

CHAPTER 2

THE SPILL-OVERS OF ILLCIT FINANCIAL FLOWS

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Abstract

The growing macro-economic policy malaise with illicit financial flows is indicative of the undesirable consequences in which these flows result. In an effort to identify an appropriate policy in response to this phenomenon, it is imperative that the impact of illicit financial flows be considered. This chapter, through a literature review, illustrates that this phenomenon not only has adverse economic and social effects, but also has the potential to threaten the stability of governments. Although the adverse impacts are significant, it is illustrated that some positive impacts can emanate from illicit financial flows. The impact of these flows cannot be illustrated without defining what they are. Thus, the appropriate point of departure is the provision of a definition adopted in this chapter.

1 Introduction

Illicit financial flows (IFFs) are believed to have grown exponentially in the age of globalised financial markets. Although the exact magnitude of IFFs cannot be determined with precision, it is estimated that the value of IFFs, in the developing region, is worth more than development assistance received from Organisation for Economic Co-operation and Development (OECD) countries.¹ There is a dearth of literature that has sought to quantitatively determine the impact of IFFs on economies, and even fewer attempts to quantitatively determine the impact of this phenomenon on developing economies. However, there are some studies that have determined the impact of a specific form of illicit flows in the context of developed and developing countries. The objective of the chapter is to

* The author would especially like to thank Jeffrey Owens for the constructive and thoughtful comments.

1 M Herkenrath Illicit financial flows and their developmental impacts: An overview International Development Policy/*Revue internationale de politique de développement* (2014) <http://journals.openedition.org/poldev/1863> (accessed 1 February 2006).

enumerate and provide a brief discussion of the consequences of IFFs that already have been determined in literature and to determine areas of further research. This is done in an effort to inform policy choices in response to IFFs. While studying IFFs with reference to their consequences may elicit the inception of ‘asymptomatic’ macro-economic policies, rather than panaceas for the underlying institutional causes of the phenomenon, it is imperative that the implications be considered in an effort to emphasise the gravitas of IFFs. This study constitutes a literature review of research conducted on the impact of IFFs. The study provides a synopsis not only of the findings made in the literature reviewed, but also of the methodology employed in order to unearth the respective findings. It is imperative that the methodology be made explicit as it is of relevance from a policy perspective.² The appropriate point of departure is to provide a concise definition of the term ‘IFF’.

2 Definition of illicit financial flows

The term ‘IFF’ gained popularity in the 1990s. In literature, the term is commonly used to refer to money and capital flows sourced or attributable to illegal activities or transferred and used in an illegal manner.³ This definition suggests that the term IFF is wide enough to encompass illicit capital flows (ICFs). However, it is imperative that the distinction between ICFs and IFFs be provided. This is because literature suggests that the nature the financial flow assumes will determine its impact.

IFFs can be divided into three categories, namely, criminal, corrupt and commercial forms.⁴ Criminal forms of ICFs are capital flows emanating from criminal or deviant activities. Corrupt capital flows are capital flows resulting from the bribery of or theft by public officials; and commercial ICFs emanate from statutorily-prohibited commercial activities such as falsified asset swaps, the abuse of transfer pricing and tax evasion. Commercial ICFs are said to amount to two-thirds of all IFFs.⁵

In traditional economic literature, capital flows refer to flows specifically allotted for the acquisition of capital stock. ICFs are defined as unrecorded and untaxed ‘illicit leakage of capital and resources out of a

2 S Blankenburg & M Khan ‘Governance and illicit outflows’ in P Reuter (ed) *Draining development controlling flows from developing countries* (2012) 23.

3 Global Financial Integrity issues: *Illicit financial flows* (2015) <http://www.gfintegrity.org/issue/illicit-financial-flows/> (accessed 1 February 2016); The World Bank *Illicit financial flows* (2016) <http://www.worldbank.org/en/topic/financialmarketintegrity/brief/illicit-financial-flows-iffs> (accessed 17 May 2016); United Nations Economic Commission for Africa *Illicit financial flows: Report of the High-Level Panel on Illicit Financial Flows from Africa* 51-59 <http://www.uneca.org> (accessed 1 February 2016).

4 RW Baker *Capitalism’s Achilles heel: Dirty money and how to renew the free market system* (2005) 6.

5 Eurodad ‘Addressing development’s black hole: Regulating capital flight’ Eurodad Report 8 May 2008 8.

country'.⁶ ICFs amount to the appropriation of domestic wealth where such appropriation puts the wealth out of the reach of domestic authorities.⁷

It is suggested that not all forms of ICFs have a negative impact on economic growth or the political settlement of a jurisdiction. The notion that all forms of ICFs have a negative impact finds its origin in the premise that when all capital flight is retained domestically it will yield a higher social rate of return.⁸ This premise does not consider the possibility that some forms of ICFs may have positive or neutral effects. An example of such a flow would be a flow that is rendered illegal or illicit as a result of ill-considered laws aimed at protecting domestic monopolies.⁹

Furthermore, the impact of ICFs can be direct or indirect in nature. The direct consequences of ICFs have an immediate impact on a county's economic development through a reduction in revenue or a reduction in private domestic investment. The indirect consequences of ICFs include effects on the social and political structures in existence in the country in which the illicit capital flows are observed.¹⁰

For purposes of this chapter, IFFs are defined as all financial flows with negative effects on economic growth, whether indirect or direct, and where such consequences are borne by the political settlement in a country.¹¹ This definition does not include all forms of ICFs, but only those with a negative effect on economic growth.

Common to all forms of IFFs is the concealment of the illicit nature of these flows and their conversion into usable assets through money laundering. Money laundering is defined as the act of obscuring the illicit nature of proceeds of illicit activities,¹² and in itself an illicit activity. Seemingly the definition implies that not only is money laundering in itself an IFF, but it is predicated by illicit activities resulting in illicit flows. Significant strides have been made, in literature, to determine the impact of money laundering. The discussion of the impact of IFFs thus commences with a synopsis of the impact of money laundering.

6 S Kapoor *Haemorrhaging money: A Christian Aid briefing on the problem of illicit capital flight* (2007) 12.

7 K Heggstad & O-H Fjeldstad 'How banks assist capital flight from Africa: A literature review' 6 January 2010 12.

8 B Schneider *The road to international financial stability: Are key financial standards the answer?* (2003) 16; RE Cumby & RM Levich 'On the definition and magnitude of recent capital flight' in DR Lessard & J Williamson (eds) *Capital flight and third world debt* (1987) 26.

9 Blankenburg & Khan (n 3 above) 63.

10 Blankenburg & Khan 23.

11 Blankenburg & Khan 26.

12 L de Koker 'The combatting of money laundering and financing of terrorism' in L de Koker *Money laundering* (2015) (ed) lexisnexisbutterworths.co.za (accessed 1 February 2016).

3 Impact of illicit financial flows

A literature review by Unger illustrates the effect of money laundering on society and the economy. The author, from an observation of literature, identifies the consequences of money laundering as including:

- distortions on consumption;
- distortions on investment and savings;
- artificial increases in prices;
- unfair competition;
- changes in imports and exports;
- negative and positive effects on growth rates;
- effects on output, income and employment;
- lower revenues for the public sector;
- the compromise of privatisation;
- changes in demand of money and exchange rates and interest;
- distortion on capital flows;
- risk to financial sector stability;¹³
- distortion of economic statistics;
- increased crime such as corruption and bribery;
- increase in crime; and
- a compromise of political institutions.¹⁴

Despite the nexus between money laundering and IFFs, it would be imprudent to impute the consequences of money laundering onto all forms of IFFs. This is because, as discussed above, not all forms of IFFs, particularly ICFs, have a direct or indirect negative effect on economic growth. However, due to the relationship between money laundering and IFFs, an analysis of the effects of money laundering provides a good indication of the potential effects of IFFs.

13 UK Ogbodo & EG Mieseigha 'The economic implications of money laundering in Nigeria' (2013) 3 *International Journal of Academic Research in Accounting, Finance and Management Sciences* 173.

14 B Unger 'The amounts and the effects of money laundering' Report for the Ministry of Finance, Utrecht School of Economics and Australian National University for the Ministry of Finance, Amsterdam (2006) 82-95.

3.1 Negative spill-overs of illicit financial flows

3.1.1 Economic impacts

Employment

The nexus between IFFs and money laundering has been explained above. The laundering of illicit proceeds has adverse effects on job creation. This is because such laundering does not require labour-intensive activity but produces what is referred to as 'sterile assets'.¹⁵ This is in accordance to a study by Bartlett which seeks to determine the impact of money laundering on economic development in developing economies by the imputing findings observed from an economic literature review. The study begins by describing the three stages of money laundering, which are the placement stage; the layering stage; and the integration stage. It proceeds to differentiate between forms of money-laundering flows innate to developing countries, which include domestic flows; returning flows; inbound flows; outbound flows; and flow-through funds. Domestic flows are defined as the laundering of the proceeds of crime in the jurisdiction in which the funds arose. Returning flows are defined as funds that arose from illicit activities in the jurisdiction to which they return subsequent to being laundered abroad. Inbound flows are defined as the proceeds of criminal activities carried out in a different jurisdiction but which are ultimately integrated into a country separate to the one where the predicate offence took place. Outbound flows are defined as funds that are essentially comprised of illicit capital flight, and flow-through funds are defined as funds that are laundered domestically but are redirected to a separate jurisdiction following such laundering, thus having little to no impact on the economy.¹⁶ The study considers the effect of money laundering across three different sectors, namely, the financial sector; the real sector; and the external sector. Of relevance to employment is the effect of money laundering on the real sector.¹⁷

The author suggests that money laundering has the most direct effect on the real sector. The author asserts that money that is not laundered through the financial sector is laundered through less productive activities.¹⁸ In an effort to justify this assertion, the author makes reference to a study prepared for the Australian Transactions Reports and Analysis Centre which applies an input-output model in an effort to determine the lost economic activity as a result of money laundering. The study infers

15 BL Bartlett 'The negative effects of money laundering on economic development' Report for the Asian Development Bank Regional Technical Assistance Project 5967, Countering Money Laundering in the Asian and Pacific Region (2002) 2.

16 Bartlett (n 16 above) 3.

17 Bartlett 4.

18 Bartlett 17.

that the loss of employment is depicted in the difference between the level of real estate purchases as a result of legitimate expenditure and the purchase of real estate as a result of money laundering. The assumption made in the study is that legitimate purchases often are made across all types of property, while properties purchased through money laundering usually are residential in nature. The study finds that money laundering results in a loss of jobs due to the acquisition of 'sterile' assets, such as residential properties. It is worth noting that the acquisition of commercial property is likely to generate economic productivity, whereas the acquisition of residential property increases individual wealth. This may have an indirect positive economic impact as the owner's purchasing power is increased. However, it exacerbates unequal wealth distribution in addition to the negative impact it has on job creation. Furthermore, Bartlett makes the observation that the adverse effect on job creation not only is a result of the purchasing of sterile assets, but also a result of the lack of economic development due to increased corruption and crime.

Economic stability

The financial sector has been identified as an area of the economy where IFFs take place. Unsecured loans, money laundering, stock market manipulation and forgery were identified as activities occurring in the financial sector to which illicit outflows may be attributed. In addition to this, the significance of the role of the financial sector in base erosion and profit shifting is evident in the Base Erosion and Profit Shifting Actions 4, 8, 9 and 10 of the OECD, which are actions targeted towards the countering of base erosion and profit shifting that occurs in this sector. Furthermore, the Financial Action Task Force has identified the need to ensure adequate regulation and supervision of the financial sector in an effort to ensure that the banking sector is not used as a money-laundering apparatus. The ability to combat financial crimes and the minimisation of IFFs are at the centre of the maintenance of financial integrity. Financial integrity is imperative to the maintenance of economic stability.

The laundering of IFFs results in the perversion of the financial system and the integrity of the financial system is seen as the basic requirement for economic development. This is particularly true for immature developing financial systems innate to most developing economies.¹⁹ Cross-border IFFs are believed to distort foreign exchange markets and stimulate the underground exchange market.²⁰ In addition to this, due to the illusive nature of IFFs, they result in a distortion of national accounts. A study by Allridge does well to articulate the distortion money laundering has on

19 S Yikona et al (eds) *Ill-gotten money and the economy: Experiences from Malawi and Namibia* (2011) World Bank Study 12 <http://elibrary.worldbank.org/doi/abs/10.1596/978-0-8213-8887-7> (accessed 7 April 2016).

20 P Allridge 'The moral limits of the crime of money laundering' (2002) 5 *Buffalo Criminal Law Review* 306.

economic stability. In this study, Allridge employs a literature review, in order to justify the criminalisation of money laundering by elucidating the economic ramifications caused by money laundering.

The author makes the observation that money laundering causes inefficiencies in the financial market. These inefficiencies are believed to be as a result of the distortion caused by money laundering on investment decisions. Money laundering encourages the allocation of money to destinations where the ease of capital control circumvention is the highest, as opposed to the destination with the most favourable expected rate of return. This further permeates the inefficient allocation of the world's resources.²¹ It is imperative that the importance of the efficient distribution of resources be explained. The allocation of most concern is the distribution of property and the entitlements associated with such property. This is because property rights enable market participation since, in the absence of such rights, or in the inefficient distribution of such rights, a segment of society is excluded from market participation. Financial markets concern themselves with the efficient allocation of resources (that is, the allocation of property rights that enable economic participation) and a distortion in financial markets manifests as a distortion in allocation efficiency. The theory of efficiency in markets presupposes the existence of perfect information. However, in the absence of perfect information, market failures manifest. In a perfectly competitive market, scarce resources would be allocated as efficiently as possible in order to satisfy the demands of consumers. However, where markets are imperfect, government intervention, such as the criminalisation of money laundering, is permitted in order to rectify these market failures and enable the efficient allocation of property rights.

Aside from the gross inequity caused by the inefficient allocation of resources, there is a growing school of thought that attributes the existence of the informal sector to non-inclusive property rights systems. It acknowledges a nexus between the informal sector and property rights system and denotes the informal sector as a representation of '[t]he people's struggle to acquire private property rights'.²² In turn, IFFs are believed to be impacted by the size of the informal sector or underground economy. In a study by Global Financial Integrity titled 'Russia: Illicit financial flows and the role of the underground economy',²³ the authors use the size of the underground economy as a proxy for governance and suggest the existence of a link between the size of the underground economy and IFFs. In this study the authors employ a least squares regression model and identify a positive correlation between the size of the underground economy and IFFs. The authors suggest that, according to

21 As above.

22 H de Soto *The other path: The invisible revolution in the Third World* (1989) 55.

23 S Freitas & D Kar *Russia: Illicit financial flows and the underground economy* (2013) www.gfintegrity.org/Reports (accessed 1 February 2016).

their model, a 1 per cent increase in the size of the underground economy was correlated with a 7 per cent increase in the size of cross-border transmitted illicit capital in the period between 1994 and 2011.²⁴

In addition to the obscured allocation of property rights, IFFs pose a systemic risk to the financial sector. This is particularly true in the case of money laundering. Money laundering creates a nexus between the formal and informal economy by enabling the flow of resources between the two economies.²⁵ The flow of proceeds of illicit activity into the formal financial system distorts the integrity of both domestic and global financial systems.²⁶

Market failures caused by IFFs not only are evident in the inefficient allocation of resources and the systemic risk to which the financial system is exposed, but also are evident in the distortion of exchange rates and interest rates. IFFs cause an artificial fluctuation in capital inflows and outflows. *Prima facie* robust capital imports lead to the appreciation and depreciation of exchange rates, and this has the potential of having an adverse impact on legitimate exports and domestic prices. Furthermore, it creates a distortion in policy choices due to the fact that such policies are espoused on the volatility of exchange and interest rates as a result of artificial capital inflows and outflows.²⁷

Competition

The neo-classical model of competition recognises that in a perfectly competitive market, scarce resources would be allocated as efficiently as possible in order to satisfy the demands of consumers.²⁸ This is also referred to as technical efficiency. However, where the market is imperfect, inefficiencies result. IFFs are believed to impair fair competition and thus lead to inefficiency. This is because factors that influence the decisions concerning the manner in which IFFs are laundered do not concern themselves with ascertaining the greatest rate of return through production, but rather with the circumvention of the cost of capital. In an effort to convert illicit proceeds into usable assets, money launderers engage in a significant number of purchases at prices that do not always reflect the market value for the acquired assets. Furthermore, their primary interest is not in the asset itself but, rather, in the level of concealment

24 D Kar 'Illicit financial flows from developing countries: 2004-2013' Global Financial Integrity Report (2015) 28 <http://www.gfintegrity.org> (accessed 17 April 2016).

25 K Hinterseer 'The economics of money laundering' in K Hinterseer *Criminal finance: The political economy of money laundering in a comparative legal context* (2002) 71.

26 A Aluko & M Bagheri 'The impact of money laundering on economic and financial stability and on political development in developing countries: The case of Nigeria (2012) 15 *Journal of Money Laundering Control* 444.

27 Aluko & Bagheri (n 26 above) 445.

28 P Sutherland et al 'Introduction to competition law' in P Sutherland et al *Competition law of South Africa* (2013) <http://www.mylexisnexis.co.za> (accessed 17 April 2014).

provided by the acquisition of the particular asset. As a result of this, they are likely to purchase the asset for more than its market value. This creates an artificial inflation in the price of the assets which may exclude a certain group of society from the legitimate acquisition of the product. This creates non-competitive markets.²⁹ Non-competitive markets, which usually take the form of oligopolies or monopolies, not only result in the minimisation of individual choices as a result of the inflation of prices,³⁰ but also create barriers to entry into a particular market, and allow for the abuse of dominance by way of price manipulation and other practices that may be considered abusive to consumers.

It must be noted that, unlike market competition, tax competition is likely to result in an inefficient allocation of resources. This is because resource allocation is likely to be motivated by the after tax rate of return on capital rather than on factors of production. Some scholars are of the view that the migration of capital into low tax jurisdictions (or tax havens) increases productivity in high-tax jurisdictions and, implicitly, the competitiveness of markets. This position suggests that the ability to relocate taxable profits into low-tax jurisdictions, which results in a reduced user cost (or pre-tax marginal product of capital) does not divert activity from non-havens but, instead, prompts investors into increasing their activity in high-tax jurisdictions.³¹ However, this position is speculative and is premised on the observation that the demand for low-tax jurisdictions increases where multinationals conduct activity in high-tax jurisdictions.³² Furthermore, criticism suggests that the arguments proffered in favour of low-tax jurisdictions are premised on the undesirability of imposing taxes on elastic inputs such as capital and remiss espoused policy choices.³³

Economic growth

The impact of illicit flows on economic development may be observed from a study by Ndikumana. The author endeavours to determine the impact of capital flight on economic development. While the term 'capital flight' implies the migration of more than just illicit capital, the author equates capital flight to IFFs. This is because the author contends that a significant degree of capital flight is spurred by illicit motives, and alleges

29 J Walker J & B Uger 'Measuring global money laundering: The Walker Gravity Model' (2009) 5 *Review of Law and Economics* 832.

30 It should be noted that specific practices to which IFFs may be attributes, such as trade mis-invoicing, may result in the distortion of a consumer's choice between imported goods and locally-produced goods due to the circumvention of import duties.

31 MA Desai et al 'Do tax havens divert economic activity?' (2005) 90 *Economic Letters* 222.

32 AJ Weichenrieder & F Xu 'Are tax havens good? Implications of the crackdown on secrecy' Working Paper 111 <http://ssrn.com> (accessed 20 June 2016).

33 J Slemrod 'Tax competition with parasitic tax havens' NBER Working Paper 12225 (2009) 4 <http://www.nber.org/papers/w12225> (accessed 20 June 2016).

that there is an absence of sufficient empirical evidence supporting the notion that capital flight is premised on legitimate portfolio choices. In traditional economic literature, capital flight refers to 'abnormal capital outflows ... propelled from a country ... by any one or more complex list of fears or suspicion'.³⁴ Ndikumana's research seeks to determine the impacts of capital flight (IFFs) and tax havens on economic development. Pursuant to this, the author employs an econometric model to analyse the impact of capital flight domestic investment, and then applies a simulation model in order to determine the gains that would have been derived from the investment but for the capital flight. The author places significance on investment as investment is recognised as the most pivotal factor contributing to long-term economic growth. Capital flight is said to have an impact on investment because it diminishes the amount of public and private domestic savings which, in turn, results in a reduction of capital creation. Furthermore, it creates macro-economic uncertainty due to the fact that it erodes trust in a specific country's macro-economic policies.³⁵ Trust in economic policies, particularly those governing the financial system, is imperative for the attraction of foreign direct investment (FDI).³⁶

The author makes the finding that capital flight has a negative effect on domestic investment and that this imposes an opportunity cost on African economies that has resulted in the forfeiture of an estimated additional 3 per cent growth in the gross domestic product of the African countries in question.³⁷ A study by Nkurunziza examines the nexus between IFFs and poverty in Africa. The author defines illicit flows as outflows resulting from theft, corruption, the mismanagement of public resources and transfer mispricing.³⁸ In order to determine the effect of IFFs on poverty, the author applied two simulation models. The first model was constructed on the basis of the capital-output ratio which establishes the number of units of investment needed to produce a unit of output. The basis for this simulation is the presumption that IFFs result in reduced investment, as illustrated above. The second simulation incorporates capital stock³⁹ instead of investment as a determinant of capital flight. The author makes the finding that in the absence of IFFs, in the period between 2000 and

34 C Kindleberger International short-term capital movements (1938) 33 *Journal of the American Statistical Association* 296.

35 L Ndikumana 'Capital flight and tax havens: Impact on investment and growth in Africa' Conference Paper: European Development Network Conference on Finance and Development, Berlin 11-13 December 2013 1-12.

36 Yikona et al (n 20 above) 12.

37 The author estimates that the GDP of African countries would have grown by an additional 3% between the period 2000 and 2010. Ndikumana (n 35 above) 19.

38 JH Nkurunziza 'Illicit financial flows: A constraint on poverty reduction in Africa' (2012) 87 *Association of Concerned African Scholars Bulletin* 15 <http://concernedafricanscholars.org> (accessed 17 May 2016).

39 The capital stock is determined on the perpetual inventory method.

2008, poverty would have been reduced by an additional four to six percentage points.⁴⁰

3.1.2 Social impacts

Crime

Money laundering is said to be a catalyst for increased criminal activity. In addition to this, money laundering is believed to increase the occurrence of corruption and other illicit crimes. This is because money laundering allows criminals to mask wealth derived from the performance of illicit activities. It allows criminals to remain active through the avoidance of criminal justice sanctions and equips criminals with seemingly legitimate financial resources required for the further advancement of criminal activity. It is alleged that a symbiosis relationship exists between money laundering and corruption. Not only do they occur in tandem, but often enrich each other.⁴¹ It is submitted that a positive correlation is observed from the existence of perception of corruption and the size of the informal sector. IFFs are aggravated by smuggling. Smuggling is said to be the result of the disparity in the manner in which certain goods are treated between jurisdictions. This disparate legal treatment, whether as a result of incongruous policies or a lack of enforcement, is believed to incite the illegal import or exportation of the specific good to which the law applies.⁴²

Equality and distribution

The forfeiture of revenue as a result of IFFs leads to the hampering of the redistribution of wealth; impedes on the curbing of socially-undesirable conduct (excises); and also causes rent seeking and impedes on the principles of democracy. Rent seeking refers to the attainment of an undue benefit, particularly where the law is structured in such a manner that a group of persons is able to attain a benefit whilst the cost of such benefit is borne by other fractions of society.⁴³ Rent seeking further exasperates social inequity or unfairness.⁴⁴ The term 'fairness' is a normative concept. Aristotle regarded fairness as a component of justice.⁴⁵ According to

40 In addition to this, the author observes a distinction in the hypothetical poverty reduction between resource-rich and non-resource-rich countries. Poverty reduction in oil-rich countries surpasses that in non-resource-rich countries. The author does not provide a rationale for this distinction. Nkurunziza (n 38 above) 15.

41 D Chaikin & JC Sharman *Corruption and money laundering: A symbiotic relationship* (2009).

42 OECD 'Policy coherence for sustainable development: Thematic module on illicit outflows' Workshop Paper (2015) 21.

43 S Ratnapala 'Economic analysis of law' in S Ratnapala *Jurisprudence* (2009) 264.

44 OECD (n 43 above) 5.

45 N Memon 'Prioritizing principles of a good tax system for small business in informal economies' (2010) 25 *Australian Tax Forum* 79.

Aristotle, justice exists in three facets, namely, distributive justice; rectificatory justice; and political justice. Distributive justice manifests in distributions of honour or resources that fall to be divided amongst those who have a share in the constitution; rectificatory justice seeks to rectify the consequences ensuing as a result of voluntary or involuntary transactions between man and man and political or legal justice which seeks to treat those who are equal, equally and those who are unequal, differently. Horizontal equity is closely linked with Aristotle's notion of legal justice. Therefore, the construction of legal justice requires that tax laws be adjusted taking into account the nature of the taxpayers in an effort to attain horizontal equity.⁴⁶ Conversely, vertical equity is closely linked to Aristotle's summations of distributive justice which concerns itself with redistribution. It is important to take note of these concepts of justice because a good legal system is one that conforms to the notions of justice and morality. In the absence of such conformity, the legal system may be construed as a fallacious one.⁴⁷ Rent seeking is undesirable as it bestows a benefit on a section of society while imposing the burden associated with this benefit on a different fraction of society, exasperating inequity and further heightening the poor distribution of resources.

In a study by Baker aimed at determining the effects of capitalism on society by considering the impact of 'dirty money', which Baker considers a resultant corollary of capitalism, 'dirty money' is defined as 'illegally earned, illegally transferred or illegally utili[z]ed' money. The author deconstructs dirty money into money that crosses borders and money that does not.⁴⁸ Additionally, Baker identifies three forms of dirty money that cross borders. These forms include proceeds of crime, corruption and commerce. Proceeds of crime are defined as proceeds emanating from conduct that is criminal in nature, such as racketeering, trafficking, embezzlement, securities fraud, credit fraud, and so forth. Proceeds of corruption are afforded separate recognition to proceeds of crime and are said to include proceeds derived from the bribery of officials or theft by government officials. Commercial proceeds are defined with reference to their characteristics. The first characteristic is that the proceeds usually result in the evasion of tax. This implies that the conduct to which the proceeds may be attributed is a predicate to tax evasion. The second characteristic is an absence of records reflecting the proceeds in the country of origin.⁴⁹ The varying methods in which the proceeds are derived include transfer mispricing; fraud; the use of shell companies; transfers to tax havens; the use of trusts and flee clauses; and the use of other intricate structures that make use of subterfuge.⁵⁰ The definition afforded to dirty

46 As above.

47 H Hart *The concept of law* (1961) 206.

48 This is implicit in the recognition of dirty money that crosses borders.

49 RW Baker 'Playing the game' in RW Baker *Capitalism's Achilles heel: Dirty money and how to renew the free-market system* (2005) 23.

50 RW Baker 'Dirty money at work' in Baker (n 49 above) 136.

money is synonymous to the definition of IFFs provided in section 2 of this article.

In an effort to determine the impact of dirty money on equality, Baker reviews statistics from a range of sources to determine income distribution. Baker refers to World Bank country statistics providing information concerning gross domestic product (GDP) and quintile shares of gross domestic product, purchasing power parity and the country rankings of the United Nations (UN). From an inspection of the statistics, Baker makes the observation that the gap in income distribution is increasing. Baker continues to illustrate how poor income distribution results in inequality by explaining the 'Gini coefficient', and goes on to review studies that have sought to determine income distribution and inequality through the use of the statistics synopsis. Baker concludes that dirty money leads to poor income distribution and causes the largest income inequality in developing countries.⁵¹

A similar observation is made by Yikona et al in a study on behalf of the World Bank which seeks to determine the effects of regulation aimed at curbing 'ill-gotten' money on Malawi and Namibia's economy. The primary objective of Yikona's study is to determine the effects of anti-money-laundering regulation on economic development. Pursuant to this, the study endeavours to determine the relationship between and the effects of the proceeds of crime on economic development. The study adopts a qualitative approach which encompasses a literature review, anecdotal evidence of the perceptions of experts in Malawi and Namibia, and conclusions derived from an observation of secondary data.⁵²

The study defines the term 'ill-gotten money' with reference to the sources from which the ill-gotten money is derived. These sources are said to include corruption; tax evasion (including transfer mispricing); organised crimes; and illicit resource dealings.⁵³ The authors conclude that tax evasion and corruption have the most significant impact on development as they encroach upon the government's tax base and this ultimately exacerbates the poverty alleviation plight.⁵⁴ Inequity in a country has the potential to instigate the disruption of the social and political fabric of a country.⁵⁵

3.1.3 Undermine of democracy

It is imperative that the positive correlation between political stability and economic productivity be noted. IFFs damage the integrity of society and

51 RW Baker 'The global divide' in Baker (n 49 above) 217.

52 Yikona et al (n 20 above) 8.

53 Yikona et al 12.

54 Yikona et al 83.

55 Memon (n 46 above) 80.

undermine democracy and the rule of law. The rule of law is imperative as it is used as a measure of institutional quality.⁵⁶ The term ‘institution’ is understood as encompassing a wider scope than its original meaning. The term is often used to describe an organisation formed for a particular social purpose. The definition we are concerned with in this study is the understanding of institutions as humanly-devised constraints, such as law⁵⁷ and societal norms that influence human interactions. The question arises as to which specific institutions are of relevance where the address of the IFFs is concerned. It is often proposed that the institution of relevance in this instance is the government and its ability to allocate secured property rights.⁵⁸

Well-functioning institutions are believed to be institutions that are able to enforce accepted policies and facilitate the allocation of property rights.⁵⁹ Corruption, in particular, predicated the abuse of government resources by redirecting those resources from the provision of public goods and services. Furthermore, corruption is implicit in the failure to uphold the rule of law and, thus, is indicative of weak institutions. It is believed IFFs are negatively impacted by the perceptions of a transparent electoral process; a belief in government’s ability to form and implement policies; a confidence in government’s ability to govern; and the allocation of secured property rights. IFFs are considered a direct challenge to government’s authority as they result in the undermining of the enforcement of laws and the corruption of government.⁶⁰ A failure to enforce coercive laws, such as anti-money-laundering legislation and laws targeted at curbing tax evasion, results in the usurpation of the authority and, thus, the legitimacy of governments.

Cognisance must be taken of the Report of the High-Level Panel on Illicit Financial Flows from Africa.⁶¹ Although the primary objective of the report is to analyse the extent of IFFs from Africa and to determine the cause of such IFFs, the report takes the opportunity to articulate the consequences of IFFs observed from case studies and literature reviews.⁶² The report stipulates that IFFs result in weakened governance, impediments on domestic and international development, discouraged

56 A Lane *Rule of law reform and development* (2010) 7.

57 The term ‘law’ includes legislation, common law and regulations. Societal norms include norms of behaviour and self-imposed codes of conduct.

58 B Powell ‘Public choice and the economic analysis of anarchy: A survey’ 7 January 2009 62, at SSRN: <http://ssrn.com/abstract=1324407> (accessed 12 February 2015).

59 Blankenburg & Khan (n 3 above) 23.

60 P Andreas ‘Illicit international political economy: The clandestine side of globalisation (2004) 11 *Review of International Political Economy* 646.

61 United Nations Economic Commission for Africa ‘Illicit financial flows: Report of the High-Level Panel on Illicit Financial Flows from Africa 51-59 <http://www.uneca.org> (accessed 1 February 2016).

62 While the report stipulates that the consequences of IFFs are determined from case studies and literature review, it does not provide a comprehensive summation of the nature of the case studies.

structural transformation and transparency and strained government resources.

It would be imprudent to restrict an analysis of the impact of IFFs to the negative effects of such flows. In the interests of establishing a well-informed policy, consideration must be given to all the impacts of IFFs, including those that are positive in nature. The positive result of IFFs must not be confused with ICFs with a positive or negligible effect. As discussed above, IFFs are those flows with a negative impact on economic development. However, despite the negative impact in which they result, it is also possible to observe the indirect positive impact. For example, while money derived from criminal activities exacerbates crime, the increase in criminal activity may cause an increase in the demand for legal services. On the other hand, an example of an ICF with a positive result may be a flow that violates an ill-considered statute which has undesirable economic results, such as the protection of monopolies, and which, but for the violation of the statute, does not have a negative effect. The morality of observing the positive impact of IFFs is neither here nor there. Such observation merely seeks to provide a holistic view of the impact of IFFs.

3.2 Positive spill-overs

Some scholars allege that IFFs may have some positive effects. These effects include the contention that the circulation of IFFs may lead to the increased demand for financial and legal services. This increased demand is said to be *pro tem*.⁶³ Furthermore, a study by Perez et al identifies a nexus between IFFs and FDI. These authors estimate the role of money laundering and illegal capital flight in FDI decisions. The authors employ secondary data depicting FDI outflows from a selection of East European countries. The authors premise that the use of data illustrating FDI outflows serves as an indicator for investment decisions.⁶⁴ In order to illustrate the effects of illicit capital flight and money laundering on FDI, the authors adopt a parsimonious model which takes into consideration the standard factors that influence FDI. The authors' parsimonious model is a variation of the knowledge-capital model (KC model) used to analyse the rationale behind FDI location decisions. The KC model looks at the movement of FDI between two countries and factors in the impact of skilled and unskilled labour across two sectors.⁶⁵ In their model, the authors assume that FDI will be located in a country where the investment is profitable because the business undertakings are profitable or because the conditions in the country enable illegal capital flight or money laundering. The authors apply the model to six transitional East European

63 Unger (n 15 above) 7.

64 MF Perez et al 'Illicit money flows as motives for FDI' (2012) 40 *Journal of Comparative Economics* 109.

65 M Petr 'The knowledge-capital model of FDI: A time varying coefficients approach' (2009) 56 *Scottish Journal of Political Economy* 197.

countries (FDI destinations), which are Bulgaria; the Czech Republic; Estonia; Hungary; Macedonia; and Slovenia, over a four-year period (2000-2003). This resulted in a total of 449 observations and 83 FDI host countries. The authors conclude that 29 per cent of FDI is attracted by countries that may be considered money-laundering centres. In addition to this, of the 29 per cent that is directed to money-laundering hubs, 20 per cent is believed to be motivated by the desire to facilitate money laundering. The authors conclude that 29 per cent of FDI is attracted by countries that may be considered money-laundering centres. Furthermore, of the 29 per cent that is directed to money-laundering hubs, 20 per cent is believed to be motivated by the desire to facilitate money laundering.⁶⁶

4 Conclusion

The first observation worth noting is the lack of quantitative research that has sought to determine the effects of IFFs in all its forms (that is, the effects of specific forms of tax evasion such as trade mispricing). Furthermore, a significant number of the studies discussed above employ secondary data which is subject to the authors' interpretation and validity of which is often left unchallenged. Thus, a need for further research in this area is evident. It is also evident that illicit flows present a wide range of adverse effects. Furthermore, in some instances the effects are interconnected and often precipitate themselves as a result of this synergy. While most of the consequences observed are undesirable, there are some alleged positive effects of IFFs. However, the negative spill-overs resulting from IFFs have the potential to impede on developmental goals and human rights.⁶⁷ This is because the forfeited revenue impedes on government's ability to attain the 2030 Sustainable Developmental Goals and, while income distribution may not amount to a human right, the inequality exasperated by the poor distribution imposes a limitation on society's right to market participation. Furthermore, a failure to indiscriminately enforce existing laws on private individuals and government officials brings government's authority into disrepute and threatens the rule of law, a principle upon which democracy is premised. While it is not the intention of this chapter to incite the inception of policy directed at correcting the negative externalities resulting from IFFs, it is imperative that cognisance of these externalities be considered in devising the appropriate panacea aimed at the root cause of IFFs.

66 Perez et al (n 66 above) 125.

67 This is evident from the growing interest in studying the implications of IFFs for human rights; refer to United Nations (2016) *Final Study On Illicit Financial Flows, Human Rights and the 2030 Agenda for Sustainable Development of the Independent Expert on the Effects of Foreign Debt And Other Related International Financial Obligations Of States On The Full Enjoyment Of All Human Rights, Particularly Economic, Social and Cultural Rights* Note by the Secretariat available www.un.org accessed 20 June 2016.

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