Governance and Illicit Flows

Stephanie Blankenburg and Mushtaq Khan

The concern about illicit capital flows from developing countries reflects a variety of relevant policy issues, but is often motivated by weakly formulated underlying analytical frameworks. We review the literature on illicit capital flows and suggest that the common underlying concern that motivates the different approaches is the identification of flows that potentially damage economic development. Implicitly, if these flows could be blocked, the result would be an improvement in social outcomes. Illicit flows can be illegal, but they need not be if the legal framework does not reflect social interests or does not cover the relevant flows. A minimal definition of an illicit capital flow has to consider both the direct and the indirect effects of the flow and has to assess these effects in the context of the specific political settlement of the country in question. To demonstrate the implications in simplified form, we distinguish among advanced countries, intermediate developers, and fragile developing countries. The types of flows that would be considered illicit are shown to be significantly different in each of these cases. The analysis provides a rigorous way of identifying policy-relevant illicit flows in developing countries. Given the potential importance of these flows, it is vital to have a rigorous framework that at least ensures that we minimize the chances of causing inadvertent damage through well-intentioned policies. Indeed, the analysis shows that many loose definitions of illicit capital flows are problematic in this sense.

1. Introduction

The concept of illicit capital flows has come to prominence relatively recently, reflecting growing concerns about the ramifications of an insufficiently regulated and apparently increasingly predatory international financial system. In advanced economies, the 2008 global financial crisis brought into sharp relief the growing gap between the effectiveness of national regulatory tools and the global operations of private financial agencies. As illustrated, for example, by the standoff between the U.S. Securities and Exchange Commission and Goldman Sachs employees over the collateralized debt obligation deal, Abacus 2007-AC 1, the debate in advanced countries has highlighted important ambiguities about what constitutes legitimate financial market behavior.

In the case of developing countries, the international concern about illicit capital flows is motivated primarily by concerns that vital developmental resources are being lost to these economies because of the ease with which capital flight can flourish in the context of a burgeoning, yet opaque international financial system (for example, see Eurodad 2008a; Global Witness 2009; Kar and Cartwright-Smith 2008; Baker 2005). Closely related to this is the idea that illicit capital flows from developing economies are indicative of deeper structural problems of political governance in these countries. Finally, there also are worries about how illicit capital flows from developing countries may affect advanced countries through diverse mechanisms, such as directly or indirectly financing crime or terror. In this chapter, we are concerned mainly with the impact of illicit capital flows on developing countries and the effectiveness of policy to control such outflows.

The next section situates the literature on illicit capital flows within the wider context of economic analyses of capital flight from developing economies and provides our definitions. The following section elaborates our definition of illicit capital flows. We simplify the range of variation across countries using a three-tier typology of different economic and political contexts: advanced economies, an intermediate group of normal developing countries in which a stable political settlement exists even though institutions still have a large element of informality, and a final tier of fragile and vulnerable developing countries in which the political settlement is collapsing, and economic processes, including illicit capital flight, are driven by the collapsing polity. A definition of illicit capital flight has to be consistently applicable across these substantially different institutional and political contexts. Keeping this in mind, we define illicit capital flows as flows that imply economic damage for a society given its existing economic and political structure. The penultimate section develops some basic policy tools to operationalize this analytical framework. The final section concludes.

2. Illicit Capital Flows and Capital Flight: Concepts and Definitions

The term illicit has strong moral undertones, but a closer look at the actual use of the term almost always reveals an underlying concern with the developmental damage that particular capital flows can inflict. We believe that, from a policy perspective, this has to be made explicit, as well as the precise methodology that is being applied to determine the damage. We start by defining an illicit capital flow as a flow that has a negative impact on an economy if all *direct* and *indirect* effects in the context of the *specific political economy* of the society are taken into account. Direct effects refer to the immediate impact of a particular illicit capital flow on a country's economic growth performance, for example through reduced private domestic investment or adverse effects on tax revenue and public investment. Indirect effects are feedback effects on economic growth that arise from the role played by illicit capital flows in the sustainability of the social and political structure and dynamics of a country. For clarity of exposition, we specify the political economy of a society in terms of the political settlement. A *political settlement* is a reproducible structure of formal and informal institutions with an associated distribution of benefits that reflects a sustainable distribution of power. Sustainability requires that the formal and informal institutional arrangements that govern societal interaction in a country and the distribution of benefits to which they give rise achieve a sufficient degree of compatibility between economic productivity and political stability to allow the society to reproduce itself without an escalation of conflict (Khan 2010).

There are two important elements in this definition. First, the judgment of impact has to consider both direct and indirect effects because we are interested in the overall net effect of particular financial flows on the developmental prospects of a country. Second, the specific political settlement of the country is important because the indirect effects, in particular, depend on the interplay between the economic and political structure of the country, and this can vary greatly across contexts. To simplify, we focus on three broad variants of political settlements, but finer distinctions can be made. The assessment of both direct and indirect effects is necessarily based on a counterfactual assessment of what would happen if the illicit capital flow in question could hypothetically be blocked. The assessment is counterfactual because, in many cases, the flows cannot actually be blocked or only partially so. The assessment is therefore subject to the analytical perspective of the observer, but we believe that this needs to be done in an explicit way to facilitate public debate. Our definition allows us to make sense of the perception that not all illegal flows are necessarily illicit, while some legal flows may be illicit. The task of policy is to identify both the particular capital flows that can be classified as illicit, but also the subset of illicit flows that can be feasibly targeted.

What constitutes damage in the sense of a negative developmental impact depends on how we define development. When illicit capital flows are equated with illegal outflows (as in Kar and Cartwright-Smith 2008; Baker and Nordin 2007), the implicit suggestion is that adherence to prevailing legal rules is sufficient for promoting the social good.[1] Yet, the use of the notion of illicitness also suggests that damaging developmental outcomes may not always correspond to violations of the law and that, therefore, social, economic, and political damage needs to be more precisely defined. Moreover, if we are not to suffer the criticism of paternalism, our criteria have to be widely accepted as legitimate in that society. In practice, it is difficult to establish the criteria that measure development and therefore can be used to identify damage in any society, but particularly in developing ones. A social consensus may not exist if there are deep divisions about social goals. However, as a first step, we can insist that analysts and observers making judgments about illicit flows at least make their own criteria explicit. This will allow us to see if these criteria are so far away from what are likely to be the minimal shared assumptions in a society as to make the analysis problematic. In addition, because the effect of capital flows (and economic policies in general) is often heavily disputed, we also require an explicit reference to analytical models that identify how particular capital flows affect particular developmental goals. Making all this explicit is important because observers may disagree in their choices on these issues.

Our definition suggests that capital flows that are strictly within the law may be illicit if they damage society and that, conversely, flows that evade or avoid the law may sometimes be benign, and blocking some of these flows may have adverse consequences. However, all illegal capital flows may be judged illicit from a broader perspective if the violation of laws is judged to be damaging for development regardless of the specific outcomes associated with law-breaking. We argue that this position is easier to sustain in advanced countries where the formal structure of rules is more or less effectively enforced by rule-based states and where political processes ensure that legal frameworks are relatively closely integrated with the evolution of socially acceptable compromises to sustain political stability and economic growth. The ongoing global financial and economic crisis has demonstrated that this picture does not always hold true even in advanced countries. Meanwhile, developing countries are typically characterized by significant informality in social organization; laws, if they exist, are, in general, weakly enforced and do not typically reflect worked out social compromises and economic programs, and

[1] "The term, *illicit financial flows*, pertains to the crossborder movement of money that is illegally *earned*, *transferred*, or *utilized*" (Global Financial Integrity summary fact sheet on illicit financial flows [IFFs], http://www.gfip.org/storage/gfip/documents/illicit%20flows%20from%20developing%20countries%20overview%20w%20table.pdf [emphasis in the original]).

significant aspects of the economy and polity therefore operate through informal arrangements and informality in the enforcement of formal rules (Khan 2005, 2010). Violations of formal rules are widespread in these contexts and do not necessarily provide even a first approximation of social damage.

To keep the analysis broad enough to include different types of societies, what then should we be looking for to judge damage to society? Is damage to be judged by the effects of particular flows on economic growth, or income distribution, or different measures of poverty, or some combination of the above? We suggest that we should use the least demanding way of judging damage because the more minimal our requirement, the more likely we are to find broad support across observers who may disagree at the level of more detailed specifications.

An illicit financial flow (IFF), according to our minimal definition, is one that has an overall negative effect on economic growth, taking into account both direct and indirect effects *in the context of the specific political settlement of a country*. A flow that has not directly affected economic growth, but has undermined the viability of a given political settlement without preparing the ground for an alternative sustainable political settlement may be seen to have, indirectly, a negative effect after we account for adjustments that are likely as a result of a decline in political stability. It is now increasingly recognized that the different ways in which the political and social order is constructed in developing countries have important implications for how institutions and the economy function (North et al. 2007). Because the construction of political settlements (and, in North's terminology, of social orders) differs significantly across societies, the economic and political effects of particular financial flows are also likely to be different.

Our definition has some overlaps with, but also important points of departure from the way in which damaging capital flight has been analyzed in the economics literature. The loss of developmental resources through capital flows from poor to rich economies has been an important topic of development economics since its inception. In particular, the literature on capital flight had made the problem of abnormal capital outflows from developing countries its main interest long before the policy focus on illicit capital outflows from such economies emerged. A brief review of this literature allows us to identify systematically different core drivers of capital flight highlighted by different strands of the literature. Our review also establishes the problems associated with ignoring the structural differences in the types of political settlements across countries, problems that our definition of illicit capital flight specifically addresses.

From capital flight as abnormal capital outflows to single-driver models of capital flight

In 1937, Charles Kindleberger famously defined capital flight as "abnormal" capital outflows "propelled from a country . . . by . . . any one or more of a complex list of fears and suspicions" (Kindleberger 1937, 158). A specialist of European financial history, Kindleberger had in mind well-known episodes of European capital flight going back to the 16th century, as well as the troubles of crisis-ridden Europe in the 1920s and 1930s. In most of these historical cases, this "complex list of fears and suspicions" can be attributed to specific events or to exceptionally disruptive periods of political, social, and economic change or confrontation. To differentiate ex post between abnormal capital outflows driven by profound uncertainty (fear and suspicion) about the future on the one hand and, on the other hand, normal capital outflows driven by usual business considerations was a rather straightforward exercise in those contexts.

For policy purposes, however, such ex post analyses are of limited relevance. What matters is sufficient ex ante knowledge of the factors that differentiate an abnormal from normal situations. Such ex ante knowledge—to facilitate effective preventive policy options—will have to include consideration of the determinants of precisely those economic, political, and social factors that may trigger the disruption that we regard as obvious from an ex post perspective. There may not be any general or abstract solution in the sense that what qualifies as capital flight requiring a policy response may differ across countries. A half-century on from his original contribution, Kindleberger himself struck a considerably more cautious note in this respect, as follows:

> It is difficult—perhaps impossible—to make a rigorous definition of capital flight for the purpose of devising policies to cope with it. Do we restrict cases to domestic capital sent abroad, or should foreign capital precipitously pulled out of a country be included? What about the capital that emigrants take with them, especially when the people involved are being persecuted . . . ? Does it make a difference whether the emigration is likely to be permanent or temporary, to the extent that anyone can tell ex ante? And what about the cases where there is no net export of capital, but capital is being returned to the country as foreign investment . . . ? Is there a valid distinction to be made between capital that is expatriated on a long-term basis for fear of confiscatory taxation, and domestic speculation against the national currency through buying foreign exchange that is ostensibly interested in short-term profits? (Kindleberger 1990, 326–27)

As attention shifted to capital flight from contemporary developing economies, in particular in the wake of the Latin American debt crisis of the early 1980s, a growing consensus emerged about the difficulty of isolating specific determinants of abnormal capital outflows ex ante (Dooley 1986; Khan and Ul Haque 1985; Vos 1992). While there was some agreement on basic characteristics of abnormal outflows (that they tend to be permanent, not primarily aimed at asset diversification, and not generating recorded foreign exchange income), the original effort to identify the characteristics of abnormal capital outflows was replaced by definitions of capital flight in terms of a single-core driver, perceived differently by different approaches (Dooley 1986, 1988; Cuddington 1987).

Capital flight as portfolio choice

First, the portfolio approach adopts standard models of expected utility maximization by rational economic agents to explain capital flight as a portfolio diversification response to higher foreign returns relative to domestic returns on assets (Khan and Ul Haque 1985; Lessard and Williamson 1987; Dooley 1988; Collier, Hoeffler, and Pattillo 2001). More specifically, this involves a counterfactual comparison of after-tax domestic and foreign returns, adjusted for a range of variables, such as expected depreciation, volatility of returns, liquidity premiums, and various indicators of investment risk, including indexes of corruption. In this view, capital flight is caused by the existence of market distortions and asymmetric risks in developing countries (relative to advanced economies). The underlying market-theoretical model of economic development builds on four core premises: (1) economic behavior relevant to capital flight is correctly described by expected utility maximization, (2) markets exist universally (and thus can be distorted), (3) individual agents possess the ability to compute the probabilities of investment risk globally and on the basis of counterfactual investment models, and (4) computable probabilities can be attached to all events.

These are obviously fairly restrictive assumptions in any case. In the present context, however, the most important conceptual drawback is illustrated by the following remark of a Brazilian economist:

> Why is it that when an American puts money abroad it is called "foreign investment" and when an Argentinean does the same, it is called "capital flight"? Why is it that when an American company puts 30 percent of its equity abroad, it is called "strategic diversification" and when a Bolivian businessman puts only 4 percent abroad, it is called "lack of confidence"? (Cumby and Levich 1987, quoted in Franko 2003, 89)

The obvious answer is that, relative to overall domestic resources, more domestic capital tends to flee for longer from Argentina and Bolivia than from the United States and that this is so because structural uncertainty about future investment opportunities is higher in the former economies. To prevent relatively scarce capital from voting with its feet in situations of great structural uncertainty, developing countries are more likely to impose regulatory barriers on free capital movement, thus turning what might simply appear to be good business sense into illegal capital flight.

By focusing on a single broad motive for capital flight, namely, utility maximization in the presence of differential policy regimes and investment risks, the portfolio approach conflates short-term utility (and profit) maximization with structural political and economic uncertainties. No systematic distinction is made between the drivers of asymmetric investment risks in developing economies, which may range from inflation and exchange rate depreciation to expectations of confiscatory taxation and outright politically motivated expropriation. Similarly, policy-induced market distortions can range from short-term fiscal and monetary policies, common to all economies, to policies promoting long-term structural and institutional changes with much more wide-ranging (and often more uncertain) implications for future investment opportunities. This failure to distinguish between different drivers of capital flight considerably weakens the effectiveness of the policy implications arising from this approach. This consists essentially in the recommendation of market-friendly reforms to eliminate such market distortions on the assumption that these will also minimize asymmetric investment risks. If, however, markets do not as yet exist or suffer from fundamental structural weaknesses, market-friendly reforms may be insufficient to minimize differential investment risk relative to, for example, advanced economies.

This problem is, in fact, at least partially recognized by advocates of this approach. Some authors use a narrow statistical measure of capital flight, the hot money measure, which limits capital flight to short-term speculative capital outflows of the private nonbank sector (taken to be the primary source of net errors and omissions in a country's balance of payments) (for example, see Cuddington 1986, 1987). In contrast, the most widely used statistical definition of capital flight, often referred to as the residual measure, includes recorded and nonrecorded acquisitions of medium- and short-term assets and uses broader estimates of capital inflows (World Bank 1985; Erbe 1985; Myrvin and Hughes Hallett 1992).[2] Cuddington thus reemphasizes the idea that abnormal capital outflows of money running away are a reaction to exceptional circumstances and events rather than ordinary business, although, in times of extensive deregulation of international financial markets, this conjecture may be less convincing. Other authors have taken a different route to distinguish portfolio capital flight from other forms of capital flight, in particular that induced by extreme political instability, such as civil war (Tornell and Velasco 1992; Collier 1999). In the latter case, capital flight can occur despite lower actual foreign returns relative to potential domestic returns (if peace could be achieved) and is part of a wider outflow of productive resources, including labor.

The social controls approach to capital flight

A second strand of the capital flight literature defines capital flight as "the movement of private capital from one jurisdiction to another in order to reduce the actual or potential level of social control over capital" (Boyce and Zarsky 1988, 192). To the extent that such capital flight is motivated primarily by the pursuit of private economic gain, this social control definition is not radically different from the portfolio approach. In both cases, capital flight occurs in response to policy intervention. However, the "social controls" approach rests

> upon an explicit premise absent in much conventional economic theory, namely that individual control over capital is rarely absolute or uncontested, but rather subject to social constraints, the character and extent of which vary through time. Unlike many authors, Boyce and Zarsky, therefore do not consider capital flight to be necessarily "abnormal." (Rishi and Boyce 1990, 1645)

As with the portfolio approach, there is no systematic distinction between fundamentally different drivers of capital flight. All capital flight occurs in response to government controls, whether these concern short-term macroeconomic stabilization through fiscal and monetary policy measures or more long-term structural interventions. However, in this case, the underlying model of the economy is not that of universal and competitive markets inhabited by maximizers of expected utility and profits, but rather that of a mixed economy in which markets are one set of several institutions ultimately governed by a (welfare or developmental) state or, more broadly, by social interventions from outside the market sphere. Different from the portfolio approach, the main policy implication is therefore not simply a focus to promote markets, but to minimize capital flight through the strengthening of existing social controls or the introduction of alternative, more effective administrative measures to control private capital movements.

The social controls approach remains ambiguous, however, about the origin and legitimacy of social (capital) controls. A weak version of the approach identifies governments as the core players in social control, and no explicit judgment is made about the legitimacy or effectiveness

[2] The most commonly applied variant of this residual measure subtracts capital outflows or uses of foreign exchange (the current account deficit and increases in central bank reserves) from capital inflows (net external borrowing, plus net foreign direct investment). An excess of inflows over outflows is interpreted as indicative of capital flight. Nonbank variants of this measure include net acquisitions of foreign assets by the private banking system in capital outflows.

of specific government controls. This position comes closest to the portfolio approach. In this vein, Walter, for example, argues that capital flight

> appears to consist of a subset of international asset redeployments or portfolio adjustments—undertaken in response to significant perceived deterioration in risk/return profiles associated with assets located in a particular country—that occur in the presence of conflict between objectives of asset holders and the government. It may or may not violate the law. It is always considered by authorities to violate an implied social contract. (Walter 1987, 105)

By contrast, the strong version adopts the more heroic assumption that social (capital) controls reflect some kind of a social consensus about the ways in which economic development is best achieved. The implied social contract here is not one merely perceived by government authorities to exist, but one based on genuine social approval. A recent example is the observation of Epstein, as follows:

> When people hear the term "capital flight" they think of money running away from one country to a money "haven" abroad, *in the process doing harm to the home economy and society*. People probably have the idea that money runs away for any of a number of reasons: to avoid taxation; to avoid confiscation; in search of better treatment, or of higher returns somewhere else. In any event, people have a sense that *capital flight is in some way illicit, in some way bad for the home country*, unless, of course, capital is fleeing unfair discrimination, as in the case of Nazi persecution. (Epstein 2006, 3; italics added)

For Epstein (2006, 3–4), capital flight is therefore an "inherently political phenomenon" and also mainly "the prerogative of those—usually the wealthy—with access to foreign exchange." This view entails a more explicitly normative position than either the portfolio approach or the weak version of the social controls approach in that capital flight is characterized not only as economically damaging for development, but also as illegitimate from the perspective of an existing consensus about the social (developmental) good.

Capital flight as dirty money

Both the portfolio approach and the social controls approach broadly interpret capital flight as a response by private capital to expectations of lower domestic returns relative to foreign returns on assets. Both are outcome oriented in that their primary concern is with the macroeconomic analysis of the perceived damage inflicted by capital flight on developing economies rather than with the origins of flight capital or the methods by which it is being transferred abroad. They differ with regard to their analytical benchmark models of a normal or ideal economy. Whereas the portfolio approach subscribes to variants of the standard model of a competitive free-market economy, the social controls approach adopts a mixed economy model in which the social control of private capital, for example by a welfare state, is normal. This translates into different single-driver models of capital flight. In the first case, the driver is simply profit (or utility) maximization (or the minimization of investment risk) at a global level, and the damage done arises not from capital flight per se, but from market distortions that lower relative returns on domestic private assets. In the second case, the driver is the avoidance of policy controls, and the damage arises from private capital breaking implicit or explicit social contracts. These models overlap only in so far as (1) market distortions arise from domestic policy interventions rather than other exogenous shocks and (2) social controls are judged, in any particular context, to be poorly designed so as to undermine rather than promote economic development and thus violate the implicit or explicit social contract.

The more recent literature on illicit capital flows adopts an explicitly normative perspective on capital flight that focuses primarily on adherence to the law or perceived good practice. Illicit capital flows are flows that break the implicit rules asserted as desirable by the observer. A crossborder movement of capital that, at any stage from its generation to its use, involves the deployment of illegal or abusive activities or practices is illicit. Probably the most well known example of this procedural or rule-based perspective on capital flight is Baker's notion of dirty money that distinguishes criminal, corrupt, and commercial forms of illicit capital flows (a term used interchangeably with dirty money) (Baker 2005; Baker and Nordin 2007). Criminal flows encompass "a boundless range of villainous activities including racketeering, trafficking in counterfeit and contraband goods, alien smuggling, slave trading, embezzlement, forgery, securities fraud, credit fraud, burglary, sexual exploitation, prostitution, and more" (Baker 2005, 23). Corrupt flows stem "from bribery and theft by (foreign) government officials" trying to hide the proceeds from such activities abroad, and the commercial component of dirty money stems from tax evasion and mispriced or falsified asset swaps, including trade misinvoicing and abusive transfer pricing (Baker 2005, 23). Of these components of dirty money, illicit commercial flows have been estimated to account for around two-thirds of all illicit outflows, and proceeds from corruption for the smallest part, around 5 percent of the total (Eurodad 2008b).

This rule-based dirty money approach leads to a conceptual definition of capital flight that is narrower than the definitions adopted by more conventional approaches. First, definitions of capital flight here are mostly limited to unrecorded capital flows. Thus, Kapoor (2007, 6–7), for example, defines capital flight as the "unrecorded and (mostly) untaxed illicit leakage of capital and resources out of a country," a definition taken up by Heggstad and Fjeldstad (2010, 7), who argue that its characteristics include

> that the resources are domestic wealth that is permanently put out of reach for domestic authorities. Much of the value is unrecorded, and attempts to hide the origin, destination and true ownership of the capital are parts of the concept.

This does not necessarily translate into the adoption of narrow statistical measures of capital flight, such as hot money estimates that take account only of unrecorded capital flows in the balance of payments. Rather, measures of illicit capital flows attempt to capture as many likely conduits for such flows as possible, in practice integrating different conventional measures of capital flight with estimates of trade misinvoicing (Kar and Cartwright-Smith 2008).

Second, consistent with the conceptual focus on dirty money, the core driver of capital flight is also more narrowly defined, as follows:

> The term flight capital is most commonly applied in reference to money that shifts out of developing countries, usually into western economies. Motivations for such shifts are usually regarded as portfolio diversification or fears of political or economic instability or fears of

taxation or inflation or confiscation. All of these are valid explanations for the phenomenon, *yet the most common motivation appears to be, instead, a desire for the hidden accumulation of wealth*. (Kar and Cartwright-Smith 2008, 2; emphasis added)

However, capital flight in response to return differentials, asymmetric investment risks, or perceived macroeconomic mismanagement through social controls can also occur in the open, in particular in a highly deregulated financial environment. Thus, the main concern of conventional approaches to capital flight is with wealth accumulation abroad in general, rather than exclusively or even primarily with hidden wealth accumulation.

Finally, illicit capital flows are also often equated with illegal outflows, on the grounds that funds originating in (or intended for) illicit activities have to be hidden and will eventually disappear from any records in the transferring country (Kar and Cartwright-Smith 2008; Baker and Nordin 2007). This narrows conventional definitions of capital flight because the latter's focus on capital outflows that are, in some sense, damaging to the economy is not limited to illegal outflows. How extensive the overlap between illegal and damaging capital outflows is will depend on how closely and effectively legal frameworks encapsulate the social or economic good, defined in terms of the respective underlying benchmark models of an ideal or licit state of affairs.

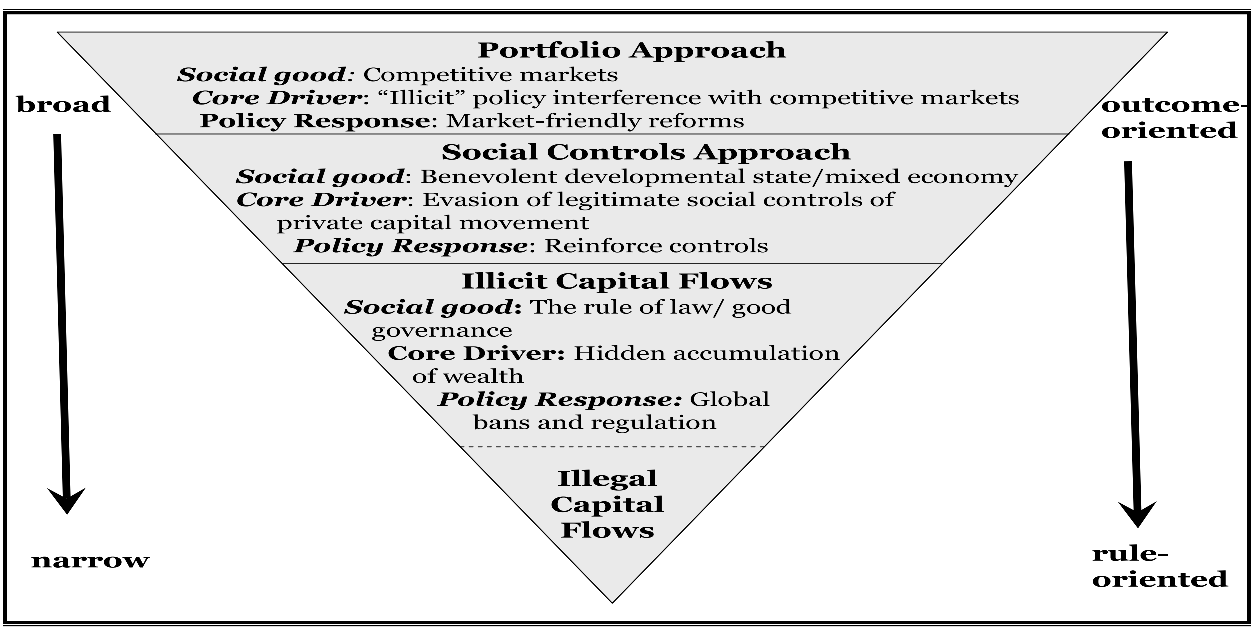
In fact, the equation of illegal and illicit capital outflows is not systematically sustained, even in the dirty money approach. At least some of the activities included in the analysis of dirty money are not illegal, but refer to practices characterized as abusive, such as aspects of transfer pricing, specific uses made of tax havens, and corrupt activities that have not necessarily been outlawed. Rather, the procedural or rule-based focus on adherence to the law in this approach to capital flight is based on an implicit claim that adherence to the law will promote economic development or, more generally, the social good. If the principal motivation for capital flight is, in fact, "the external, often hidden, accumulation of wealth, and this far outweighs concerns about taxes" (Baker and Nordin 2007, 2), the policy response has to be directed primarily at eliminating the dirty money structure through the enforcement of national and global standards of financial transparency and democratic accountability. The core obstacle to economic development then becomes the lack of good governance, corruption, and the absence of or weaknesses in the rule of law (rather than specific legislation).

Thus, the dirty money approach to illicit capital flows from developing countries differs from more conventional definitions of capital flight mainly in that it appears to be rooted less in outcome-oriented models of economic growth and development, but in a specific rule-based liberal model of good governance and a good polity, perceived to be a necessary condition for achieving any more substantially defined social good.

From the above, we see that the literature identifies three core drivers of capital flight from developing economies, each implying a different underlying view of what constitutes damage to these economies and each adopting a monocausal perspective. Figure 2.1 summarizes features of these approaches, as follows:

1. In the portfolio approach, social damage is a result of interference with competitive markets that are presumed to otherwise exist. Capital flight is driven by economic incentives to escape such interference given profit-maximizing investment strategies. The best way to eliminate capital flight in this perspective is to remove the damaging government interventions in competitive markets. This largely ignores the fact that competitive markets require government regulation even in advanced economies and that extensive market failures imply that significant government intervention may be required to achieve developmental outcomes in developing economies.
2. The social controls approach is almost the mirror image of the portfolio approach. All social controls over private capital movements are presumed to reflect a legitimate social contract that is welfare enhancing. As a result, capital outflows that violate social controls imposed by a welfare-developmental state are damaging and illicit, presumably because the indirect effects of violating the social contract will be socially damaging. The best way to eliminate capital flight is to reinforce social controls. This largely ignores the fact that not all formal social controls and regulations in developing countries are legitimate, growth enhancing, or politically viable.
3. In the dirty money approach, social damage is the result of violating the rule of law. Capital flight is driven by the desire to accumulate wealth by hiding from the rule of law. No substantial view on what constitutes social, economic, or political damage is typically offered. This largely ignores the fact that, in developing countries in particular, existing legal frameworks may not adequately encapsulate the economic and political conditions necessary to achieve whichever substantial idea of the social good is adopted (economic development, social justice, the preservation of specific human rights, and so on).

Figure 2.1. Definitions of Capital Flight



Source: Author compilation.

3. Illicit Capital Outflows: An Alternative Policy Framework

The discussion above suggests that the search for a conceptual definition of capital flight in general and of illicit capital outflows from developing countries in particular has been motivated by differing perceptions of what constitutes the social or developmental good. Implicit differences in the values and theoretical models of observers explain the significant differences in how illicit capital flows have been defined. These hidden differences are not conducive for developing effective policy responses on the basis of which some minimum agreement can be reached. We believe we can go to the core of the problem by defining illicit capital flows as *outflows that cause damage to the economic development of the country, taking into account all direct and indirect effects that are likely, given the specific political settlement*.

An implicit assumption in many conventional approaches is that all flight capital, however defined, will yield a higher rate of social return in developing economies if it can be retained domestically (Schneider 2003a; Cumby and Levich 1987; Walter 1987). From a policy perspective, locking in potential flight capital is supposed to reduce the loss of developmental resources directly and indirectly stabilize domestic financial markets and improve the domestic tax base (Cuddington 1986). In contrast, we argue that the problems faced by countries with capital flight can be different in nature. The widely shared premise of a general negative relationship between capital outflows and domestic capital accumulation simply is not valid (Gordon and Levine 1989). Dynamic links among capital flows, economic growth, technological change, and political constraints mean that, even in advanced economies, the regulation of capital outflows is an uphill and evolving task. In developing countries, too, some capital outflows may be desirable to sustain development. Moreover, the idea underlying some of the illicit capital flow literature that adherence to the law is sufficient for identifying the social or economic good clearly does not always apply.

On the basis of our minimalist definition of illicit capital flows, we proceed to develop a simple three-tier typology of economic and political constellations and governance structures and the ways in which these pose policy challenges in controlling illicit capital outflows. Specifically, we distinguish between advanced economies (in opposition to developing countries in general), and, within the latter group, we distinguish between normal or intermediate developing countries and fragile developing countries.

Advanced economies: the differences with respect to developing economies

Advanced economies are likely to be supported by rule-based states and political institutions such that the social compromises for political stability and the economic policies required for sustaining growth—the political settlement—are reflected and codified in an evolving set of laws. In these contexts, it is not unreasonable to expect that *as a first approximation, damaging capital flows are likely to be capital flows that violate existing laws*. Illegal capital flows are likely to be damaging and can justifiably be described as illicit in this context. However, some damaging flows may not be illegal if laws do not fully reflect these conditions or have not caught up with the changing economic and political conditions involved in sustaining growth. For instance, the proliferation of inadequately regulated financial instruments that resulted in the financial crisis of 2008 was driven by financial flows that were, in many cases, not illegal, but turned out, ex post, to be seriously damaging. A focus on identifying damaging financial flows independently of the existing legal framework may therefore be helpful even in advanced countries, though, most of the time, a focus on illegal financial flows may be adequate.

Advanced economies, by definition, have extensive productive sectors, which is why they have high levels of average income. As a result, formal taxation can play an important role not only in providing public goods, but also in sustaining significant levels of formal, tax-financed redistribution. Both help to achieve political stability and sustain existing political settlements. Taxation may be strongly contested by the rich, but an implicit social contract is likely to exist whereby social interdependence is recognized and feasible levels of redistributive taxation are negotiated. Significant fiscal resources also provide the resources to protect property rights and enforce a rule of law effectively.

Tax evasion and capital flight in this context are likely to represent individual greed and free-riding behavior rather than escape routes from unsustainable levels of taxation. Moreover, if economic policies and redistributive taxation represent the outcome of political negotiations between different groups, illegal capital flows would also be illicit in the sense of damaging the sustainability of the political settlement and thereby, possibly, having damaging indirect effects on economic growth. Transparency, accountability, and the enforcement of the rule of law can therefore be regarded as mechanisms for limiting tax-avoiding capital flight and other forms of illicit capital flows in advanced countries.

Nonetheless, even within advanced countries, if legal arrangements cease to reflect economic and redistributive arrangements acceptable to major social constituencies, the correspondence between illegal and illicit can break down. The more recent discussion of illicit capital flows in advanced countries has to be considered in a context in which the increase in the bargaining power of the rich to define economic laws in their own interest has exceeded the pace at which other social groups have accepted these changes. This allows us to make sense of the more recent preoccupation with IFFs in many countries of the Organisation for Economic Co-operation and Development (OECD) where the concern with dirty money has been closely associated with changes in the structure of many of these economies as a result of the decline in manufacturing and a growth in the service sectors, in particular finance. The result has been not only a gradual change in the formal structure of taxation and redistribution in ways that reflect the regressive changes in power, but also a growing tendency of the super-rich to evade even existing legal redistributive arrangements through financial innovations or outright illegal capital flows. The avoidance and evasion of taxation have not been uncontested in advanced countries. Many social groups have criticized these developments and questioned the legitimacy of capital flows that seek to avoid and evade taxes. This constitutes an important part of the concern with illicit capital flows in advanced countries.

Palma (2005) points to the significant decline in manufacturing profits as a share of total profits in advanced countries over the last three decades and the concomitant search for global financial, technological, and resource rents (see also Smithin 1996). The decline in manufacturing can at least partly explain the significant change in income distribution in OECD countries, generally in favor of the highest income groups. For example, in the United States, the average real income of the bottom 120 million families remained roughly stagnant between 1973 and 2006, while that of the top 0.01 percent of income earners increased 8.5 times, meaning that the multiple between the two income groups rose from 115 to 970. During the four years of economic expansion under the Bush Administration, 73 percent of total (pretax) income growth accrued to the top 1 percent of income earners compared with 45 percent during the seven years of economic expansion under the Clinton Administration (Palma 2009). The structural change in advanced countries is obviously complex and differs across countries, but there has been a significant structural change over the last few decades, and the redistributive arrangements that emerged out of the postwar political consensus have faced renegotiation as a result.

The contemporary concern with illicit capital flows in advanced countries is motivated by a growing dissatisfaction both with the enforcement of law and with the extent to which the law in critical areas still effectively supports the social good. Narrower debates about illegal capital flows have focused on capital movements that have flouted existing legal redistributive arrangements because of the growing power of the rich to evade taxes through complex financial instruments and the threat of relocation to other jurisdictions. But a more profound concern with illicit capital flows is based on a feeling of unease that the increase in the political power of these new sectors has enabled them to change laws without the acquiescence of groups in society that would once have had a say. This includes changes in laws that have weakened regulatory control over capital seeking to move much more freely in search of risky profits or tax havens. Even legal capital flows could be deemed to be illicit from this perspective if economic welfare or political stability were threatened by a unilateral redefinition of the implicit social contract.

The steady deregulation of financial flows in advanced countries in the 1980s and 1990s is a case in point. Changes in regulatory structures increased returns to the financial sector, arguably at the expense of greater systemic risk for the rest of society, and diminished the ability of states to tax these sectors (Eatwell and Taylor 2000). Some of the associated financial flows could therefore easily be judged to have been illicit according to our definition. Underlying this judgment is the implicit claim that the restructuring of law is based on an emergent distribution of power that is not legitimate because it eventually produces economic and political costs in which many social constituencies no longer acquiesce and that thereby threatens to become unsustainable (Crotty 2009; Wray 2009; Pollin 2003). The concern here is that some of these financial flows were illicit either because they were directly damaging to the economy or because they damaged the political settlement in unsustainable ways and may eventually bring about economic costs in the form of social protests and declining political stability. These are obviously matters of judgment, but our definition provides a consistent way of structuring the policy debate without getting locked into a monocausal definition.

As long as the new sectors grew rapidly, the critique that some capital flows were illicit (even if legal) remained a fringe argument. However, the financial crisis of 2008, largely the result of excessive risk taking by an insufficiently regulated financial sector, showed, ex post, that some of these financial flows were not only questionable in terms of their legitimacy and their impact on social agreements, they were damaging in a straightforward sense of economic viability. If the political process in advanced countries responds to these pressures by enacting laws that combine socially acceptable redistributive arrangements with regulatory structures that make sense for sustained economic growth, the law could once again reflect a broadbased social compromise grounded on maintaining politically sustainable economic growth. Under these circumstances, illicit capital flows will once again become coterminous with illegal capital flows.

Even so, the basic features of advanced countries that we discuss above have often created an expectation that a rule of law can and should be enforced at a global level, making illicit capital flows relatively easy to identify and target. Unfortunately, while this analysis makes sense at the level of individual advanced countries, it falls apart as an analytical framework at a global level. It ignores the obvious fact that global laws guiding economic policy or capital flows would only be legitimate if there were a global social consensus based on the same principles of redistributive taxation and social provision on which cohesive societies are constructed at the level of individual countries. It also presumes that a global agency would have the fiscal resources to enforce laws at the global level in the same way that individual advanced countries can enforce national laws. None of these presumptions are reasonable given the current global gaps among countries in terms of economics and politics. By our definition, the absence of a sustainable global political settlement based on global redistributive and enforcement capabilities makes problematic any attempt to define IFFs at the global level.

To understand this more clearly, the differences between the political settlements in advanced and developing countries need to be spelled out. First, developing countries are structurally different because their internal political stability and economic development are not (and cannot normally be) organized through formal rules and laws to the extent observed in advanced countries. *In developing countries, the legal framework is not an adequate guide for identifying illicit capital flows even as a first approximation*. There are two essential limitations on a purely legal analysis of what is illicit in the typical developing country. First, in the realm of politics, the internal political stability of developing countries is not solely or even primarily based on social agreements consolidated through legal fiscal redistributions. For a variety of reasons, including limited fiscal space and more intense conflicts given the context of social transformations, redistributive fiscal arrangements are typically less transparent and less formal compared with those in advanced countries. The political problem involves delivering resources to powerful constituencies that would otherwise be the source of political instability in a context of fiscal scarcity.

If politically powerful constituencies have to be accommodated legitimately and transparently, acceptable redistributions to more deserving groups such as the severely poor have to be agreed upon simultaneously to achieve political legitimacy. The fiscal sums typically do not add up in developing countries for a redistributive package that would pass the test of public legitimacy, as well as provide the redistribution required by powerful groups. As a result, it is not surprising that the critical redistributions to powerful constituencies typically occur through patron-client politics and other mechanisms characterized by limited transparency. If successful, these arrangements achieve political stabilization by incorporating sufficient numbers of politically powerful factions within the ruling coalition. Even in developing countries where significant fiscal redistribution takes place, critical parts of the overall system of political redistribution are not based on transparently negotiated arrangements codified in fiscal laws and economic policies (Khan 2005).

Second, the economies of developing countries are also significantly different from the economies of advanced countries. Their formal or regulated modern sectors are normally a small part of the economy, and a much larger informal sector is unregulated or only partially regulated.

Much of the economy, including the formal sector, suffers from low productivity and does not generate a big enough taxable surplus to pay for across-the-board protection of property rights and adequate economic regulation. The achievement of competitiveness also often requires periods of government assistance and strong links between business and politics. This is because, even though wages may be low, the productivity of the modern sector is often even lower. Developing countries have poor infrastructure and poor skills in labor and management, and, in particular, they lack much of the tacit knowledge required to use modern technologies efficiently, even the most labor-intensive ones.

The strategies through which developing countries progress up the technology ladder while maintaining their internal political arrangements can differ substantially across countries (Khan and Blankenburg 2009). These strategies usually involve creating opportunities and conditions for profitable investment in at least a few sectors at a time. Because the creation of profitable conditions across the board is beyond the fiscal capacities of developing countries, these strategies inevitably create privileges for the modern sector and, often, for particular subsectors through government interventions in prices, exchange rates, interest rates, regulations, taxes, subsidies, and other policy instruments. The strategies for assisting learning in industrial policy countries such as the East Asian tigers are well known. But the growth of modern sectors in all developing countries has required accidents or smaller-scale policy interventions that overcame the built-in disadvantages of operating profitably given the adverse initial conditions (Khan 2009). Some of this assistance may be formal and legal, but other aspects of assistance may be informal and even illegal. For instance, some firms may informally have privileged access to land, licenses, and other public resources. Some of these privileges may be important in offsetting initial low productivity or the higher costs created by poor infrastructure and the poor enforcement of property rights and the rule of law. Deliberately or otherwise, these arrangements can assist some firms in starting production in adverse conditions and engage in learning by doing, but they can also simply provide privileges to unproductive groups (Khan and Jomo 2000; Khan 2006).

Thus, in many cases, business-government links in developing countries are predatory from the perspective of the broader society. Resources captured by privileged firms in the modern sector are wasted, and, in these cases, the modern sector remains inefficient at significant social cost. However, in other cases, periods of hand-holding and bailouts do lead to the emergence of global competitiveness through formal and informal links between emerging enterprises and the state. The efficacy of developmental strategies depends on the nature of the relationships between business and politics, the compulsions on both sides to generate productivity growth over time, the time horizons, and so on, but not in any simple way on the degree to which formal laws are upheld (Khan and Blankenburg 2009; Khan 2009).

It is not surprising that all developing countries fail the test of adherence to a rule of law and political accountability. Yet, some developing countries perform much better than others in terms of politically sustainable growth that eventually results in poverty reduction, economic development, and movement toward the economic and political conditions of advanced countries. These observations suggest that what constitutes a damaging financial flow may be more difficult to identify in developing countries. Because of the significant differences in the economic and political conditions across developing countries, we find it useful to distinguish between normal developing countries, which we call intermediate developers, and fragile developers that suffer from more serious crises in their political settlements.

Normal developing countries: the intermediate developers

Our term intermediate developers refers to the typical or normal developing country in which internal political and economic arrangements sustain political stability. Their internal political settlements can be quite varied, but also differ from those in advanced countries in that their reproduction typically requires significant informal arrangements in both redistributive arrangements and the organization of production. Nonetheless, in most developing countries, there is a political settlement that has characteristics of reproducibility, and these societies can sustain economic and political viability. This does not mean that the governments are universally recognized as legitimate, nor are violence and conflict entirely absent, but the political arrangements are able to achieve development (at different rates) without descending into unsustainable levels of violence.[3] Countries in this category include, for example, China and most countries of South Asia, Southeast Asia, and Latin America. In contrast, fragile developers are countries such as Somalia or the Democratic Republic of Congo in which a minimally sustainable political settlement among the contending forces in society does not exist and in which the fundamental problem is to construct this in the first place.

Our analysis of illicit capital flows from intermediate developers can be simplified by distinguishing between political and economic actors according to their motivations for making decisions about financial flows. The former are likely to be concerned about threats to the processes through which they accumulate resources and about the political threats to these resources; the latter are likely to be primarily concerned with profit opportunities and expropriation risk. In reality, political and economic actors may sometimes be the same persons; in this case, we have to look at the motivations jointly. The simplification may nonetheless help one to think through the different analytical issues involved so that appropriate policies can be identified in particular cases.

–Financial outflows driven by political actors

An obvious reason why political actors in developing countries may engage in capital flight is that their opponents may expropriate their assets if the opponents come to power. A significant amount of the resource accumulation is likely to have violated some aspect of the structure of formal laws. The legality can be questioned by the next ruling coalition for a number of reasons, including expeditious political reasons, for instance, to undermine the ability of previous ruling factions to return to power. Let us assume that this capital flight is immediately damaging because it represents a loss of resources. The issue from the perspective of an analysis of (illicit) capital flight involves assessing the consequences of hypothetically blocking specific financial outflows in these circumstances. The important point is that patron-client politics cannot be immediately replaced by fiscal politics because these countries are developing economies with a limited tax base. Therefore, the fundamental mechanisms through which political entrepreneurs gain access to economic resources are unlikely to disappear in the short run in most developing countries, with the exception of those that are close to constructing Weberian states.

[3] Our intermediate developers should not be confused with middle-income countries. Relatively poor and middle-income developing countries can both have sustainable political settlements, and both can suffer from internal political crises that result in fragility as a result of a collapse in the internal political settlements.

Given the nature of political settlements in developing countries, attempting to block financial outflows driven by politicians is unlikely to lead to a liberal rule of law because any new ruling coalition will also require off-budget resources to maintain political stability and will keep resources available for elections (and for their own accumulation). If these resources can be expropriated by a new coalition after an election, this can significantly increase the stakes during elections. Expropriating the financial resources of former politicians may therefore have the paradoxical effect of increasing instability (the case of Thailand after 2006, for example). It can increase the intensity with which assets of the current ruling coalition are attacked by the opposition, and it can increase the intensity of opposition by excluded coalitions as they attempt to protect their assets from expropriation. Indeed, the evidence from stable intermediate developers such as Brazil or India suggests that the stability of the political settlement in the presence of competition between patron-client parties requires a degree of maturity whereby new coalitions understand that it is not in their interest to expropriate the previous coalition fully. An informal live-and-let-live rule of law guiding the behavior of political coalitions can reduce the costs of losing and allow elections to mature beyond winner takes all contests. However, this type of informal understanding is vulnerable.

If the competition between political factions has not achieved a level of maturity that informally sets limits on what can be clawed back from a previous ruling coalition, a premature attempt at restricting financial flows may have the unintended effect of significantly raising the stakes in political conflicts. If the ruling coalition cannot protect some of its assets in other jurisdictions, it may feel obliged to use violence or intimidation to stay in power, and this can increase the likelihood of eventual expropriation. Paradoxically, some amount of flexibility in politically driven financial flows at early stages of state building may help lower the stakes at moments of regime change. Thus, restrictions on political financial flows are only likely to improve social outcomes if live-and-let-live compromises between political coalitions have already been established. For instance, in more stable political settlements such as in Argentina, Brazil, or India, a gradual increase on restrictions on financial outflows could lead to better social outcomes as long as current politicians feel that the risk of domestic expropriation is low and the restrictions simply restrict excessive illegal expropriation by political players.. If formal rules restrict political accumulation that is beyond what is normally required to sustain political operations in this political settlement, then financial flows that violate these rules can justifiably be considered illicit. In contrast, if the informal understanding between competing parties is still vulnerable and live-and-let-live arrangements have not become entrenched (as in Bangladesh, Bolivia, Thailand, and, to an extent, República Bolivariana de Venezuela), attempts to limit financial outflows driven by political players are likely to be evaded or, if forcefully enforced, can occasionally have damaging consequences in raising the stakes during elections. According to our definition, we should not consider all capital outflows by political actors to be illicit in these contexts, with critically important policy implications. Clearly, these judgments reflect an attempt to take into account direct and indirect effects and are open to a degree of disagreement. However, we believe that these judgments have to be made and that they are best made explicitly.

– Financial outflows driven by economic actors

Financial outflows driven by economic actors can be motivated by concerns about expropriation or low profitability (in addition to tax evasion and tax avoidance). These factors help explain the frequent paradox that economic actors in developing countries often shift assets to advanced-country jurisdictions where tax rates are higher and the returns achieved, say, on bank deposits, are nominally lower (Tornell and Velasco 1992). Some of these flows are damaging, and blocking them (if that were possible) is likely to leave society more well off. Others are not damaging, or, even if they are damaging, attempts to block them would not be positive for society after all the direct and indirect effects are weighed.

Financial outflows with net negative effects

The simplest cases involve capital flight whereby both the direct and indirect effects are negative, such as those driven by tax evasion or tax avoidance. The direct effect of these outflows is likely to be negative if tax revenue and, with it, public investment is reduced, and, in addition, the indirect effect is also likely to be negative if the taxes are socially legitimate and their loss undermines political stability. The capital flight in these cases is clearly illicit. Another clear-cut case is that of theft of public resources with the collusion of political actors. A particularly serious example is the two-way capital flow involved in the odious debt buildup resulting if external borrowing by governments is turned, more or less directly, into private asset accumulation abroad by domestic residents. Examples include the Philippines and several Sub-Saharan African economies (Boyce and Ndikumana 2001; Cerra, Rishi, and Saxena 2008; Hermes and Lensink 1992; Vos 1992). Odious debt has no redeeming features, and, if it can be blocked, the developing country is likely to be more well off in terms of direct investment effects. In normal cases where a political settlement involving powerful domestic constituencies exists, theft on this scale by a subset of the ruling coalition is likely to undermine the political settlement and have additional negative effects on growth. Blocking these financial outflows is therefore likely to have a positive effect on growth through both direct and indirect effects. The flows are thus rightly classified as illicit.

Many cases are more complex. Consider a plausible case wherein capital flight is driven by attempts to evade environmental restrictions, labor laws, or other socially desirable regulations that reduce profits. In principle, these could be welfare-enhancing regulations, and capital flight to evade them could be judged illicit. However, a more careful evaluation suggests that the issue may vary from case to case. Because developing countries are often competing on narrow margins with other developing countries, investors may threaten to leave and begin to transfer resources away from a country. What should the policy response be? If social policies in the developing country are significantly out of line with competitors, these policies may have made the country uncompetitive. Yet, removing all social protections is also not desirable. The real issue in this case is coordination in social policy that takes into account differences in initial conditions across countries, not an easy task. If such a coordinated policy structure is not possible across countries, the enforcement of restrictions on capital flight is unlikely to improve growth because domestic investors may become globally uncompetitive. These capital flows would therefore not be illicit according to our definition because blocking capital flight without deeper policy coordination may fail to improve economic outcomes in a particular country. This has important policy implications: all our effort should not be put into trying to block capital flight regardless of the underlying causes. Rather, the policy focus should be either to achieve the coordination of social policies across developing countries or, more realistic, to change policies such that regulations are aligned across similar countries.

An even more important example concerns policies to overcome major market failures such as those constraining technological capabilities. Growth in developing countries is typically constrained by low profitability because of the *absence* of formal and informal policies to address market failures and, in particular, the problem of low productivity because of missing tacit knowledge about modern production processes (Khan 2009). In the absence of policies that assist technological capability development, capital is likely to flow out of the developing country despite low wages. Countervailing policies, variously described as technology policies or industrial policies, involve the provision of incentives for investors to invest in particular sectors and to put in the effort to acquire the missing tacit knowledge. In the presence of such policies, some restrictions on capital movements may be potentially beneficial. The provision of incentives to invest in difficult processes of technology acquisition and learning may be wasted if domestic investors can claim the assistance without delivering domestic capability development. Unrestricted financial outflows may allow domestic investors to escape sanctions attached to poor performance. If the policy is well designed and the state has the capability to enforce it, restrictions on financial outflows may be socially beneficial. Some amount of capital flight may still take place, and liberal economists may want to argue that this is a justification for removing the policy and returning to a competitive market. However, if the market failures constraining investments are significant, this may be the wrong response, *if a credible technology policy exists*. The restrictions on capital flight in East Asian countries in the 1960s and 1970s worked dramatically because they combined significant incentives for domestic investment with credible restrictions on capital flight. In such cases, capital flight would be directly damaging in the sense of lost investment and not have any indirect positive effects either. It would therefore be illicit according to our definition.

The mirror image of this is capital flight driven by the *absence* of profitable domestic opportunities in a country without effective technology policies. Capital is likely to seek offshore investment opportunities. Even if this capital flight appears to be damaging in an immediate sense, it may not be. This is because attempting to block capital fleeing low profitability is unlikely on its own to solve the deeper problems of growth. Indeed, enforcing restrictions on capital outflows in a context of low profitability and absent policies to correct market failures could paradoxically make economic performance worse by reducing the incomes of nationals. Capital flight in these contexts is not necessarily damaging in terms of direct effects on growth, and the indirect effects may also not be negative unless we optimistically believe that blocking these flows will force the government into adopting the appropriate policies for tackling market failures. Because this is an unlikely scenario, it would be misleading to classify these financial outflows as illicit. There is an important policy implication: developing countries need to design policies to address low productivity and to absorb new technologies. Attempting to block financial outflows without solving these problems will not necessarily improve social outcomes.

A different and even more obvious case is one in which capital flight is induced by the *presence* of bad policies such as the protection of domestic monopolies that disadvantage investors who are not politically connected or privileged with monopoly rights. In this situation, if capital leaves the country, the direct effects may appear to be damaging in the sense of lost investment, but may not be if domestic investment opportunities are poor. The problem is not the capital flight, but the growth-reducing arrangements that induce it. Blocking financial outflows could, in an extreme case, lead to the consumption of capital by some investors because profitable investment opportunities may be unavailable. The indirect effects of blocking financial outflows in this context may also not be positive, and the financial outflow is not usefully described as illicit. The appropriate response would be to remove some of the underlying restrictions on investment.

Finally, a particularly interesting set of cases concerns financial outflows associated with activities that are directly growth-sustaining, but have significant negative effects on a society's political settlement and, therefore, on long-run growth through indirect effects. A classic example is the business associated with narcotics and drugs. For many countries, including relatively developed countries like Mexico, the income from the production and marketing of drugs is a significant contributor to overall economic activity. By some measures, there could be a significant positive effect on growth as a direct effect. However, given the legal restrictions on the business in many countries, the activity inevitably involves criminality and massive hidden rents that disrupt the underlying political settlement of the producing country. The indirect negative effects are likely to far outweigh any positive direct effect. It would be quite consistent with our definition to describe the financial flows associated with these sectors as illicit.

Financial outflows with positive or neutral effects

We discuss in passing above a number of examples in which financial outflows do not have a net negative effect if both direct and indirect effects are accounted for. In some cases, this can involve making difficult judgments that are specific to the context. For instance, in the presence of significant market failures facing investors, it may sometimes be useful not to enforce restrictions on capital flight too excessively. In textbook models, developing countries lack capital and, therefore, capital should flow in if policies are undistorted. In reality, the productivity in developing countries is so low that most investments are not profitable, and temporary incentives are needed to attract investments (Khan 2009). It is possible that some of these incentives have to be made available in other jurisdictions to be credibly secure from expropriation. In these contexts, the strict enforcement of restrictions on financial flows may reduce the degree of freedom states have in constructing credible incentives for investors taking risks in technology absorption and learning.

For example, a significant part of the foreign direct investments in India in the 1980s and 1990s came from jurisdictions such as Mauritius. A plausible interpretation is that much of this was Indian domestic capital going through Mauritius to come back for reinvestment in India. One side of this flow was clearly a hidden financial outflow, the other a transparent inflow in the form of foreign direct investment. As a result, the developing country may not be a net capital loser, and, indeed, the incentives provided through this arrangement may make new productive investment possible in areas where investment may not otherwise have taken place. As in the case of odious debt, recycling is also only one side of a two-way flow and is generally assumed to be driven by tax and regulatory arbitrage and to be harmful for society (for example, see Kant 1998, 2002; Schneider 2003b, 2003c). However, in the case of countries with low productivity and missing tacit knowledge, the rents captured in this way may, in some situations, serve to make investments more attractive and thereby increase net investments. The direct effect may be to promote growth. Recycling through a foreign jurisdiction may also be a mechanism for hiding the source of funds in cases in which much of the initial capital base of emerging capitalists has involved questionable processes of accumulation that could be challenged by their competitors in terms of a formal interpretation of laws. Declaring these flows illicit for the purpose of blocking them may be a mistake. The direct effect is likely to be a reduction in investment because these types of accumulation may continue to remain hidden or be diverted into criminal activities. The expectation of positive indirect effects, for instance by creating disincentives for accumulating resources through questionable informal processes, may also be misguided given the structural informality in developing countries discussed elsewhere above. These are matters of judgment in particular cases.

Sometimes, capital outflows may appear to be illicit simply because they are disallowed by ill-considered laws that cannot be enforced. If the laws were enforced, society might become even less well off. For instance, in some developing countries, vital imports may be illegal for no obvious reason, forcing importers to engage in illegal financial transfers to get around the restrictions. In many developing countries, remitting foreign exchange out of the country may also be disallowed for many purposes, including vitally important ones. An example is the widespread practice of illegally remitting foreign exchange from Bangladesh to foreign employment agencies that want a commission for arranging overseas employment for Bangladeshi workers. If, as a result, domestic workers are able to find employment on better terms than in the domestic market, their higher incomes are likely to have a positive effect on welfare, and their remittances are likely to support domestic growth. If illegal financial outflows involve payments to people smugglers, and most domestic workers end up less well off, the direct effects alone would make us classify the financial flows as illicit. A careful analysis is required in each case, but, in many cases, the problem may be an inappropriate legal or regulatory structure.

Table 2.1 summarizes some of the examples we discuss. Only flows falling in the middle row of the table are properly illicit according to our definition. Defining as illicit the other capital flows listed may be a policy error even in the case of financial flows in which the direct effect appears to be damaging. Nor is the legal-illegal divide of much use in the typical developing-country case if the aim is to identify financial flows that need to be blocked to make the developing country better off. In any particular country, many financial flows may be simultaneously driven by different underlying causes. The judgment that has to be made involves identifying the drivers of the most significant financial flows and assessing whether these are damaging in the context of the specific political settlement.

Table 2.1. Logical Framework for Identifying Illicit Flows from Developing Countries

Net effect	*Direct effect on growth negative (flow can be legal)*	*Direct effect on growth positive or neutral (flow can be illegal)*
Net effect negative (including indirect effects): this row describes illicit flows	Examples: Capital outflows to evade/avoid legitimate taxes Evasion of restrictions that support an effective industrial policy Financial outflows of political actors in the presence of live-and-let-live agreements.	Examples: Financial flows associated with the production of drugs and narcotics
Net effect positive or neutral (including indirect effects): flows in this row are not illicit even if illegal	Examples: Financial outflows of political actors in the absence of informal agreements restricting expropriation	Examples: Unauthorized payments to overseas agencies to provide jobs that are better than domestic opportunities (Bangladesh) Recycling that bypasses critical market failures in developing economies and increases investment by domestic investors in their own country Outflows from countries in which profitability is low because of absent industrial policy or presence of damaging policies such as protection for domestic monopolies

Source: Author compilation.

4. Developing countries in crisis: the fragile developers

Fragile developing countries are ones in which the internal political settlement is close to collapsing or has collapsed, and political factions are engaged in violent conflict. This group includes, for example, Afghanistan, the Democratic Republic of Congo, and Somalia. It also includes a number of other developing countries in North and Sub-Saharan Africa, Latin America and the Caribbean, and Central Asia in which political settlements are highly vulnerable to collapse in the near future. IFFs may appear to be at the heart of their fragility and, indeed, may be fueling conflicts. However, we argue that it is difficult to define what is illicit in such a context of conflict. Fundamental disagreements about the distribution of benefits are unlikely to be resolved without recourse to systemic violence.

Violence is, nonetheless, not the distinctive feature of fragile countries; there may also be pockets of intense violence in intermediate developers such as Bolivia, Brazil, India, or Thailand. Rather, fragile countries are characterized by a significant breakdown of the political settlement and, in extreme cases, also of social order. While pockets of rudimentary social order may spontaneously emerge in such societies, this is largely limited to the organization of violence and subnational economies supporting the economy of violence. There is a grey area between intermediate developers facing growing internal conflicts and a developing country classified as fragile. Nonetheless, in intermediate developers, while a few political groups and factions may be engaging in significant violence, most significant political factions are engaged in the normal patron-client politics of rent seeking and redistribution using the formal and informal mechanisms through which political settlements are constructed in these countries. A political settlement is possible because there is a viable distribution of resources across the most powerful groups that reflects their relative power and that can be reproduced over time. This is a necessary condition describing a sustainable end to significant violence and the emergence of a political settlement.

The defining characteristic of fragility is that a sustainable balance of power and a corresponding distribution of benefits across powerful political actors have not emerged. Violence is the process through which contending groups are attempting to establish and test the distribution of power on which a future political settlement could emerge. But this may take a long time because the assessment by different groups of what they can achieve may be unrealistic, and some groups may believe that, by fighting long enough, they can militarily or even physically wipe out the opposition. In some cases, this belief may be realistic (Sri Lanka in 2010); in other cases, the attempt to wipe out the opposition can result in a bloody stalemate until negotiations about a different distribution of benefits can begin (perhaps Afghanistan in 2010). The analysis of what is socially damaging needs to be fundamentally reevaluated and redefined in these contexts, and this has implications for our assessment of illicit flows.

The historical examples tell us that apparently predatory resource extraction has been the precursor of the emergence of viable political settlements that have generated longer-term social order and viable states (Tilly 1985, 1990). Yet, in contemporary fragile societies, new circumstances make it less likely that conflicts will result in the evolution of relationships between organizers of violence and their constituents that resemble state building. First, natural resources can give organizers of violence in some societies access to previously unimaginable amounts of purchasing power, destroying incentives for internal coalition building with economic constituents in the sense described by Tilly. Second, the presence of advanced countries that manufacture sophisticated weapons and can pump in vast quantities of resources in the form of military assistance or aid also changes the incentives of domestic organizers of violence. Instead of having to recognize internal distributions of power and promote productive capabilities, these people recognize that the chances of winning now depend at least partly on international alliances and the ability to play along with donor discourses. Domestic organizers who try to fight wars by taxing their constituents in sustainable ways are likely to be annihilated by opponents who focus on acquiring foreign friends.

These considerations should give us serious cause for concern in talking about IFFs in these contexts in which the indirect effects of financial flows through the promotion or destruction of political stability are likely to far outweigh the direct effects on growth. By its nature the construction of politically stable settlement involves winners and losers: strategies of state or polity formation are not neutral in any sense.

The terminology of illicit flows in these contexts should preferably be avoided, or its use should be restricted to financial flows that are illicit explicitly from the perspective of the observer. For instance, the flow of narcotics incomes, grey or black market transactions in the global arms market, or sales of natural resources by warlords may go against the legitimate interests of outsiders, and they are entitled to declare the associated financial flows as illicit *from the perspective of their interests*. This is justifiable if these flows are causing damage to the interests of other countries.

We should not, however, pretend that blocking particular flows is in any way neutral or necessarily beneficial for the construction of viable political settlements, because there are likely to be many possible settlements that different groups are trying to impose. Moreover, competing groups of outsiders are also likely to be providing aid, guns, and, sometimes, their own troops to their clients within the country. There is no easy way to claim that some of these resource flows are legitimate and constructive and others are not without exposing significant political partiality toward particular groups.

The real problem is that we do not know the outcomes of these conflicts, and the internal distribution of power is both unstable and changing. Because the sustainability of the eventual sociopolitical order that may appear depends on the emergence of a sustainable distribution of power among the key groups engaged in conflict, we cannot properly identify ex ante the resource flows that are consistent with a sustainable political settlement. The resource flows are likely to help determine the political settlement as much as sustain it.

It follows that the analysis and identification of illicit capital flows must be different across intermediate developers and across fragile developers. Fragile societies typically do not have internationally competitive sectors in their economies, nor do their competing leaders have the capacity to encourage productive sectors effectively. The adverse conditions created by conflict mean that significant countervailing policies would have to be adopted to encourage productive investment in these contexts. Though this is not impossible, as the example of the Palestinian Authority in the five years immediately following the Oslo Accords shows (Khan 2004), the likely direct growth effect of particular financial flows is a moot question in most cases of fragility.

Globally competitive economic activities do take place in many conflicts, but these are of a different nature from the development of technological and entrepreneurial skills with which intermediate developers have to grapple. One example is natural resource extraction that is a special type of economic activity because it does not require much domestic technical and entrepreneurial capability. The returns may be large enough for some foreign investments or for extraction based on artisanal technologies even in war zones. A similar argument applies to the cultivation of plants associated with the manufacture of narcotics. The financial flows from these activities are likely to be directly controlled by political actors and may provide the funds for sustaining the conflict. The only type of capital flight that is likely to emanate directly from the decisions of economic actors is the obvious one of attempting to escape destruction or appropriation. But if individuals try to move their assets out of a war zone to avoid expropriation, it would be unhelpful to characterize these as illicit.

Of most concern in fragile societies are the flows organized by political actors, as these are bound to be connected with ongoing conflicts in some way. In the case of intermediate developers, our concern is that, under some conditions, restrictions on financial flows may inadvertently increase the stakes for holding on to power. A similar, but obviously more serious set of uncertainties affects the analysis of conflicts. In theory, if all parties to a conflict were blocked from accessing the outside world, this may have a positive effect in forcing them to recognize the existing distribution of power and reaching a compromise more quickly than otherwise. In the real world, a total sealing off is unlikely. Some parties to the conflict are likely to be recognized by outside powers as legitimate well before an internal political settlement has been arrived at and receive financial and military assistance.

Two entirely different outcomes may follow. The less likely is that the groups excluded by the international community recognize the hopelessness of their situation and either capitulate or agree to the settlement that is offered. A more likely outcome, as in Afghanistan, is that external assistance to help one side while attempting to block resource flows to the other by declaring these to be unauthorized or illicit can increase the local legitimacy of the opposition and help to intensify the conflict. In the end, every group is likely to find some external allies and ways to funnel resources to fight a conflict where the stakes are high. Paradoxically, finding new foreign allies becomes easier if the enhanced legitimacy of the excluded side makes it more likely that they will win. These considerations suggest that a neutral way of defining IFFs is particularly difficult, perhaps impossible, in the case of fragile developers. Table 2.2 summarizes our analysis in this section.

Table 2.2. Illicit Financial Flows in Different Contexts

Country type	*Defining features*	*Main policy concern*	*Main types of illicit capital flows*	*Policy focus in addressing illicit capital flows*
Advanced economies	High average incomes and long-term political stability. Political process responds effectively to economic underperformance and distributive concerns.	Laws and fiscal programs should maintain social cohesion and economic growth.	Mainly flows that violate existing laws (for example, tax evasion). Occasionally refer to legal flows where laws no longer reflect social consensus or economic sustainability.	Strengthen enforcement and regulation. At moments of crisis, attempt to bring law back into line with broad social consensus on economic and political goals.
Intermediate or normal developers	Lower average incomes, and politics based on a combination of formal and informal (patron-client) redistributive arrangements. Achieves long-term stability without sustained violence.	Develop, maintain, and expand viable development strategies, in particular the development of broadbased productive sectors.	Flows that undermine developmental strategies. Capital flight in a context of a failure to raise domestic profitability is problematic, but is not necessarily illicit. Flows associated with internationally criminalized activities like drugs.	Economic policies to enhance profitability primarily by addressing critical market failures. Build governance capabilities to enforce restrictions on financial flows that make these policies less vulnerable to political contestation.
Fragile developing countries	Breakdown of existing political settlements resulting in the outbreak of sustained violence that undermines longer-term conditions for the maintenance of basic sociopolitical order.	State building and reconstruction of a viable political settlement to allow society to embark on a sustainable path of economic development.	Not possible to define illicit flows in a neutral way when elites are in conflict. The effects of financial flows have to be judged primarily in terms of their effects on the establishment of a particular political settlement.	A viable political settlement requires competing groups to accept a distribution of benefits consistent with their understanding of their relative power. Difficult for outsiders to contribute positively and easy to prolong conflicts inadvertently.

Source: Author compilation.

5. Policy Responses to Illicit Flows

Our discussion above suggests that capital outflows from developing countries qualify as illicit according to our definition if they have a negative economic impact on a particular country after we take both direct and indirect effects into account in the context of a specific political settlement. Both judgments about effects are counterfactual in the sense that we are asking what would directly happen to growth if a particular flow could be blocked, and then we are asking what would happen after the indirect effects arising from adjustments by critical stakeholders to the new situation have taken place. The latter assessment depends on our knowledge about the economy and polity of the society as summarized in the political settlement. This methodology allows us to derive some useful policy conclusions in the case of intermediate developers. By contrast, the use of the illicit flow terminology involves significant dangers in the case of fragile countries. Policy makers should at least be explicitly aware of this.

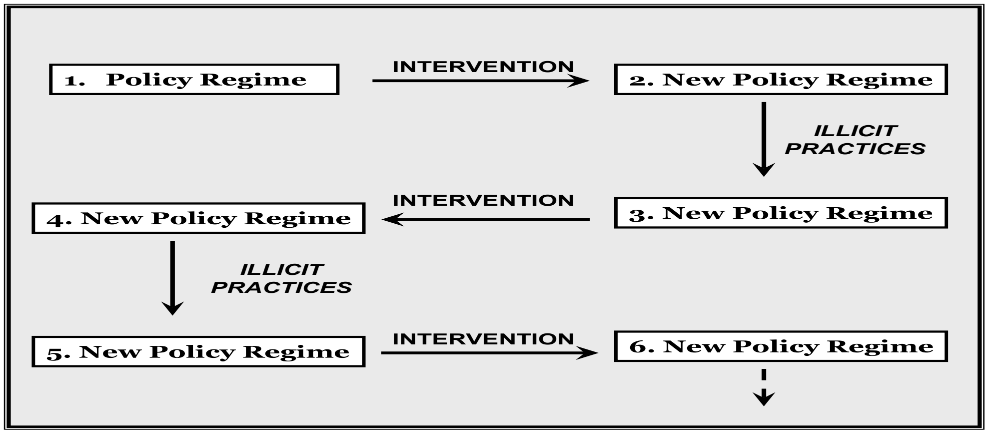
In this section, we discuss a sequential approach for the identification of feasible policy interventions to address illicit capital outflows that satisfy our definition and that occur in intermediate developers.

Assume that a particular capital outflow from an intermediate developer is illicit according to our definition. The core policy concern here is a microlevel assessment of how any particular set of measures to restrict the illicit capital outflow affects the macrodynamics of the economy and society in question. While our assessment about the nature of an illicit flow has taken into account the indirect effects of blocking the flow, the implementation of any policy almost always gives rise to unintended consequences, and all the indirect effects may not be understood. More often than not, policy failure is the failure to take such unintended consequences into account ex ante.

An illustration of such unintended consequences, in this case pertaining to the international regulation of financial flows, is provided by Gapper's analysis (2009) of the Basel Accords I (1998) and II (2004), which were designed to regulate global banks essentially by setting higher capital adequacy standards and improving the measurement of leverage. Ironically, these standards inadvertently accelerated rather than muted financial engineering by banks, in particular the securitization of risky mortgage debts. The accords raised the threshold of responsible banking, but simultaneously created incentives to find a way around the thresholds that would prove more disastrous to the global economy. As Gapper remarks (2009, 1), "it would be wrong to throw away the entire Basel framework . . . because global banks found ways to game the system." The obvious implication is that one must strengthen rather than throw away existing regulations.

More generally, in our view, *an effective policy response to illicit flows requires a step-by-step, sequential assessment of the macrolevel effects of blocking particular capital flows*. To illustrate what this entails in the case of an intermediate developer, consider the example provided by Gulati (1987) and Gordon Nembhard's analysis (1996) of industrialization policies in Brazil and the Republic of Korea from the 1960s to the 1980s. Both authors argue that trade misinvoicing in these countries during this period followed an unusual pattern in that imports tended to be underinvoiced. Both authors explain this in terms of domestic producers and traders, "rather than being preoccupied with evading controls to earn foreign exchange, may be more concerned about meeting export and production targets and maximizing government plans" (Gordon Nembhard 1996, 187). In these two countries (but not necessarily in others), there were potentially avoidable losses from trade misinvoicing, and these flows were therefore illicit. Nonetheless, the losses were significantly smaller than the gains from the incentives created for higher investments in sectors promoted by the industrial policy. To decide whether or not to block illicit trade misinvoicing in these circumstances (and, if so, how), the most important aspect of policy design is to prepare a microlevel analysis of the impact of different ways of blocking these flows on the overall economy. This analysis has to take account of economic and political circumstances and the likely impact of particular regulatory strategies. Figure 2.2 illustrates the iterative process required to arrive at policy decisions that avoid unintended negative consequences.

Figure 2.2. Choosing Attainable Benchmarks for Policy Design



Source: Author compilation.

Assume that the policy intervention from stage 1 to stage 2 in figure 2.2 introduces an industrial policy regime to promote manufacturing exports. This, in turn, provides incentives for some illicit practices, giving rise to stage 3. Despite the presence of the illicit practices arising from the implementation of the industrial policy introduced in stage 2, the overall development outcome at stage 3 is reasonably good. There are several possible responses to the observation of illicit practices at stage 3. One option is to abandon the export promoting industrial policies on the grounds that these create the incentive to underinvoice imports. This would be in line with the portfolio approach to capital flight that adopts competitive markets as the benchmark model. However, if critical market failures were significant to start with, developmental outcomes at position 1 may be worse than at position 3. Hence, an immediate response to the illicit flow problem at stage 3 that does not take account of developmental problems at stage 1 may be self-defeating. Indeed, in terms of our definitions, the financial flows at position 3 are not illicit with respect to position 1, though they are illicit with respect to position 2.

An obvious option would be to run a more efficient customs administration to raise the transaction costs of import underinvoicing, ideally to the point at which this becomes unprofitable. This is the preferable policy option: it could shift the policy framework from position 3 to position 4. The result would be a reduction in underinvoicing that then takes us to position 5, a combination of the new policy framework and a new (reduced) level of illicit flows. The developmental outcomes at stage 5 would be better than those at stage 3, and, so, this response to the illicit flow problem would be entirely justified. Yet, to get from position 3 to position 5 requires a careful microlevel analysis of the costs and benefits of different policies. If import underinvoicing and the illicit profits associated with it could be eliminated without jeopardizing the participation of private sector firms in the export promotion program, the policy of better enforcement would be effective and economically justified.

In contrast, consider the case (such as Brazil in the 1970s rather than Korea) in which tolerating some import underinvoicing is an informal incentive to ensure private sector participation in a growth-enhancing export promotion program. If the extra incomes from this source are important to ensuring private sector participation in the policy, an attempt to remove these rents could inadvertently result in more damaging rent seeking by the private sector or the sector's political refusal to participate in industrial policy programs. If either happened, the economy would be less well off and could revert to the less preferable position at stage 1. This assessment would depend on our understanding of the political settlement and the power of the private sector to resist the imposition of policies that the sector perceives to be against its interests. The attempt to control the illicit flows would then have failed in a developmental sense even if the illicit flows disappeared. The core policy task in this case would not be to block the illicit capital flows associated with stage 3 (import underinvoicing), but to support the creation of state capacities and an adjustment of the political settlement that would allow the effective implementation of efficient customs administration in the future without reliance on informal perks such as import underinvoicing. More generally, this suggests that a careful sequential microanalysis of the macro-outcomes of blocking particular illicit capital flows is required, locating particular strategies in the context of specific initial conditions.

6. Conclusion

Our core concern has been to show that what constitutes an illicit capital outflow can vary across countries, depending on the core political and economic features. The number of capital outflows that are *unequivocally* illicit in our minimal definition is likely to be more limited than the number that might be defined as such in single-driver approaches based on questionable underlying economic models. Quantitative estimates of illicit flows using our definition are therefore likely to be considerably less spectacular than, for example, recent estimates of dirty money (see Kar and Cartwright-Smith 2008). This is precisely our point. We argue that, *if* economic development is to be the main concern in this debate, then the promotion of economic growth in the context of a distribution of benefits that is politically viable has to be the condition that any policy intervention must meet. Wider criteria than this to define illicit capital outflows as a target for policy intervention by necessity rely on some broader notion of the social or economic good based on an abstract underlying model that may have little relevance in seeking development in the real world.

Our analysis also questions the validity of a core premise of the capital flight literature, namely, that all flight capital, if retained domestically, will yield a higher social rate of return (Schneider 2003a; Cumby and Levich 1987; Walter 1987). The purpose of our analytical typology is to show that, from the point of view of economic and political development, blocking all capital outflows from developing countries is not desirable. Moreover, as we outline in table 2.1, blocking some apparently *damaging* flows can also do more harm than good if these flows are driven by deeper problems (such as the absence of industrial policy, live-and-let-live rules between competing political factions, or the presence of domestic monopolies). In these cases, we argue, it is a mistake to describe the resultant flows as illicit. The policy implication is not that nothing should be done in such cases. It is rather that the solution is to look for policies that address the underlying structural problems. In the case of fragile developers, our analysis points out the dangers of too easily defining what is illicit. Finally, our sequential impact assessment suggests that there are dangers even in simplistically attacking capital flows that we do deem illicit. Even in these cases, it is possible that some policy responses are more effective than others, and policies that tackle illicit capital flows in isolation from the wider political settlements of which they are a part may leave society less well off.

Consider the following example on anti–money laundering (AML) policies. The cost-effectiveness of the AML regime promoted by the intergovernmental Financial Action Task Force is doubtful even for advanced economies (Reuter and Truman 2004; Schneider 2005).[4] Sharman (2008) extends this analysis to developing countries, with a special focus on Barbados, Mauritius, and Vanuatu, and finds that AML standards have had a significant net negative impact on these three developing countries. Essentially, the costs imposed on legitimate businesses and states having limited administrative and financial capacity far outweighed the extremely limited benefits in terms of convictions or the recovery of illicit assets. Yet, according to Sharman, rather than rethinking the policy model, its enforcement was strengthened mainly by blacklisting noncompliant countries and through competition between states for international recognition and imitation.

Sharman (2008, 651) highlights the case of Malawi, as follows:

> Malawi is not and does not aspire to be an international financial center, nor has it been associated with money laundering or the financing of terrorism. Speaking at an international financial summit in September 2006, the Minister of Economics and Planning recounted how his country had come to adopt the standard package of AML regulations. The Minister was told that Malawi needed an AML policy. The Minister replied that Malawi did not have a problem with money laundering, but was informed that this did not matter. When the Minister asked if the package could be adapted for local conditions he was told no, because then Malawi would not meet international standards in this area. The Minister was further informed that a failure to meet international AML standards would make it harder for individuals and firms in Malawi to transact with the outside world relative to its neighbors, and thus less likely to attract foreign investment. The Minister concluded: "We did as we were told."

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[4] See Financial Action Task Force, Paris, http://www.fatf-gafi.org/.

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