private investors to macroeconomic instabilities or other policy-induced investment risks.<sup>4</sup> This is why the Cuddington approach focuses only on the acquisition of short-term foreign assets by private non-bank investors, and errors and omissions instead of the private sector's total acquisition of external claims.<sup>5</sup> Cuddington chooses only the short-term foreign assets because they presumably respond quickly to changes in expected profitability or shift in risks. Cuddington thus defines capital flight ( $KF_{CUD}$ ) as:

$$KF_{CUD} = -NEO - NAC \quad \dots \quad \dots \quad \dots \quad \dots \quad \dots \quad \dots \quad (1)$$

where,  $NEO$  stands for net errors and omissions; and

$NAC$  for net acquisition of non-bank private short-term capital.

The direct measure of capital flight is not free from criticism as it does not take other than short-term capital flows into account because long-term foreign financial assets are close substitutes for short-term assets due to the existence of very active secondary markets in long-term financial assets. On the other hand, errors and omissions include unrecorded flows or statistical discrepancies. In view of this criticism, indirect approaches to capital flight are also suggested.

Indirect approaches include the World Bank's (1985) and that of Morgan (1986). In these approaches, capital flight is considered as a residual of increase in external debt, net foreign direct investment, foreign exchange reserves and the current account deficit. Here, the idea is that the first two inflows finance the latter two outflows. If the first two *sources of funds* cannot finance the latter two *uses of funds* then the difference would indicate occurrence of capital flight.

The World Bank approach considers increases in external debt and net foreign direct investment as capital inflows to the country, and deducts from these inflows the sum of current account deficit and increase in official reserves. This difference is taken as a claim on foreign assets by private individuals. In other words, this approach assumes that if the capital inflows do not finance the current account deficit or official reserve accumulation (i.e., the recorded use of foreign funds), it leaves the country in the form of capital flight. The World Bank definition of capital flight ( $KF_{WB}$ ) can be expressed as follows:

<sup>4</sup>Also see, Eggerstedt, Hall, and Wijnbergen (1993).

<sup>5</sup>It may be noted that 'errors and omissions' usually consist of both unrecorded short-term and long-term capital; therefore, estimates based on Cuddington's definition are not purely short-term. Moreover, capital flight cannot be restricted to short-term assets only, because the long-term foreign bonds are now considered as close substitute to short-term assets as there is very little loss of liquidity associated with acquisition of long-term assets in the secondary capital market.

$$KF_{WB} = CED + NFDI + CAB + COR \quad \dots \quad \dots \quad \dots \quad \dots \quad (2)$$

where,

$CAB$  is Current account balance,  
 $COR$  is Changes in official reserves,  
 $CED$  is Changes in external debt, and  
 $NFDI$  is Net foreign direct investment.

The Morgan definition<sup>6</sup> works out foreign capital inflows on the lines of the World Bank definition. In this approach inflows are used to finance the current account deficit, increase in official reserves and increase in the net foreign assets held by commercial banks. Thus, the Morgan definition of capital flight ( $KF_{MOR}$ ) can be written as:

$$KF_{MOR} = CED + NFDI + CAB + COR + NAFA \quad \dots \quad \dots \quad \dots \quad (3)$$

where,  $NAFA$  is Net acquisition of foreign assets by commercial banks.

## 5. ADJUSTMENT OF CAPITAL FLIGHT WITH TRADE MISINVOICING

Trade and foreign exchange restrictions and lax enforcement of controls create incentives for trade misinvoicing in such a way that it can result in both way movement of private capital, i.e., capital flight from the country and/or reverse capital flight to the country. Interestingly, the difference in trade statistics of the reporting country and its trading partners often helps to identify this problem. Using the partner country data technique,<sup>7</sup> we adjust the capital flight estimates derived from three approaches with estimates of trade misinvoicing in the following way:

$$\begin{aligned} KFM_{WB} &= KF_{WB} + MI \\ KFM_{MOR} &= KF_{MOR} + MI \\ KFM_{CUD} &= KF_{CUD} + MI \end{aligned}$$

where,

$KFM_{WB}$  is Capital flight estimates adjusted for trade misinvoicing using the World Bank approach.

$KFM_{MOR}$  is Capital flight estimates adjusted for trade misinvoicing using the Morgan approach.

$KFM_{CUD}$  is Capital flight estimates adjusted for trade misinvoicing using the Cuddington approach.

$MI = MI_x + MI_m$  = Misinvoicing in total trade.

$MI_x = M_{icp} - X_{pic} * Ad$  = Misinvoicing of exports.

If  $MI_x < 0$  then exports over-invoicing is taking place from the country.

<sup>6</sup>The definitions of capital flight by the World Bank and Morgan consider total accumulation of foreign assets short-term and long-term (both reported and unreported).

<sup>7</sup>In this technique, cif import values of the country are compared with cif-fob adjusted export values of the partner country to find 'perverse' discrepancies in trade statistics [see, Bhagwati (1964); Bhagwati, Krueger, and Wibuswasdi (1974); Gulati (1987); Mahmood and Mahmood (1993); Mahmood (1997) and Mahmood and Azhar (2001)].



If  $MI_x > 0$  then exports under-invoicing is taking place from the country.

$$MI_m = M_{pic} - X_{icp} * Ad = \text{Misinvoicing of imports.}$$

If  $MI_m > 0$  then imports over-invoicing is taking place in the country.

If  $MI_m < 0$  then imports under-invoicing is taking place in the country.

$M_{icp}$  = Imports of industrial countries from Pakistan (*cif*).

$X_{pic}$  = Exports of Pakistan to industrial countries (*fob*).

$M_{pic}$  = Imports of Pakistan from industrial countries (*cif*).

$X_{icp}$  = Exports of industrial countries to Pakistan (*fob*).

$Ad$  = Adjustment factor defined as *cif-fob* ratio.

## 6. DATA

We adopt here the sign convention used in the balance of payments accounts. The data used here are for the period 1972-2009. The data definitions and sources used are as following:

- (1) Changes in external debt. World Bank: *World Debt Tables*.
- (2) Net foreign direct investment. IMF: Balance of Payments. Line 3..XA.
- (3) Current account surplus. IMF: Balance of Payments. Line A..C4.
- (4) Changes in official reserves. IMF: Balance of Payments. Line 2..X4.
- (5) Errors and omissions. IMF: Balance of Payments. Line A..X4.
- (6) Non-bank private short-term capital. IMF: Balance of Payments. Line 8..2X4.
- (7) Net acquisition of foreign assets by banks. Figures are multiplied by -1 for consistency with the balance of payments sign convention. IMF: *International Financial Statistics*. Line 7ad.
- (8) Trade data for Pakistan and industrial countries IMF: *Direction of Trade*.
- (9) *cif-fob* factor. IMF: *International Financial Statistics*.
- (10) Before 1982, values in items 1-6 were reported in terms of Special Drawing Rights (SDRs). These values are converted into US dollars by using the average SDR/dollar exchange rate reported in IMF: *International Financial Statistics*, Line sb.

## 7. ESTIMATES OF CAPITAL FLIGHT

How large is the size of illicit capital flows in Pakistan? Between 1972 and 2013, Pakistan received (net) illicit capital inflow (or reverse capital flight) of about \$30 billion.<sup>8</sup> Accumulated reverse capital flight represents 50.5 percent of the total outstanding external debt and 13 percent of the GDP in 2013. Such a large size of reverse capital flight negates the widespread and exaggerated impression about the net capital flight from the country.

In illicit capital flow activities individuals with varied behaviours and interests are involved. Their motive essentially is to circumvent economic policies to draw maximum benefit for themselves. As economic policies change from time to time to meet

<sup>8</sup>It needs to be underlined here that since workers' remittances through official channels are also partly used to reverse the capital flight, the above figure is, somewhat, an understatement of the true size of the reverse capital flight. In the FY2005-06 Pakistan received \$4.6 billion, which rose to \$13.92 billion in FY2012-13—a 3-times rise in remittances.

developmental objectives of the economy, so does illicit capital movement in intensity and direction. The preceding analysis shows that illicit capital flow is an area which successive governments in Pakistan have not been able to contain.

Table 1 shows that on average in all periods, the Pakistani traders over-invoiced exports and under-invoiced imports to bring illicit capital to the country. More specifically, Table 1 reveals that in the first phase (1972-1981) exports were under-invoiced by an average of \$28.43 million per annum. It shows the clear motive to take capital out of the country. This is the period when capital account restrictions were the harshest. Exports of intermediate inputs were restricted by using export duties. Thus, exporters not only circumvented capital controls but also export restrictions with connivance of the Customs staff. In the same phase, however, imports were under-invoiced by \$277.48 million per annum. In this case, the clear motive was to bring illicit capital back to the country and evade high import duties. On the net basis, during the first phase there was a reverse capital flight of \$249.10 million per annum through trade misinvoicing.

In all the remaining three phases, Table 1 shows that there was over-invoicing of exports and under-invoicing of imports. Consequently, in the period when managed floating exchange rate or flexible exchange rate policies were in force, the country received a net inflow of illicit capital through the balance of payments account. The highest average per annum export over-invoicing was recorded during the third phase (1998-2000). This period was marked with depletion of foreign exchange reserves, economic sanctions imposed by the Western countries, freezing of foreign currency accounts, use of multiple exchange rates and later, adoption of the dirty floating exchange rate, and use of export-performance linked export subsidies. At the time when government was looking for financial resources, exporters deprived the country by obtaining extra subsidy on account of over-invoiced exports. Nonetheless, government was satisfied as the over-invoiced earnings on exports raised its foreign exchange reserves.<sup>9</sup>

Table 1

*Trade Misinvoicing (Average Per Annum, US Dollar in Million)*

Period/Phase	Exports	Imports	Total Trade
I: 1972-1981	28.43	-277.48	-249.10
II: 1982-1998	-161.52	-769.62	-931.14
III: 1998-2000	-443.35	-160.10	-603.46
IV: 2000-2013	-166.38	-557.97	-724.35
Total Period	-138.48	-548.66	-687.14

*Source:* Author's estimates.

The highest under-invoicing of imports was recorded during the second phase (1982-1998), when by and large tariffs and NTBs were very high, so there was an incentive for importers to circumvent trade policy restrictions and indulge in import under-invoicing activities and bringing home illicit capital (Table 1). The fourth phase

<sup>9</sup>It may be noted that in the absence of export over-invoicing, remittances that were to be used to over-invoice exports may come through legal channels thus raising the official foreign exchange reserves.

(2000-2013) also recorded very high levels of average per annum import under-invoicing. During this period, tariff rates were not very high but still high enough to entice importers to resort to such activities. Although, NTBs declined during this period but NTMs increased owing to corruption and bad governance. On the net basis, the overall illicit capital inflow was the highest during the second phase followed by the fourth phase. Total trade misinvoicing estimates show that relatively lower trade restrictions and liberalisation of current and capital accounts, especially in the fourth phase, could not stop illicit capital movement. This implies that implicit trade and capital accounts restrictions remained widespread, which enticed people to defy them to draw benefits. The pertinent question is how this large illicit capital inflow was financed. The answer is through Hundi/Hawala, a channel that is used to finance trade misinvoicing. In addition, illicit capital that was taken out of the country at some earlier date became a major source of reverse capital flight at a later date.

Table 2 reports estimates of capital flight that are un-adjusted for trade misinvoicing using the three approaches discussed earlier: the World Bank, Morgan and Cuddington's. Estimates using these approaches are not very consistent with each other; thus, it is difficult to arrive at any consensual conclusion. Whereas the Morgan and Cuddington estimates are consistent with each other in the first three phases, they are inconsistent with each other in the fourth phase.

The World Bank estimates show that there was a net capital flight from Pakistan in the first three phases, while both Morgan and Cuddington approaches show net inflow of illicit capital (Table 2). In the fourth phase, estimates based on the World Bank and Cuddington approaches show reverse capital flight while the Morgan approach shows a net capital flight from the country; this is mainly because of large acquisition of foreign assets by commercial banks, a component this approach includes in addition to the components of the World Bank approach (see Equations 2 and 3). Arguably, acquisition of foreign assets by commercial banks is not capital flight, so the Morgan estimates should be used with some care. On the whole, for all periods unadjusted estimates for the World Bank and Morgan definitions show net capital flight from Pakistan, while the Cuddington approach shows reverse capital flight.

Table 2

*Un-adjusted Capital Flight (Average Per Annum, US Dollar in Million)*

Period/Phase	World Bank	Morgan	Cuddington
I: 1972-1981	16.9	-6.3	-29.00
II: 1982-1998	39.71	-357.71	-121.53
III: 1998-2000	89	-227.67	-461.33
IV: 2000-2013	-57.46	2216.00	-43.46
Total Period	8.47	511.47	-100.12

Source: Author's estimates.

Although, we could not arrive at some consensus using estimates of capital flight that are un-adjusted for trade misinvoicing, yet the adjusted estimates of capital flight are congruous in all approaches in all phases except for Morgan in the fourth phase (Table 3). The World Bank approach shows that with the change in exchange rate regime and trade

liberalisation, the size of reverse capital flight has increased. A similar result can be noticed for the Cuddington approach. This pattern has emerged due to a fall in cost of illicit capital flow transactions owing to both trade and capital accounts' liberalisation, especially as the regulatory bodies are weak in implementing the rules and regulations. All in all, Table 3 reveals that Pakistani private citizens have been bringing huge amounts of illicit capital every year since 1972.

Table 3

*Adjusted Capital Flight (Average Per Annum, US Dollars in Million)*

Period/Phase	World Bank	Morgan	Cuddington
I: 1972-1981	-232.15	-255.35	-278.05
II: 1982-1998	-891.44	-1288.85	-1052.67
III: 1998-2000	-514.45	-831.12	-1064.79
IV: 2000-2013	-781.81	1492.57	-767.81
Total Period	-678.67	-175.67	-787.25

Source: Author's estimates.

So far we have discussed the trends in illicit capital movement across borders. We can gain more insights if we use the estimates to find out the importance of illicit capital flows in terms of GDP and foreign exchange earnings. The ratio of reverse capital flight to GDP<sup>10</sup>, for example, can be considered as the investment going into the underground economy. The ratio of reverse capital flight to foreign exchange earnings indicates the significance of illicit capital inflow *vis á vis* official capital inflows.

Using the World Bank approach, the estimates of reverse capital flight to GDP show the highest ratio in the second phase (1982-1998), followed by the third phase, the first phase and the fourth phase (Table 4). What these estimates signify? On average, they are about 1.5 percent of the annual GDP. If we recap the happenings in the second phase, it may be noticed that during this period Pakistan launched a programme of economic liberalisation, privatisation and denationalisation, the structural adjustment programme with donors' support, a shift in the exchange rate regime from fixed to a managed float, policy of whitening of domestic black capital and the illegal capital residing abroad and permission for opening of foreign currency accounts to residents. With these major policy changes, when the cost of transaction of capital flows declined, it became easy for private citizens to bring back their capital held abroad. To avoid any legal actions at a later date by the government, most of this capital was brought into the country through illegal channels instead of legal channels.

The ratio of reverse capital flight to foreign exchange earnings was the highest in the third phase (Table 4). This was the time period when the country followed multiple exchange rate policy, freezing of foreign currency accounts as a result of decline in foreign exchange earnings including remittances and export earnings. Consequently, in this period of uncertainty private citizens proportionately brought home more capital through illegal channels.

<sup>10</sup>Different studies estimate that the size of the underground economy in Pakistan is about the same as that of the formal economy. See for instance, Kemal and Qasim (2012).

Table 4

*Significance of Adjusted Illicit Capital Flows for Pakistan (Annual Average; Percent)*

Period/Phase	Capital Flight as a Percentage of GDP			Capital Flight as a Percentage of Foreign Exchange Earnings		
	World Bank	Morgan	Cuddington	World Bank	Morgan	Cuddington
I: 1972-1981	-1.259	-1.460	-1.721	-8.415	-10.410	-14.950
II: 1982-1998	-1.932	-2.650	-2.395	-9.531	-13.115	-11.969
III: 1998-2000	-1.856	-1.540	-1.513	-1.0561	-9.254	-8.785
IV: 2000-2013	-0.499	1.063	-0.821	-2.512	4.756	-4.234
Total Period	-1.357	-1.277	-1.722	-7.369	-7.089	-10.241

Source: Author's estimates.

## 8. CONCLUSION AND POLICY RECOMMENDATIONS

The findings of this paper refute the general assertion that providing external funds to countries like Pakistan could be futile if they lead to capital flight. Contrary to this claim, this paper shows that reverse capital flight takes place on net basis all the time. These illicit inflows complement the resources received by the country in the form of foreign loans, foreign investment and the country's own foreign exchange earnings. Of course, illicit capital is largely invested in the underground part of the economy. The underground part of the economy, including the real estate sector, is out of the tax net. Industries in Pakistan prefer to under-report their true installed capacity by under-invoicing their plant and machinery and hence under-report the actual size of the establishment. This practice ultimately helps industries to also evade taxes on their sales, purchase of domestic inputs and income.

Capital flight exacerbates problems in the domestic economy including unfavourable investment climate. By implication, a healthy state and conducive economic environment should be instituted in the event of reverse capital flight. The paper finds evidence of large volume of reverse capital flight to Pakistan. Does this mean that everything on the economic front is very well in the country? Perhaps not! As noted earlier, the way business in commercial markets and real estate sector is flourishing and expanding, one is tempted to conclude that the situation is favourable for absorbing reverse capital flight.

An important finding is that the reverse capital flight increased during the period of trade and exchange liberalisation. This indicates that in the absence of strong regulatory bodies, liberalised trade and exchange regimes allowed private citizens to manipulate trade and exchange laws.

Tax evasion and avoidance have been the key sources of illicit movement of capital across borders in Pakistan. Improving tax administration and effective enforcement of trade laws can control to and fro movements of illicit capital. The following specific measures are suggested to restrict the cross-border movement of capital through illegal channels:

- (1) Money obtained through corruption and tax avoidance/evasion is the main source of illicit funds that are illegally transferred across borders. There is therefore a dire need to introduce governance reforms to control rampant corruption in the country, which undercuts lawful activities in the country.

- (2) Illicit capital movements are largely due to lax enforcement of capital and trade controls by regulatory bodies. This provides high premium to private citizens if they circumvent trade and foreign exchange controls and misuse trade incentives. An effective implementation of trade and exchange controls is, therefore, expected to discourage illicit movement of capital. In this context, it would be very rewarding if customs administration is improved, tariff structure is simplified by making it more uniform, and appointing pre-shipment inspection companies with good reputation.
- (3) To control Hundi/Hawala (correspondent) businesses, their related individuals or entities be traced by banking authorities who are holding large sums of funds to settle laundered money in Pakistan. Government's Remittance Initiative has made a little dent in this system but this menace is still going on at a large scale.
- (4) A policy support that discourages undervaluation of capital in the country would make under-invoicing of imports of plants and machinery less attractive. For example, a policy of accelerated depreciation allowance to attract investment might offset under-invoicing of imports of capital goods and other goods.
- (5) For domestic capital that is residing illegally abroad, arrangements may be made with other countries about prompt sharing of information concerning private citizens' bank accounts and trade-related transactions to and from Pakistan. Moreover, the international community must be reminded of its responsibilities of not allowing its jurisdiction for movement of illicit capital to and from Pakistan by using international forums.
- (6) As most of the reverse capital flight ends up in the informal part of the economy, there is an urgent need to bring this part of the economy under the tax net to resolve the problem of illicit capital movement. But this raises a pertinent question; is Pakistan's taxation system so unfair and punitive that capital owners prefer to invest in the informal sector? To be fair with the tax authorities, it seems that it is not a question of paying some tax, but no tax at all! Thus, a culture of tax compliance needs to be created, but this calls for an active role of the decision-makers.
- (7) Use of trade misinvoicing (i.e., the trade account) to move capital in and out of the country indicates that the capital account in the *de facto* realm is not fully convertible although in the *de jure* area the system seems to be fully convertible. This dichotomy needs to be eliminated by taking appropriate and effective measures.
- (8) Last but not least, sound macroeconomic environment and policies in the country should be able to prevent cross-border movement of illicit capital.

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