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GREED OF THE TAX HAVENS: THE PIVOTAL ROLE OF CAPITAL FLIGHT AND MONEY LAUNDERING IN ACCESSING THE FATE OF DEVELOPING ECONOMIES

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Abstract

The objective of this study is to investigate the conceptual differences between "capital flight" and "money laundering" by concentrating on the theories that are pertinent to each of these processes. Both the Capital flight and the Money Laundering pose a substantial risk to economies that are still in the process of developing because they have the ability to bring about a reduction in economic activity, lead to a depreciation of the currency, and prevent economic expansion. This paper makes a contribution to the existing body of knowledge by expanding on the role that capital flight and money laundering play in assessing the performance of developing economies. More specifically, the paper calculates the volume of these two phenomena for developing economies and investigates the impact that they have on the economic performance. In order to shed light on the relationship that exists between capital flight and money laundering, the political economy theory of globalization is applied in the research. This is done so that the connection may be better understood. One of the "dark sides" of globalization is the practice of money laundering, which is by far the most common form of improper use of the international monetary system. According to the findings of this study, money laundering has a detrimental effect on the economy of a country by contributing to the growth of the shadow economy and criminal activities, as well as capital flight has become an increasing worry for policymakers in developing nations and because capital flight implies a loss of resources that could be used to support economic growth and development.

Keywords: *Capital flight, Money laundering, Country Risk, Economic performance, Developing economies, Residual method.*

1. Money Laundering and Capital Flight:

Over the last two decades, the nature of money laundering and capital flight has shifted dramatically. It could be argued that an institutional phenomenon explains the origins of money laundering and capital flight, as well as the magnitude of the problem. Money laundering, on the other hand, thrives in environments shrouded in secrecy and reliant on the services of informed elites (Schneider & Windischbauer, 2008). As previously stated, it is the "deviant" individuals who are starving and lack the ability to exercise self-control who are responsible for money laundering and capital flight. It has been argued that financial institutions that are actively engaged in both legal transactions and global financial activities have the potential to be used as a vehicle for illegal activity (Palan, Murphy, & Chavagneux, 2013). The Mafia in the United States attempted to "launder" illegal funds by "washing" them through the acquisition or expansion of cash-intensive businesses such as launderettes, and the term "money laundering" was coined to describe these activities. In general, money laundering is divided into three stages, which are as follows: When we talk about "putting illegal profits first," we're referring to the act of depositing money earned through illegal activity into the financial system. After this money has been converted into book money, also known as primary and secondary deposits, the layering process can begin (stacking of illegal funds). These intricate actions are used to conceal the source of the money by constructing multiple tiers of interactions and organizing intricate financing transactions across multiple states. The third stage entails reintegrating and parking this illegal money, which has no connection to organized crime and is transformed into an externally visible asset through investments in commercial firms, industrial businesses, and tourism-related initiatives. At this point, the money is not associated with any illegal activity. Money laundering is the practice of concealing the origins of monetary assets (cash and book money (electronic bank transfers) or their surrogates, as well as non-monetary assets (movable goods and real estates)) that are either generated directly or indirectly from a punishable action or are intended to be used to carry out such an activity. The practice of concealing the origins of monetary assets (cash and book money (electronic money)) is known as "money laundering." The adjustment's goal is to convert illegal funds into a form that can be used in the legal economy. As a result, the proceeding is distinguished by a

criminal intent to change intentionally and methodically, mix, transfer, convert, and falsify the true origin or nature of the things under investigation. During the annual conference, the managing director of the International Monetary Fund (IMF) stated that money laundering is one of the most significant challenges confronting the global financial system (ML). Money laundering (ML) has become a source of concern for academics and policymakers in recent years due to its link to terrorist financing and the instability it can cause in the financial sector. This is due to the negative consequences of money laundering. According to the "United Nations Office on Drugs and Crime" (UNODC), criminal activities reduce global GDP by 3.6%, with an additional 2.7% lost due to money laundering. The United Nations Office on Drugs and Crime estimate is very close to the conclusion reached by the International Monetary Fund (IMF) in 1998, which put the figure between 2 and 5% of total global GDP. This astounding amount of money laundering is nearly equal to the gross domestic product of the United Kingdom, which has the world's third-largest economy (Moody, 2013). Money laundering has catastrophic and devastating consequences on both the micro and macro levels of any economy. Furthermore, the consequences of money laundering on societies, economies, and financial systems are becoming more severe as a result of globalization and technological advancement. Economic policy errors (such as falsification of official or financial data) and insufficient tax collection are two of the most damaging things that can happen to an economy. However, the country that ends up using the money from illegal activities may benefit from increased liquidity and economic growth. However, when these funds return to the country from which they were taken, there is a temporary decrease in liquidity, posing a threat to the financial sector's stability, which is the goal of money laundering (Aluko, 2011).

Capital flight, defined as the withdrawal of capital due to economic uncertainty or the fear of devaluation, is common in emerging economies on the global market (Uche & Effiom, 2021). However, since the start of the financial crisis and the precipitous reduction in capital inflows from wealthier countries that it caused, it has been a source of concern for those in charge of developing public policy. Capital flight has been identified as a factor impeding economic growth because it implies a loss of resources needed for domestic investment and because its severe and widespread

consequences are particularly concerning at the global level (Wong, 2021). Furthermore, it is widely assumed that reversing these capital outflows would make a significant contribution to resolving the debt problem (Hermes et al., 2004). Although the concept of capital flight has existed for as long as money has moved across national borders, it was not widely recognized until the early 1980s. Although capital flight is not a new issue, Adam Smith was the first to document it in his seminal book "The Wealth of Nations," which was published around two centuries ago. "The owner of stock is inevitably a global citizen who is not necessarily tied to any single country," is how the concept of capital flight is typically explained. He would most likely leave the country where he was subjected to a vexatious inquisition in order to avoid paying a burdensome tax and relocate his stock to another country where he could either continue his business or enjoy his fortune with greater ease. "He would most likely flee the country in which he was subjected to a vexatious inquisition in order to avoid paying a burdensome tax" (Smith, 1776, p.358). According to the stylized argument, residents prefer to invest their wealth abroad rather than in the domestic economy, either because the domestic investment climate is unappealing or because economic actors consider domestic investment to be too risky (Owens, 2017). The term "capital flight" refers to the unrecorded net departure of resident capital in response to poor domestic economic and political conditions, resulting in domestic assets with lower real value when compared to assets held outside the country (Beja, 2005). "Abnormal flows forced out of a country by one or more complex lists of fears and suspicions," according to Kindleberger's (1937) definition. According to the study's findings, an outflow of capital must meet all three criteria in order to be considered a case of capital flight: (a) it must be extraordinary; (b) it must be sudden; and (c) it must be motivated by pessimistic, almost pathological expectations. As a result, not every outflow of capital from a country should be considered capital flight. Capital flight refers to large and unusual outflows of capital from a country. These capital outflows pose significant macroeconomic challenges for both established and emerging economies. Although capital flight is theoretically significant, conducting empirical research on the topic is complicated by the often-secret nature of domestic international money transfers. While many of these strategies are based on important discoveries, they all have significant limitations and flaws. Because capital flight is so

important to economic growth, it is critical to improve measuring techniques in order to gain a better understanding of the factors that contribute to it and the effects it has. Given that we are attempting to solve a problem for which no direct measures are available, it should come as no surprise that many of the approaches used in previous research are incorrect in some way. According to Johannesen and Pirttila (2016), the results of various widely used methods for monitoring capital flight should be interpreted with greater scepticism than previously. This is because the results have previously been shown to be inaccurate. If this is not done, monetary penalties will be imposed.

2. Literature Review:

Conceptual Differences of ML and CF:

Generally, money laundering means pouring back the illegal funds generated from different illegal activities into a legitimate economy after changing their source (Duyne, 2003). Despite having contrary definitions, every country is agreed while specifying the procedure followed for money laundering, and it comprises of following three phases. The very first or initial stage in the money laundering cycle is "placement." According to US crimes and miscount (2005), illegal funds can be placed or moved into the legal financial system by directly depositing massive amounts into personal or commercial accounts or in it may be in the form of unnoticeable small sums of banking instruments like checks or money drafts. Besides this, there are few other approaches for placement, like purchasing offshore banks to influence the financial institutions in their own country (Schneider, 2010). The next stage is "layering," by layering activity; criminals try to increase gaps between the illicit proceeds and their origin by performing or engaging in multiple complex transactions. Here the speed of performing transactions also increased to make funds undetectable or untraceable. Miss invoicing and misuse of swaps and financial derivatives are the most common tools which money launderers exploit for layering purpose (Khan et al., 2018). The last step of money laundering is "integration," the illicit proceeds are brought back into the legitimate economy. Usually, these funds are employed to acquire assets like real estate and luxurious goods or some financial assets like shares or various deposit schemes (Aluko & Bagheri, 2012). However,

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Capital flight is a different phenomenon as it talks about the heavy flight of money from a country to protect it from all sorts of disturbances, i.e., political instability, social imbalance, economic downfall, and financial abruption, and when an investor loses faith in own country.

Theories of ML and CF:

It's important to talk about the three big ideas behind capital flight: the portfolio approach, the dirty money approach, and the political risk approach (Owens, 2017). The portfolio approach thinks that the macroeconomic situation is very important when it comes to capital flight. Most economists try to explain capital flight by using the standard market models of expected utility maximization by rational economic actors. When growth, profits, and returns are hurt by macroeconomic factors, investors will be more likely to move their assets out of the country (Dooley, 1988). Second, illegal, unrecorded capital flows are part of the dirty money that comes from criminal, corrupt, and business activity. Third, the term "political risk" can mean a lot of different things, but it usually means making political decisions. Investors will take a big risk if the political situation is not stable or right, or if the government is changing. The main reason why money leaves developing economies is because of political risk (Le, Zak, 2006; Waszkiewicz, 2017). Capital flight is associated with many unfavorable economic, social, political, and other factors that aggravate and shape the worst economic condition, leading to poor financial performance. The rational choice theory and the parasite theory are the two main theories of money laundering. According to the rational choice theory, money launderers want to "clean" funds by providing complete "anonymity," "safety," and "high returns." Criminals who use money laundering as a strategy pick location where it will most effectively further their objectives. Knowing how money launderers make rational decisions and what factors in a cost-benefit analysis outweigh the benefits will help us better understand the phenomenon of money laundering. This knowledge will also help us create better investigation and prevention strategies. According to parasite theory, money laundering has a dual nature and alters its nature in terms of effects depending on the nation in which it operates. Money laundering is a parasite that changes from a parasitic to a mutualistic behavior when it exists in a developed nation. Mutualism is

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an advantageous symbiotic relationship between two species (host and parasite) and the country that facilitates money laundering benefits economically and financially from these activities.

Measures of CF and ML:

There are four measures of capital flight, one of which is;

A) Residual method

Capital flight is estimated using balance-of-payments data, with the sources-and-uses technique being a popular method. Private individual capital transfers to foreign countries must be the cause if the sources of capital inflows, such as net increases in foreign debt and net increases in foreign direct investment (FDI), exceed the uses of capital inflows, such as current account deficits and increases in a country's foreign reserves. As a result, capital flight can be estimated using this residual.

B) Dooley measures

Dooley (1988) examine the stock of privately held overseas assets that do not generate revenue that is disclosed to domestic authorities. To account for unreported capital withdrawals, the capital outflows in the balance of payment are combined together and three adjustments are applied. The first step is to fix any errors or omissions, then compare the external debt shown in the World Bank external borrowing balance of payment.

C) Hot Money Measure

Hot money is used to calculate private money. Capital flows directly from the balance of payments by subtracting the negative of errors and omissions from the balance of payments and the private short-term capital statistics. Different measures of private short-term capital are used in different parts of the world (Cuddington, 1987).

D) Trade mis-invoicing

By exporting under-invoicing and importing over-invoicing, Capital Flight can be camouflaged. However, because both under-invoicing of exports and over-invoicing of imports contribute to capital flight, the overall effect of trade mix-invoicing on

capital flight would be mixed (Gautier, 2020). While all the estimating techniques of money laundering are broadly divided into five categories.

1- Field and Case study approach

2- Surveys and Interviews approach

3- Suspicious or Unusual transactions approach

4- Statistical Discrepancies approach

4.1- Hot money Method

4.2- Residual Method

4.3- Currency demand and supply Method

4.4- Economic activity approach

4.5- The Dooley Method

4.6- Trade misinvoicing Method

4.7- Global Financial Integrity (GFI) Method

5- Latent Variable Approach

5.1- Multiple Indicators, Multiple Causes (MIMIC) approach

5.2- Dynamic multiple-indicators multiple-causes (DYMIMIC) model

5.3- Dynamic two-sector equilibrium model

5.4- Walker Model

3. Money laundering in Developing Economies:

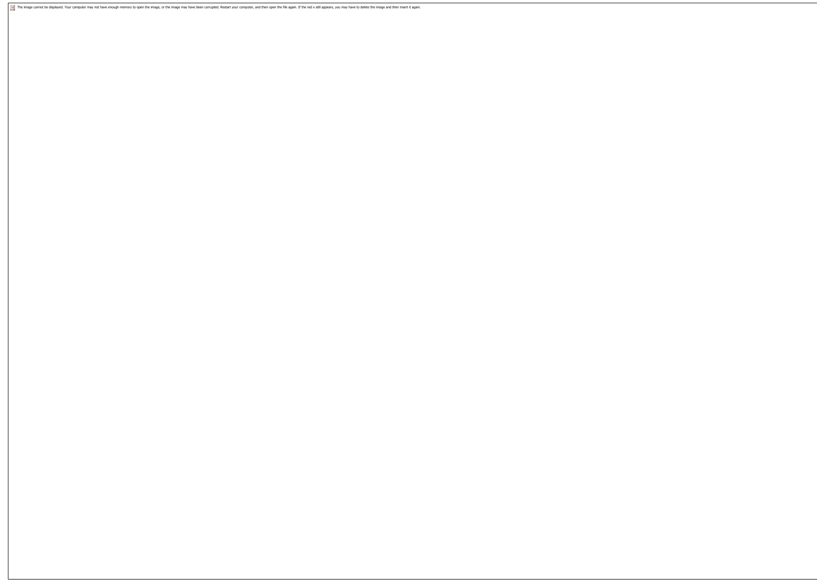
Money laundering can be devastating to developing economies, especially those with weak institutions. One of the greatest threats to international stability is money laundering because of the role it plays in financing terrorist organizations (Levi & Gilmore, 2002). Terrorism is a global threat to people's safety and governments' stability (Shah & Khan, 2006). Due to its connections with terrorist financing, money laundering undermines or disrupts international relations at a time when their strength is essential to achieving economic stability and growth (Agu et al., 2016). While an understanding of the phenomenon's fundamentals is necessary for effective coordination and compliance with international standards against money laundering. Money laundering poses a great danger to developing economies by reducing the

GDP and growth while disturbing the normal activities of the economy while disturbing the macroeconomic factors on a huge level.

4. Capital flight in Developing Economies:

Because of the negative effects it has on economic growth, income distribution, criminal activity, macroeconomic stability, welfare, and other developing activities, capital flight is a key worry for emerging countries. Global Financial Integrity (GFI), the Centre for Applied Research at the Norwegian School of Economics, and a group of international experts collaborated to write a report that was released toward the end of 2016 and estimated that developing countries have lost a total of $16.3 trillion in balance of payments leakages, trade mis-invoicing, and unrecorded financial transfers since 1980. 2019, the Year of Integrity With a total of 247 billion dollars, China is ranked first among the top ten emerging nations in the world in terms of the flight of capital (Kar & Spanjers, 2014).

Emerging economies that are extremely indebted and consistently struggle with problems related to the servicing of their debt are forced to contend with the prospect of capital flight. As a result of the difficulty in obtaining loans, the public, and particularly the political leaders of the country, are making efforts to return some of the money they have saved. The outflow of money from developing countries can be attributed to a number of variables, including tax policy, the purpose behind the exchange rate, risk, and security. The impact of capital flight on developing nations is considerably exacerbated by the fact that emerging economies typically have limited access to liquid financial assets. The flight of capital has a huge impact on the economy, and it has a disproportionately negative effect on developing countries. Regardless of the circumstances, significant capital flight will have an effect on the economy of any nation. This is generally the result of there being insufficient readily available funds for investment purposes.



- An overpriced currency and the attendant rumors of a devaluation could be the spark that sets off a currency flight. Investing in foreign countries does not require the use of this currency. People engage in smuggling for a variety of reasons, the most common of which are to avoid paying excessive export tariffs or to obtain a better price for their goods in foreign markets, particularly in situations in which local prices are kept artificially low and a marketing board maintains a monopoly (Ayadi, 2008).
- The yield incentive is activated whenever domestic returns are determined to be lower than those of overseas returns. People who keep their money in savings accounts would rather have positive real interest rates on international accounts than negative real interest rates on their savings accounts (Rahman, 2019).
- The yield incentive will decrease if the returns on investment that can be earned at home are lower than those that can be gained elsewhere. Lastly, the desire to protect one's assets is a factor in the decision to export one's money. Concerns about one's portfolio or one's safety are typically the driving force behind investment decisions, not yield considerations. For political concerns, particularly the fear of having their property taken away, residents invest a portion of their wealth outside of the country (Schineller, 1997).

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5. Tax Havens and Developing Economies:

Tax havens no longer conjure thoughts of tiny Caribbean islands. If states employ secrecy and unique advantages to attract foreign firms and riches, OECD members are the main culprits. Tax havens have four traits. Tax havens are low-tax jurisdictions. Financial confidentiality restrictions hinder tax and law enforcement information sharing. Third, legislation, law, and administration lack openness. Fourth, operations need not be "significant" for a jurisdiction to obtain minimal revenue from tax evasion. Black money flows from developing economies to wealthy nations and then returns to developing economies with the help of weak institutions, corruption, and poor governance. Money flows between developed and emerging economies, with emerging economies bearing the risk. Capital flight affects both affluent and poor nations. "Fly to quality" refers to the portfolio diversification hypothesis that investors will transfer or invest money for higher returns. Fly to quality in underdeveloped and developed nations. Several reasons are listed below: Interest, exchange, and inflation rates, as well as social, political, economic, and financial factors, affect capital flight. Tax havens are developed nations.

6. Data and Methodology:

The study is of quantitative nature and it follows a deductive approach, generally it starts from the theory and then generates hypothesis, collect data and testifies the theory. Positivism is the paradigm this study follows on the basis of Ontology, Epistemology, Axiology, Rhetoric, Methodology, Strategies of inquiry and method. This paradigm assumes that there is an external world in which human and physical entities exist. These entities have the ability to influence other entities. Former entities are the causes of the emergence of subsequent entities, through which change occurs. As a result, the world is an offshoot of various causal inferences, each of which results in a specific effect. Data of 62 developing economies for the year 2005-2019 has been used to calculate the capital flight and money laundering. For the calculation of capital flight residual methodology has been used and for money laundering shadow economy method has been used. Furthermore the impact of capital flight on economic performance has been checked via using pooled regression technique. This study is mainly focused on the theories and differences of capital flight and money

laundering but additionally it focuses on the economic performance via taking foreign direct investment, capital investment and Gross Domestic product as dependent variable while taking capital flight and money laundering as independent variables separately.

7. Results and Discussion:

Descriptive Statistics

Variable		Mean	Std. Dev.	Min	Max	Observation	
Capital Flight	overall	3.47E+10	3.99E+11	-1.80E+12	7.40E+12	N =	930
	between		1.72E+11	-3.94E+11	1.10E+12	n =	62
	within		3.61E+11	-2.04E+12	6.33E+12	T =	15
Shadow Economy	overall	26.05281	12.26118	7	65.64	N =	930
	between		12.19005	7.890531	54.01535	n =	62
	within		1.994617	17.52356	37.67746	T =	15
Capital Investment	overall	0.0357829	1.067679	-3.20294	2.53994	N =	930
	between		0.9575388	-2.547592	1.852832	n =	62
	within		0.4866973	-3.68399	3.020108	T =	15
Foreign Direct Investment	overall	0.0087286	1.340672	-37.6203	4.6153	N =	930
	between		0.4680051	-2.370035	2.127257	n =	62
	within		1.257646	-35.25899	4.030479	T =	15
Gross Domestic Production	overall	4.37E-02	1.13E+00	-3.80E-01	12.6702	N =	930
	between		9.23E-01	-3.79E-01	6.168707	n =	62
	within		6.60E-01	-6.41E+00	6.545228	T =	15

Table: 1

This table shows the descriptive statistics of all the dependent and independent variables. The mean value of capital flight from developing economies is less than the mean value of money laundering which shows there is a huge amount of money is being smuggled to developed economies to become white. The capital flight and money laundering overall plays a vital role in loss on income and resources and further it causes the tax evasion from developing economies (Otusanya et.al, 2021). This table shows the more money laundering is observed in developing economies as

compared to capital flight specifically shadow economy method measures the sort of economic activities which are hidden from the main economic activities and does not use the financial institutions to transfer the money so it is concluded hidden activities are more than using the financial institutions.

Capital flight, Money laundering and Economic Performance

	Capital Investment		**Foreign Direct Investment**		**Gross Domestic Production**	
	Capital Flight	Shadow Economy	Capital Flight	Shadow Economy	Capital Flight	Shadow Economy
Coef.	-0.5831768	-0.0136437	-0.1233712	-0.0140932	-0.1450189	0.0043369
Std.	0.1076099	0.0079764	0.2713737	0.0073142	0.187796	0.011432
Err.	-5.42	-1.71	-4.55	-1.93	-0.77	0.38
Z	0	0.087	0	0.054	0.44	0.704
P>|z|	-0.0940884	-0.0292772	-0.0765595	-0.0284288	-0.5130923	-0.0180695
[95% C. Int]	-0.3722653	0.0019899	-0.7018294	0.0002424	0.2230545	0.0267432
Hausman	0.7478	0	0.2061	0.6823	0.1393	0.0807

Table: 2

This table summarizes the regression results for 62 developing countries. The majority of the data indicate that there is a negative link between capital flight and the other three independent variables, including foreign direct investment, capital investment, and gross domestic product, and that all three of these factors are significant for capital flight. Clearly, capital flight will rise and badly affect the economic performance of developing nations. The findings are congruent with earlier research, such as (Kuamvi, 2022; Otusanya et.al, 2021). Capital Flight is detrimental to the Economic Development of developing economies. This indicates that the limited capital available for Investment, Innovation, and Expansion is concentrated in a small number of economies, which has a negative impact on the growth of developing economies. The result for money laundering through the shadow economy indicates that money laundering, capital investment, and foreign direct investment are significantly and negatively related, and that an increase in money laundering will have a negative impact on money laundering, whereas money laundering and GDP are significantly and positively related to study for each other. The amount of money laundering is significantly greater than capital flight, and it has a significant impact on foreign direct investment (FDI) and capital investment. ML has a positive relationship

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with GDP, indicating that the more money laundering via the shadow economy has a positive relationship with GDP. Although GDP is not the only indicator that reveals everything about a country's economy and strength, it is a very good indicator of an economy's overall health. Therefore, the other two indicators are more useful for measuring economic performance in relation to money laundering, and a study in 2020 will report the same results (Bashir et.al).

8. Conclusion

Drawing upon the rich dataset and insightful analysis provided in the research paper titled "Greed of the Tax Havens": The Impact of Capital Flight and Money Laundering on the Situation of the Developing Economies: The research conducted the empirical analysis that recounts the foundations and magnitude of capital flight and money laundering and presents these activities as detrimental to the economy of developing nations. The paper proposes a strong framework for analyzing the economic consequences of capital flight and money laundering which includes the integration of the residual method for capital flight calculation and the shadow economy approach for expressing Money Laundering.

Capital flight which signifies unregistered net outflow of finance motivated mainly by social-economic-and political burns remains a pursuit of the forms of unkind issues especially in developing countries; worsening the reduction of the nation's capital base for investment. The research irrefutably shows how capital flight, which is initiated by the mutual decision making processes of economic uncertainties, devaluation apprehensions, and political instability, subtract from the chances of developing countries. It also points to economists' perceptions' deem capital flight as a polished concept which is not just the economic phenomenon but also social-political crisis crisscross.

Additionally, channels that cover money laundering, that is, the phenomenon of concealing the sources of illicit wealth, emphasize their role as agents magnifying the internal flaws of developing economies. The sound empirical data in the case-study are powerful demonstration of a relationship between laundering and shadow economy, which are consequentially conceal and misinterpret correct economic indicators leading up to the economy's failures. These disquieting stages of

laundering from placement to integration help to understand the method how they intrude and rupture the whole formal economy structure.

The paper's political economy theory of globalization is focused on money laundering and capital flight through the interconnectedness of the relationship is fascinating. Consequently, such activities are placed in the context of the wider discussion about the alleged "dark sides" of globalization. At the same time, it highlights how the growth of trade in financial services, while a way of integration of the economy, has nevertheless generated conflicts around national economic sovereignty issues, especially for the countries which are in the developing stage.

This is absolutely confirmed in the study where empirical observations are made, and it is revealed that the negative relationship between capital flight and main economic indicators especially foreign direct investment, capital investment and gross domestic product is observed. Such a put forward of the outcomes of the presented research is a very argumentative part of the problem of the capital flight as an obstacle for economic growth. This detailed dissection of the effects of money laundering on the economies of developing countries also identifies a rather complex relationship between them, in the sense that on the one hand some aspects of money laundering might appear to bring short-term economic benefits, but in reality the whole picture should always be perceive as something completely unfavorable and negative for the economy of countries at the beginning of their development cycles.

Relative to the end, this research does enter into the existing academic discourse on the economic determinants of the capital flight and money laundering on the developing economies. Not only the precepts of how these prevailing trends operate are clarified but also the need for full-scale policy actions is accentuated. The study drives for alignment of international policies and rules to address the driving forces of capital flight and money laundering, including more transparency, regulatory silences, international cooperation. Future research paths could cover effectiveness of varied anti-money laundering and capital control measures. International institutions and their roles into the mitigation of offshoring financial system malpractice and it adverse impacts is also an important channel to study. Lastly, the outcome of the battle to stop capital flight and money laundering is not just a matter of economic

policy but it is also a crucial area of the war against an unequal and unsustainable global development.

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