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25

Illicit Financial Flow in view of Financing the Post-2015 Development Agenda

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ILLICIT FINANCIAL FLOW IN VIEW OF FINANCING THE POST-2015 DEVELOPMENT AGENDA

Southern Voice Occasional Paper 25

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Preface

The *Southern Voice on Post-MDG International Development Goals* works as an open platform, and is a network of 48 think tanks from Africa, Latin America and Asia that seeks to contribute to the global post-2015 dialogue. Motivated by the spirit of wide academic inquiry, the initiative is committed to provide quality data, empirical evidence and policy analyses, derived from research in the countries of global South. Through strategic engagements, *Southern Voice* aspires to address the existing 'knowledge asymmetry' and 'participation deficit' afflicting the global discourse on post-2015 agenda.

With these goals in mind, *Southern Voice* launched a call for papers among its members to inform the global debate based on promoting original research on new issues that have emerged from various reports, structured conversations concerning the post-2015 agenda as well as from the discussions around them and beyond. Eleven research grants were offered during this phase.

In response to the call, we received numerous proposals which were reviewed by *Southern Voice* members. The research papers were also peer reviewed, and the revised drafts were later validated by the reviewer.

The resulting collection of papers highlights some of the most pressing concerns for the countries of the global South. In doing so, they explore a variety of topics including social, governance, economic and environmental concerns. Each paper demonstrates the challenges of building an international agenda which responds to the specificities of each country, while also being internationally relevant. It is by acknowledging and analysing these challenges that the research from the global South supports the objective of a meaningful post-2015 agenda.

In connection with the ongoing debates on post-2015 international development goals, the paper titled **Illicit Financial Flow in view of Financing the Post-2015 Development Agenda** by *Mr Towfiqul Islam Khan*, Research Fellow and *Mr Mashfique Ibne Akbar*, Senior Research Associate, Centre for Policy Dialogue (CPD), Bangladesh argues that it is not only important to have dedicated targets and indicators towards curbing illicit financial flow (IFF) in the post-2015 development agenda, but is also necessary to understand the influencing factors behind the growing IFF phenomenon.

Contributions of *Ms Andrea Ordóñez*, Research Coordinator of the initiative and *Ms Mahenaw Ummul Wara* (Research Associate, Centre for Policy Dialogue (CPD) and Focal Point at the *Southern Voice* Secretariat) in managing and organising the smooth implementation of the research programme are gratefully acknowledged.

I would also like to thank *Dr Vaqar Ahmed,* Deputy Executive Director, Sustainable Development Policy Institute (SDPI), Pakistan, for peer reviewing the paper. I would like to take this opportunity to recognise the support of Think Tank Initiative (TTI) towards *Southern Voice*, particularly that of *Dr Peter Taylor*, Programme Leader, TTI.

I hope the engaged readership will find the paper stimulating.

Dhaka, Bangladesh
February 2015

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Abstract

The present study argues that not only is it important to have dedicated targets and indicators towards curbing illicit financial flow (IFF) in the post-2015 development agenda, but it is also necessary to understand the influencing factors behind the growing IFF phenomenon. The results of the quantitative analysis are intuitive in certain arenas, as well as confirmative in other aspects. Per capita GDP, openness and capital account convertibility have been found to be significant determinants of IFF in the developing countries. Nonetheless, exchange rate, inflation, democratic accountability and political stability also influence the flow of capital outflow, but these variables are interpreted with caution since these variables were not found to be influencing IFF in all of the estimation techniques considered in the analysis. The paper emphasises that continuous efforts will have to be put to uphold this issue when the Sustainable Development Goals (SDGs) are finalised at the United Nations General Assembly.

Contents

Acronyms

DAC	Development Assistance Committee
FE	Fixed Effects
GDP	Gross Domestic Production
GNI	Gross National Income
HT	Hausman Test
IFF	Illicit Financial Flow
IPoA	Istanbul Programme of Action
LM	Lagrange Multiplier
MDG	Millennium Development Goals
MoI	Means of Implementation
ODA	Official Development Assistance
OWG	Open Working Group
POLS	Pooled Ordinary Least Square
RE	Random Effects
SDG	Sustainable Development Goals
VIF	Variance Inflation Factor
UNCTAD	United Nations Conference on Trade and Development
USD	United States Dollar
WDI	World Development Indicator

Illicit Financial Flow in view of Financing the Post-2015 Development Agenda*

Towfiqul Islam Khan

Mashfique Ibne Akbar

1. Introduction

As the Millennium Development Goals (MDGs) deadline approaches, the international development community is gearing up in shaping the international development agenda beyond 2015. Many stakeholders, with their optimistic views (including members of research communities) would argue that the MDGs were a historical breakthrough. Hence, the post-2015 development agenda has attracted significant policy formulation efforts and advocacy activities.

Whilst the global leaders should carry forward the spirit of the Millennium Declaration and the best of the MDGs, they must also take into cognisance the lessons learnt from the attainment of MDGs to make the most out of the post-2015 development agenda. Hulme (2013) pointed out that MDGs could interest the 'big global players' only at a limited scale. As a result, the weakest performance among the MDGs was observed in the area of Goal 8 which deals with global partnership for development, particularly in the area that pledged volumes of official development assistance (ODA) (United Nations 2013a). The concept of global partnership over the last six decades has been tailored as a package of commitments on promoting development via making conditional financial transfers in addition to providing technical assistance to developing countries, granting trade preferences, and affording special and differential treatment. A symposium of countries at Monterrey, Mexico in 2002 jointly made commitments to generate a sufficiency of development finance to meet the MDGs. The conference came up with the so called Monterrey Consensus where the Development Assistance Committee (DAC) countries were encouraged to ensure that at least 0.7 per cent of their gross national income (GNI) would be disbursed as ODA. Nevertheless, it is the case that the DAC countries were not able to keep to their commitments (United Nations 2013a). Accordingly, the need for innovative financing for global development is felt (Sobhan 2013).

World Bank (2013) stressed that financing development agenda during post-2015 era would require using available resources more effectively and catalysing additional financing strategically from official and private sectors. In relation to this, curbing illicit financial flows (IFF) can help financing development in both ways – by mobilising more domestic resources through tax collection, and by saving the foreign exchange reserve. The combat against IFF can assist to fund the goals under Sustainable Development Goals (SDGs), while simultaneously prompting a fair global taxation regime, and a more just global system. The post-2015 agenda can address the challenges towards making more efficient and effective use of the different resources available. This will require country leaders to work together in order to establish the right policy environment at the national and international levels (Dafe *et al*. 2013).

*The authors were benefited from helpful comments received from the anonymous reviewer. During the study valuable research support was received from *Mr Mostafa Amir Sabbih*, Research Associate, CPD. Support was also received from *Ms Alaka Halder*, Former Research Intern, CPD.

IFF has become a common phenomenon across the globe – in developed, transitional and emerging economies alike. Indeed, IFFs from the developing countries are leaving a deep scar in the investment regime of developing countries. Kar (2011: 8) defined IFF as the financial flows which include, but are not limited to, "cross-border transfers of the proceeds of tax evasion, corruption, trade in contraband goods, and criminal activities such as drug trafficking and counterfeiting." United Nations (2013b) classified IFF into three main forms: "(i) the proceeds of theft, bribery and other forms of corruption by government officials; (ii) the proceeds of criminal activities including drug trading, racketeering, counterfeiting, contraband, and terrorist financing; and (iii) the proceeds of tax evasion and laundered commercial transactions." Curiously, it has been observed that laundered commercial money through multinational companies constitutes the largest component of IFF, followed by proceeds from criminal activities, and lastly corruption (Baker 2005).

In connection to the above, the current study aims to explore the relevance of IFF in the post-2015 framework. The study identifies available options with regard to the target which the post-2015 development agenda can consider. The study also identifies IFF in a more methodological conduct together with the employment of econometric techniques to explain the determinants of IFF from the developing counterparts.

The rest of the paper is organised as follows. Section 2 discusses the relevance of IFF in the context of post-2015 development framework. On the other hand, Section 3 discusses data and methodology of the econometric exercise – the findings of which are presented in Section 4. Conclusion and way forward have been covered in the concluding segment, Section 5.

2. IFF in the context of Post-2015 Development Framework

One of the appealing aspects of having a common international development agenda is that it can unite the member countries on development issues where it requires close cooperation at the global level. Indeed, an agenda towards addressing the IFF will call for close cooperation among the members, as it encompasses policies which require reform at the international level. In this context, IFF is certainly one of the deserving candidates to be included in the forthcoming international development agenda, to be implemented during post-2015 period.

World Bank (2013) argued that country efforts to address IFFs need to occur at two levels. First, the more complex and difficult path involves tackling the underlying dynamics that help drive IFF. Other approaches aim to reduce IFFs directly rather than targeting their underlying causes. Such efforts can focus on improving transparency in declaring revenues and payments by multinational corporations, tightening the regulation of tax havens and secrecy jurisdictions, or strengthening efforts to curb money laundering. In particular, governments working with private companies should ensure beneficial ownership information on legal entities and legal arrangements.

The case of IFF is so severe in some of the developing countries that illegal financial outflows tend to outpace ODA inflow (Table 1). Indeed, IFF deprives the local economy of a considerable

Table 1: Illicit Financial Flow as percentage of Overseas Development Assistance in Selected Developing Countries: 2010 and 2011

Country	2010	2011
Nigeria	1008.10	725.44
Sudan	248.30	607.91
Ethiopia	160.08	116.26
Zambia	285.56	124.44
Bangladesh	154.83	187.26

Source: Estimated from Kar and LeBlanc (2013) and OECD data.

portion of the resources that would otherwise have been employed for development financing. Thus, IFF undermines domestic investment, ultimately hindering long-term growth. Some of the developing countries, especially those in the African continent with very low savings rate, continue to experience substantial IFF. Recent evidence indicating that Sub-Saharan Africa is a "net creditor" to the rest of the world is quite compelling; it is the case that the assets held by Africans abroad exceeds the liabilities of the Africans to the rest of the world (African Development Bank and Global Financial Integrity 2013).

In recent years, considerable intellectual interest has arisen over the extent to which such flows may have developmental consequences for both developed and developing countries (e.g. Baker (2005); Ndikumana and Boyce (2008)). For example, the UN Istanbul Programme of Action (IPoA), adopted in 2011, also highlighted the issue and charted out separated actions (United Nations 2011). No wonder IFF has deservedly found its place in a number of debates and discussion as regards the global cooperation under the post-2015 development agenda (including Southern Voice on Post-MDG International Development Goals (2013)). World Bank (2013) also urged developing countries to step up efforts to finance their own development by improving domestic resource mobilisation (in ways such as strengthening tax administration, better harnessing natural resource revenue and curbing IFF). In this backdrop, it is important to emphasise the merit of the IFF issue in the context of framing the post-2015 development agenda.

Regrettably, a number of other global and regional contributions towards shaping the post-2015 development agenda did not directly mention the need for curbing IFF (e.g. ECE *et al*. (2013); Sustainable Development Solutions Network (2013, 2014); UN System Task Team (2012); United Nations Global Compact (2013)). UN System Task Team (2012) however urged for a renewed global partnership which could enhance government capacity to efficiently and effectively mobilise public and private domestic resources in order to promote good corporate governance and combat illicit capital flight. United Nations General Assembly (2012) also stressed that the member states fight corruption and illicit financial flows at both the national and international levels.

A number of processes within the UN system flagged IFF and other related issues in the context of post-2015 development framework. The report of United Nations High Level Panel also highlighted the need to tackle IFF. High Level Panel (2013) urged the developed countries to "co-operate more effectively to stem aggressive tax avoidance and evasion, and illicit capital flows." High Level Panel (2013), in their illustrative goals and targets, recommended reducing illicit flows and tax evasion, and increase stolen-asset recovery (under goal 12 concerning 'create a global enabling environment and catalyse long-term finance'). However, they also mentioned than it would require further technical work to find appropriate indicators. Indeed, there is a lack of consensus about the appropriate methodology towards estimating IFF. Vandemoortele (2008) argued that MDGs were essentially based on an extrapolation of past trends at the global level. Curiously, IFF is a growing phenomenon; hence a more comprehensive assessment will be required to determine its target.

A number of academic contributions outside the UN processes also highlighted the need for addressing IFF in the post-2015 development agenda. CPD *et al*. (2014) under the goal area titled 'Establish a Global Partnership for Sustainable Development' included a target on 'Create an enabling environment for sustainable development'. One of the candidate indicators for this target was proposed to be 'Existence of laws for ensuring country-by-country reporting by multinational corporations, disclosure of beneficial ownership and preventing money laundering'. Indeed, the document also proposed this indicator to be one of the candidate indicators for being 'global minimum' or 'zero'. Cobham (2014) also proposed three candidate targets – (i) reduce to zero the legal persons and arrangements for which beneficial ownership information is not publicly available; (ii) reduce to zero the cross-border trade and investment relationships between jurisdictions for which there is no bilateral automatic exchange of tax information; and (iii) reduce to zero the number of multinational businesses that do not report publicly on a country-by-country basis. Rowe *et al*. (2014) conducted a survey involving 27 experts to help identify consensus regarding

desirable policy options as regards IFF. The study came up with ten policy options which could be considered 'consensually desirable':

i. Require disclosure of the ultimate beneficial owners of companies, and of the controlling parties of trusts and foundations;
ii. Reform international tax rules so that the taxable profits of multinational corporations are aligned with the location of their economic activity;
iii. Require public reporting of funds paid to governments for the sale of natural resources such as oil, gas, metals, and minerals, and the use of those funds;
iv. Significantly increase developing country tax authority capacity;
v. Implement automatic exchange of tax-relevant financial information on a global basis;
vi. Implement public country-by-country reporting for multinational corporations;
vii. Require that all governments carry out clear, reliable, frequent and timely public fiscal reporting and that governments' fiscal policy-making process be open to public participation;
viii. Increase capacity building, training and resources for law enforcement for work on financial sector investigations;
ix. Impose tougher sanctions, including jail time, on professionals who facilitate illicit financial flows, e.g. senior officers from global banks, accounting firms, law firms, insurance firms and hedge funds; and
x. Harmonise anti-money laundering regulations internationally.

Thus far, the final Open Working Group (OWG) proposal for SDGs remain the most relevant document in the context of the post-2015 agenda (Bhattacharya *et al*. 2014). Regrettably, the scope of the addressing the IFF issue has been narrowed subsequently during the negotiation process, evident from the lexical analysis presented in Annex 1. The two earlier versions, 'Zero Draft' (UN Open Working Group 2014b) and 'Zero Draft Rev 1' (UN Open Working Group 2014c) had included targets which addressed the issue of IFF. It was frustrating to observe that the final set of proposals (UN Open Working Group 2014d) was revised in a way which reduced the scope for fighting against IFF.

The final document, OWG (2014), proposed a target (16.4) which states 'by 2030 significantly reduce illicit financial and arms flows, strengthen recovery and return of stolen assets, and combat all forms of organized crime'. Beyond this target, at least three targets are closely related with – and can address the objective of – curbing IFF, if sufficiently conceptualised. These are: '16.5 Substantially reduce corruption and bribery in all its forms'; '16.6 Develop effective, accountable and transparent institutions at all levels'; and '17.1 Strengthen domestic resource mobilization, including through international support to developing countries to improve domestic capacity for tax and other revenue collection'. However, a number of potential means of implementation (MoI) related targets remain absent (Bhattacharya *et al*. 2014). One may recall that, an earlier version (Zero Draft) included two important MoI targets, viz. 'cooperate globally to reduce substantially international tax evasion and avoidance', and 'cooperate globally to combat illicit financial flows and transfers, recover stolen assets and return them to their countries of origin'.

It may be understood that IFF is one of the so called 'soft' areas of development where progress is relatively difficult to measure. However, this argument cannot stand in the way of addressing the issue adequately in the post-2015 development agenda, particularly in view of strong evidence associated with its negative impact on the overall development outcome. The best way to address the IFF issue is to include policy targets which can help to curb IFF. If the aforementioned contributions outside the UN system (e.g. CPD *et al*. 2014; Cobham 2014; Rowe *et al*. 2014) towards post-2015 development agenda in view of IFF are analysed, it can be observed that there is more emphasis on policy targets (e.g. disclosure of the beneficial owners, country-by-country reporting of multinational corporations) compared to outcome targets (e.g. 'reducing IFF by x%'). These issues perhaps can also be addressed while setting the indicators against the proposed post-2015 development targets. At the same time, as Bhattachrya *et al*. (2014) has mentioned, it is critically important to ensure

that languages on monitoring and accountability of the goals, targets and indicators, including those addressing the IFF issues, are stringent enough to promote and accelerate implementation of the post-2015 international development framework.

3. Data and Methodology

With IFF embarking on an increasing trend in the developing countries during the last decade, these countries have been missing out on the opportunity to invest domestic funds in the local market because of the illegal transfer of funds to other destinations (Kar 2011). It is evident from the earlier sections that IFF from the developing countries, especially from the low-income counterparts, is a growing concern alongside the inherent low-income country characteristic of low domestic investment. While the issue has been flagged by the international community together with national agendas, very little effort has been made in this front. This calls for a discussion as to why funds are being directed to other destinations in spite of opportunities of investment in the home country.

Global studies on IFF is often limited to estimates and so far has made inadequate effort to understand the underlying causes. Kar (2011) and Kar and Cartwright-Smith (2008) highlighted a number of possible reasons underlying IFFs – and these would include macroeconomic, structural, external and institutional attributes. Macroeconomic issues contributing to financial outflows would include unmanageable fiscal deficits, inflationary phenomena and overvaluation of the exchange rate. Worsening of income inequality, rapid but non-inclusive economic growth and emergent trade (Rahman *et al*. 2011) would be the constituents of structural issues contributing to financial outflows. Additionally, weak institutional governance serves as an impetus to evade taxes, doubling the prospect towards enhanced illegal capital outflows.

With an aim to identify determinants of IFF from the developing countries, the study performs an econometric application. A panel data exercise has been considered for the current study, studying the available data[1] for the developing countries over the time period of 2002 to 2011. The dataset has included all developing countries for which data is available for the aforementioned period (a list of developing countries employed in the study is presented in Annex 2). Panel data analysis has been carried out since observations would be examined over a time period. The current analysis has employed Pooled Ordinary Least Square (POLS) regression, the Random Effects (RE) and Fixed Effects (FE) estimation. Advantage of panel data over other methods of econometric techniques pertains to the ability of the methodology to control for variables which cannot be measured or observed. Furthermore, the methodology allows for the control of other variables such as those that change over time but not across entities, together with controlling for factors that could cause omitted variable bias if the respective variables are omitted.

The study employs the recently available estimates of IFF from Kar and LeBlanc (2013).[2] Towards this end, the study puts together these latest available estimates of IFF and juxtaposes with other secondary data. Data has been compiled from a number of sources including IFF estimates by Kar and Freitas (2012), World Bank's World Development Indicators (WDI), UNCTAD (United Nations Conference on Trade and Development) statistics, Polity IV Database and the PRS Group database. Macroeconomic variables which have been included in the analysis are: per capita gross domestic product (GDP) (current USD)[3], degree of openness of the economy, exchange rate, capital formation, inflation, capital account convertibility and average tax rates. Other indicators which have been

[1]Data unavailability for some of the developing countries was a major concern. Also, it is to be noted that data for some of the variables for a particular country were not available for another country. Hence, cross-country comparison and dataset matching also resulted in some of the developing countries to be deleted from the analysis.

[2]Estimates of Kar and LeBlanc (2013) are prone to errors because of irregularities in the compilation of balance of payments data, which is a component of the overall illicit financial flow estimate. It should be mentioned that an earlier version of the estimates are available in Kar and Freitas (2012).

[3]Since IFF estimates are available in terms of current values, other explanatory variables are also considered in current values.

included are level of corruption in the economy, law and order situation, institutional democratic and political instability. Additionally, regional dummies[4] (East Asia and the Pacific, Europe and Central Asia, Latin America and the Caribbean, Middle East and North Africa, South Asia and Sub-Saharan Africa) have also been included in the analysis.

POLS runs a simple OLS regression by stacking the time series data of the cross-sections, one above another. The following model encapsulates the POLS model:

$$IFF_{it} = \alpha_0 + \alpha_1 lnPCGDP_{it} + \alpha_2 OPEN_{it} + \alpha_3 ER_{it} + \alpha_4 lnCAPFOR_{it} + \alpha_5 INF_{it} + \alpha_6 TAX_{it} + \alpha_7 DEM_{it} + \alpha_8 CORR_{it} + \alpha_9 LAW_{it} + \alpha_{10} POL_{it} + \alpha_{11} CAPCNV_{it} + \alpha_{12} EASTDUM_{it} + \alpha_{13} EURDUM_{it} + \alpha_{14} LATINDUM_{it} + \alpha_{15} MENADUM_{it} + \alpha_{16} SOUTHDUM_{it} + \alpha_{17} SUBAFRDUM + \epsilon_{it}$$

where IFF = illicit financial flows as a percentage of GDP
PCGDP = per capita GDP (current USD)
OPEN = degree of openness of the economy
ER = exchange rate (local currency against USD)
CAPFOR = capital formation
INF = rate of inflation
TAX = average tax rates
DEM = index of institutional democracy
CORR = index of corruption within the political system
LAW = index representing the law and order state
POL = index of political stability
CAPCNV = index measuring a country's degree of capital account openness
EASTDUM = dummy variable for the region East Asia and the Pacific
EURDUM = dummy variable for the region Europe and Central Asia
LATINDUM = dummy variable for the region Latin America and the Caribbean
MENADUM = dummy variable for the region Middle East and North Africa
SOUTHDUM = dummy variable for the region South Asia
SUBAFRDUM = dummy variable for the region Sub-Saharan Africa
ln denotes natural logarithm of the variables.

The FE model has been employed with a rationale to explore if country-specific issues (e.g. government policy) affect IFF. This model recognises that different cross-sectional elements will have different attributes not captured in the model, but assumes that for a given cross section, they will remain time-invariant. The effect of these attributes are captured in the intercepts. Thus the model estimated through this approach is:

$$IFF_{it} = \alpha_i + \alpha_1 lnPCGDP_{it} + \alpha_2 OPEN_{it} + \alpha_3 ER_{it} + \alpha_4 lnCAPFOR_{it} + \alpha_5 INF_{it} + \alpha_6 TAX_{it} + \alpha_7 DEM_{it} + \alpha_8 CORR_{it} + \alpha_9 LAW_{it} + \alpha_{10} POL_{it} + \alpha_{11} CAPCNV_{it} + \epsilon_{it}$$

where, the symbols represent corresponding variables as mentioned before
and the $_i$ of the intercept indicates the unobserved individual country-specific factors which in this model is assumed to remain fixed over time.
ln denotes natural logarithm of the variables.

Unlike the FE estimation, the variation across entities is assumed to be random and uncorrelated with the independent variables in the RE estimation. In this model, the intercept represents the mean value of the cross-section intercepts and error component represents the random deviation of individual intercept from the mean value (Gujarati 2003). Moreover, the RE model assumes that the error terms are not correlated with the explanatory variables, which allows for time invariant variables to play the role of explanatory variables. Hence, the RE model captures both country and time-specific effects.

[4]According to the World Bank classification of developing countries.

$$IFF_{it} = \alpha_0 + \alpha_1 lnPCGDP_{it} + \alpha_2 OPEN_{it} + \alpha_3 ER_{it} + \alpha_4 lnCAPFOR_{it} + \alpha_5 INF_{it} + \alpha_6 TAX_{it} + \alpha_7 DEM_{it} + \alpha_8 CORR_{it} + \alpha_9 LAW_{it} + \alpha_{10} POL_{it} + \alpha_{11} CAPCNV_{it} + \alpha_{12} EASTDUM_{it} + \alpha_{13} EURDUM_{it} + \alpha_{14} LATINDUM_{it} + \alpha_{15} MENADUM_{it} + \alpha_{16} SOUTHDUM_{it} + \alpha_{17} SUBAFRDUM + \mu_{it} + \pi_{it}$$

where the symbols represent corresponding variables as mentioned before
and the μ_{it} captures the between-entity component and the π_{it} capturing the within-entity component.
ln denotes natural logarithm of the variables.

GDP per capita (current USD) has been included in the model because it is assumed that the level of development of a country influences her capital outflow either in terms of trade mispricing or any other money laundering measure. Low-income countries are not able to contain capital outflow as a result of low regulatory capacity, and high incidence of corruption can be one of the prime reasons. Natural log of the variable has been performed as a measure to linearise the variable.

A measure of the degree of openness of the economy has been included as the next variable. Openness has been measured by taking export and import as a percentage of GDP (current USD). The greater the openness of an economy, the more the economy would be integrated with the global economy, and the more would be the rationale to invest in countries other than the home country by means of illegal channels.

Exchange rate (local currency against USD) stimulates IFF in the sense that a depreciation of the local currency impedes investor confidence, applicable for both local and foreign investors. Exchange rate fluctuations can arise from a range of domestic and overseas shocks, such as political instability, financial market variability and a range of other dynamics. It is expected that the exchange rate variable will take a negative sign in the respective regressions.

Gross capital formation (current USD), or gross domestic investment, indicates the status and growth of investment in the domestic economy (natural log of the variable is performed to linearise the variable). It is expected that the level of capital formation in the domestic economy will have a significant impact in the determination of capital outflows from the home country.

In connection to investment, it is also assumed that the rate of inflation substantially determines IFF by eroding purchasing power. Investors, irrespective of the level of investment, would base their expectation on the levels of current levels of inflation. Inflation is measured "by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals" (World Bank 2014).

The tax rate variable "measures the amount of taxes and mandatory contributions payable by businesses after accounting for allowable deductions and exemptions as a share of commercial profits" (World Bank 2014). Commercial tax rates will act as a determinant of IFF. The primary concern of any business is to generate profit; higher rates of taxes would inevitably push finances from the home country to foreign destinations where business operations can be carried out at lower costs.

The Chinn-Ito index (2006) has been considered to account for a country's degree of capital account openness. The rationale for the consideration of the variable lies in the assumption that capital account convertibility would undeniably impact the flow of illicit capital. The index takes on higher values as an economy moves up the ladder with more integration and openness towards cross-border capital transactions.

A number of governance-related indicators have been included in the analysis. The first is the index of institutional democracy. This index gives an insight to the type of regime that a particular country

is governed by. The regime authority is based on an 11-point scale and ranges from 0 to +10.[5] This indicator will shed light on the effect of governmental regime on the intensity of IFF.

Furthermore, it would not be incorrect to assume that corruption would stimulate IFF. Klitgaard (1998) states that corruption includes "bribery, extortion, influence peddling, nepotism, fraud and embezzlement." Other factors may also be equally important to encourage corruption, such as complicated tax laws, excess power vested in tax administrators, weak judicial and legal systems, low salary regimes in the public sector, lack of accountability and transparency in tax administration (Tanzi, 1998). Whatever the motivation for corruption may be, corruption would distort foreign investment together with the local counterparts, and would certainly alter the economic and financial environment.

An index representing the state of affairs of law and order shows the strength and impartiality of the legal system together with the assessment of the rule of law. This index ranges from 0 to 3 points. A higher rating indicates a sound rule of law and judicial system while, on the other hand, a low rating indicates rejection of the rule of law and negligence of the judicial counterpart. The political risk[6] rating index is a variable which provides an assessment of the inherent political stability. The lower the risk point of the index, the higher would be the political risk of a particular country.

Additionally, a number of regional dummy variables[7] (taking values of 1 if the point of interest is valid, otherwise 0) have been included in the regressions, and these include East Asia and the Pacific, Europe and Central Asia, Latin America and the Caribbean, Middle East and North Africa, South Asia and Sub-Saharan Africa.

A robustness check has been performed for the POLS estimation. Multicollinearity is often a problem in OLS estimations, and hence tests have been performed to assess multicollinearity. The primary concern which arises from collinearity between one and more of the variables is that regression estimates of the coefficients can become flawed with the standard errors of the coefficients getting inflated. To check for multicollinearity, the variance inflation factor (VIF) values has been calculated for each of the variables. The rule of thumb is that a VIF value of 10 or more indicates milticollinearity, meaning a variable could be expressed as a linear combination of one or more independent variables. VIF values of the variables have been found to be below 10, taking an average value of 3.38. Hence, it can be inferred that there is no presence of multicollinearity. Other tests were also carried out to test for multicollinearity, and there were no deviation of results.

Tests for heteroskedasticity were also performed. Cameron and Trivedi's decomposition of IM-test and Breusch-Pagan/Cook-Weisberg test for heteroskedasticity were the tests which were carried out. Both of the tests assess the null hypothesis that the variance of the residuals is homogenous (not heteroskedastic). Both the tests rejected the null hypothesis of homogeneity of the residuals, indicating residuals to be heteroskedastic. Accordingly, adjustments were made in the regressions to account for heteroskedasticity.[8] Robust standard errors were obtained by applying the sandwich estimator (the Huber and/or White estimator) to each of the regressions, which is a popular exercise

[5]Three components are included in the institutional democracy index. "One is the presence of institutions and procedures through which citizens can express effective preferences about alternative policies and leaders. Second is the existence of institutionalized constraints on the exercise of power by the executive. Third is the guarantee of civil liberties to all citizens in their daily lives and in acts of political participation" (Polity IV 2013).

[6]Components employed to compute the political risk rating index include government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability and bureaucratic quality (PRS 2014).

[7]According to the World Bank classification of developing countries.

[8]It is recognised that Blackburne and Frank (2007) recommended using mean-group estimator and pooled mean-group estimator, instead of making such adjustments. However, the technique as also pointed by Blackburne and Frank (2007), is applicable when number of groups and number of time series observations are both large. Given the nature of dataset available for this study the present technique has been followed.

in econometric literature. The estimator is robust to misspecifications, keeping in mind that the observations on which the estimator is applied are independent. Huber (1967) and White (1980, 1982) were the pioneers of the estimator, but there were others including Gail *et al*. (1988), Kent (1982), Royall (1986) and Lin and Wei (1989) who developed the model further.

Other tests of linearity and model specification were also performed; but due to the problematic nature of the IFF estimates and the already-stated predicament of omitted variable bias, hypothesis of normality, linearity and model specification were rejected.

4. Model Selection and Empirical Results

Different methodologies cater to different estimations and hence, a range of estimations have been carried out to cater to the weak estimation capacity of the dependant variable. But before carrying out these tests, a summary statistic is presented in the following Table (Table 2) which offers an introductory impression of the variables and their properties.

Table 2: Summary Statistics

Variable	Observation	Mean	Standard Deviation	Min	Max
IFF	835	9.331453	21.55858	0	260.91
lnPCGDP	836	7.71175	1.364073	4.702132	11.39483
OPEN	834	87.21714	39.77659	21.95467	397.5304
ER	832	8081436	2.33e+08	0.0550983	6.72e+09
lnCAPFOR	810	22.49562	1.971428	16.87217	28.89343
INF	799	40.82464	864.3911	-4.863278	24411.03
TAX	581	51.66472	46.96115	10.7	339.1
DEM	820	3.384146	12.1967	-88	10
CORR	830	2.099548	0.7026343	0	4.5
LAW	830	3.262902	1.125856	0.5	6
POL	830	62.8819	9.974426	34.29167	86.41666
CAPCNV	839	0.5040485	0.3658756	0	1
EASTDUM	840	0.0952381	0.2937184	0	1
EURDUM	840	0.166667	0.3729	0	1
LATINDUM	840	0.25	0.4332707	0	1
MENADUM	840	0.1428571	0.3501356	0	1
SOUTHDUM	840	0.0357143	0.1856874	0	1
SUBAFRDUM	840	0.3095238	0.4625728	0	1

Source: Authors' calculations.

It needs to be mentioned at this outset that time-fixed effects have been considered for both the FE and RE models. The rationale for this deviation from the custom is derived from the fact that the exercise does not aim to distinguish the variation between countries. Rather, the analysis wants to probe into the properties of the countries as a whole and not separate the outcomes.

The Breusch-Pagan Lagrange Multiplier (LM) test is carried out first to choose between the POLS and the RE models. The null hypothesis of the LM test is that the variances across entities is zero, which essentially refers that there is no significant difference across units. The LM test rejects the null hypothesis, which essentially indicates that co-variance across the entities is zero. Hence, it can be stated that RE is the preferred model in the current exercise as there is significant difference across time periods.

The Hausman Test (HT) was carried out to distinguish between FE and RE models. The HT, with the null hypothesis that the unique errors (μi) are uncorrelated to the regressors (FE model) against the alternative hypothesis that the μi are correlated (RE model), cannot reject the null hypothesis of RE estimation and indicates that the RE model is a more appropriate model for the current dataset at hand (probability>chi^2 = 0.9492).

Although both POLS and FE estimations have been rejected by tests of model specification, yet the POLS estimation have been presented in the following Table.[9] RE estimation, namely Generalized Least Square (GLS) and Maximum-Likelihood (ML) regressions, are presented in Table 3. Since estimations of IFF are prone to errors, three methodologies (together with POLS) have been estimated to give a robust dimension to the analysis. It can be observed from Table 3 that there are variables which are significant in all the estimations, and there are variables too which are only significant in selected estimations.

Table 3: Regression Results

Variable	POLS		GLS		ML	
	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value
Dependant variable: IFF						
lnPCGDP	-4.454443	0.046**	-4.454443	0.014**	-4.454443	0.001***
OPEN	0.2787158	0.002***	0.2787158	0.006***	0.2787158	0.000***
ER	-0.0004221	0.041**	-0.0004221	0.000***	-0.0004221	0.173
lnCAPFOR	0.8282569	0.387	0.8282569	0.334	0.8282569	0.212
INF	-0.000776	0.000***	-0.000776	0.000***	-0.000776	0.305
TAX	-0.465764	0.005***	-0.465764	0.028**	-0.465764	0.013**
DEM	0.135991	0.030**	0.135991	0.001***	0.135991	0.134
CORR	-0.9207053	0.458	-0.9207053	0.186	-0.9207053	0.582
LAW	1.198796	0.180	1.198796	0.108	1.198796	0.295
POL	-0.2547866	0.014***	-0.2547866	0.000***	-0.2547866	0.128
CAPCNV	6.108627	0.077*	6.108627	0.020**	6.108627	0.030**
EASTDUM	4.622584	0.783	-13.13849	0.001***	-13.13849	0.001***
EURDUM	9.637813	0.493	-8.123264	0.000***	-8.123264	0.008***
LATINDUM	17.76108	0.209				
MENADUM	10.14618	0.451	-7.614898	0.002***	-7.614898	0.047**
SOUTHDUM	11.34839	0.432	-6.412683	0.000***	-6.412683	0.206
SUBAFRDUM	19.53103	0.146	1.769955	0.528	1.769955	0.570
Constant			17.76108	0.174	17.76108	0.225
R^2	0.4421		0.3343			

Source: Authors' calculations.
Note: *represents significance at 10 per cent level; **represents significance at 5 per cent level; ***represents significance at 1 per cent level.

Per capita GDP, with a negative sign, is significant across all the estimations at 1 per cent significant level. This shows that with increasing levels of income, IFF will be reduced. This can arise as a result of improved law and order situation, just judicial components and/or the mind-set of the citizens of a more developed country. The openness variable, with a positive sign across the estimations, is also significant across the estimations at 1 per cent significant level. It is only common that capital outflow will be increased with increased levels of global integration. Capital account convertibility is also significant with a positive sign, although with varying levels of significance. Although this implies that IFF increases with the extent of capital account openness, this might not form a general

[9]The POLS estimation can be considered to be a reference or benchmark for the other estimations (GLS and ML).

conclusion. Keeping in mind that developing countries only form the sample, this conclusion can be accepted as capital from the developing countries will flow out more easily to other stable destinations with relaxed restrictions on capital transfers.

Exchange rate, inflation, democratic accountability and political stability has been found to be significant in the POLS and GLS regressions, but not the ML estimation. Exchange rate adopts a negative sign in both of the estimation techniques, in which the variable is significant. This shows that IFF from the respective countries will increase as the local currency depreciates, siding with our assumption. Inflation too attains a negative sign. This follows from the hypothesis that with higher levels of inflation, there will be gradual erosion of purchasing power and costs of doing business will increase. And therefore, the incidence of IFF will rise. Political instability attains a negative sign across both the estimations. In this regard, it is established that political instability has a significant influence on IFF as political instability and IFF converges to a negative relationship.

Average tax rates were also found to be significant across the estimations, but with a negative sign throughout. This is contradictory with our assumption of the variable. The tax rate variable has fewer observations (as can be seen from Table 1) and is a relatively new variable in the block. Nevertheless, one could ponder as to how increasing tax rates can lead to lower levels of IFF. Democratic accountability takes a positive sign across both the estimations (POLS and GLS). Does this indicate more loopholes in more democratic and decentralised countries leading to higher incidences of IFF?

Regional dummies[10] which were found to be significant include the East Asia and the Pacific dummy, the Europe and Central Asia dummy and the Middle East and North Africa dummy. These dummies are significant in both the GLS and ML estimations, but not in the POLS technique. This reflects that the above mentioned regions have higher incidences of capital outflow compared to the other regions, namely, South Asia and Sub-Saharan Africa (Latin America and the Caribbean regional dummy was omitted from the regressions to avoid perfect multicollinearity).

Variables which were considered in the analysis but which did not provide significant results include capital formation, corruption and the law and order. However, such findings can also stem from data discrepancy and also frequency of the data. For now, we may consider these variables as having a null impact determining the flow of IFF from the developing countries.

5. Conclusion and Way Forward

Although the topic of the paper, IFF, is prominent in post-2015 discussions, it has been left unattended in specific discussions. Several contributions towards post-2015 development framework both within and outside the UN system have highlighted the issues related to IFF. The present study argues that it is not only important to have dedicated targets and indicators towards curbing IFF in the post-2015 development agenda, it is also necessary to understand the influencing factors behind the growing IFF phenomenon.

The results of the study are intuitive in certain arenas as well as confirmative in others. Per capita GDP, openness and capital account convertibility have been found to be significant determinants of IFF in the developing countries. Nonetheless, exchange rate, inflation, democratic accountability and political stability also influence the flow of capital outflow, but these variables are interpreted with caution since these variables were not found to be influencing IFF in all of the estimation techniques considered in the analysis.

As the significance of IFF is highlighted from several quarters, it is important that continuous efforts are put in place to uphold this issue when the final development outcome is finalised at the United Nations General Assembly.

[10]According to World Bank country classification.

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Annex 1: Chronological Evolution of IFF in OWG Documents

Revised FA Document	Zero Draft	Zero Draft Rev 1	Final Outcome Document
FA 12. Promote equality Some areas that could be considered in furtherance of greater equality between and among countries through and sustained growth in developing countries include: b) curbing illicit financial flows **FA 18. Means of Implementation/ Global Partnership for Sustainable Development** Some areas that could be considered include: h) strengthening capacities for tax collection, reducing tax evasion **FA 19. Peaceful and non-violent societies, rule of law and capable institutions** Some areas that could be considered for governance, rule of law and capable institutions include: k) curbing illicit financial flows	**Proposed Goal 16. Achieve peaceful and inclusive societies, rule of law, effective and capable institutions** 16.3 by 2030 reduce illicit financial flows by x% and reduce money laundering and all forms of organized crime including human trafficking and illicit trade in arms, drugs and wildlife **Proposed goal 17. Strengthen and enhance the means of implementation and global partnership for sustainable development** 17.45 cooperate globally to reduce substantially international tax evasion and avoidance 17.46 cooperate globally to combat illicit financial flows and transfers, recover stolen assets and return them to their countries of origin	**Proposed Goal 16. Achieve peaceful and inclusive societies, access to justice for all, and effective and capable institutions** 16.3 by 2030 reduce illicit financial flows by x% globally, increase stolen asset recovery and return by y% globally, fight all forms of organized crime, and reduce corruption and bribery in all its forms and at all levels and ensure accountability and transparency	**Goal 16. Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels** 16.4 by 2030 significantly reduce illicit financial and arms flows, strengthen recovery and return of stolen assets, and combat all forms of organized crime

Source: Authors' compilation.
Note: Documents considered 1. *Revised Focus Area Document-OWG 10th session* held on 31 March-4 April 2014 (UN Open Working Group 2014a); 2. *Zero Draft (Introduction and Proposed Goals and Targets on Sustainable Development for the Post-2015 Development Agenda* published on 2 June 2014 (UN Open Working Group 2014b); 3. *Zero Draft Rev 1* published on 12 July 2014 (UN Open Working Group 2014c) and 4. *Outcome Document – Introduction to the Proposal of the Open Working Group for Sustainable Development Goals* (19 July 2014) (UN Open Working Group 2014d).

Annex 2: List of Developing Countries Included in the Econometric Exercise

Albania	Dominican Republic	Liberia	Russian Federation
Algeria	Ecuador	Lithuania	Saudi Arabia
Angola	Egypt, Arab Rep.	Madagascar	Sierra Leone
Armenia	El Salvador	Malawi	South Africa
Azerbaijan	Ethiopia	Malaysia	Sri Lanka
Bahamas, The	Gambia, The	Mali	Sudan
Bahrain	Ghana	Mexico	Suriname
Bangladesh	Guatemala	Moldova	Swaziland
Belarus	Guinea	Mongolia	Syrian Arab Republic
Bolivia	Guinea-Bissau	Morocco	Tanzania
Brazil	Guyana	Nicaragua	Thailand
Bulgaria	Haiti	Niger	Togo
Burkina Faso	Honduras	Nigeria	Trinidad and Tobago
Cameroon	Hungary	Oman	Tunisia
Chile	India	Panama	Uganda
China	Indonesia	Papua New Guinea	United Arab Emirates
Congo, Dem. Rep.	Jamaica	Paraguay	Uruguay
Congo, Rep.	Kazakhstan	Philippines	Venezuela, RB
Costa Rica	Kuwait	Poland	Vietnam
Cote d'Ivoire	Latvia	Qatar	Zambia
Croatia	Lebanon	Romania	Zimbabwe

Source: Authors' compilation.

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Southern Voice on Post-MDG International Development Goals (*Southern Voice*) is a network of 48 think tanks from Africa, Latin America and South Asia, that has identified a unique space and scope for itself to contribute to the post-MDG dialogue. By providing quality data, evidence and analyses that derive from research in the countries of the South, these institutions seek to inform the discussion on the post-2015 framework, goals and targets, and to help give shape to the debate itself. In the process, *Southern Voice* aims to enhance the quality of international development policy analysis, strengthen the global outreach capacity of Southern think tanks, and facilitate professional linkages between these institutions and their respective governments. *Southern Voice* operates as an open platform where concerned institutions and individuals from both South and North interact with the network members. *Southern Voice Occasional Papers* are based on research undertaken by the members of the network as well as inputs received at various platforms of the initiative. *Centre for Policy Dialogue (CPD)*, Dhaka works as the Secretariat of the *Southern Voice*.

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