Institutional Quality and Illicit Capital Outflow: A Comparative Analysis of the Eastern European Countries

Luca Andriani[1*] & Anna Zajaczkowska[1]

[1] Department of Management, Birkbeck University of London, London, UK

[*] Luca Andriani, E-mail: luca.andriani@bbk.ac.uk

Abstract

It is estimated that $1 trillion flows out of the developing and emerging economies illegally on a yearly basis. This affects the ability of governments to raise the tax revenue and deprive the citizens of crucial services. Multinational Corporations (MNCs), as one of the big player in the global economy, are suspected to play a role in those capital outflows. For the multinational, the outflows enable strategic allocation pf taxes as a mean to enhance profits. This study tests whether institutional quality and tax level are significant predictors of the illicit capital outflow. The analysis uses panel data regressions on a group of Eastern European countries for the years 2004-2013. Empirical evidence suggests that illicit capital outflow reduces with institutional quality and increases with the tax level. We speculate on the importance of cross-country coordination actions to improve the quality of the institutions not only domestically but also at the supranational level.

Keywords

institutional quality, tax level, capital outflow, East Europe

1. Introduction

Global Financial Integrity (GFI) estimates that each year approximately $1 trillion flows out of the developing and emerging economies illegally. This sum exceeds the total amount that these countries receive yearly from Foreign Direct Investments (FDI) and aid. There are three sources of illicit financial outflow: crime, corruption and tax evasion (GFI, 2016). However, it is estimated that tax evasion is the biggest source of illicit capital outflow (OECD, 2014). Multinational Corporations (MNCs), as one of the big player in the global economy, are suspected to play a role in those capital outflows. For the multinational, the outflows enable strategic allocation pf taxes as a mean to enhance profits.

Three methods most commonly used for money outflows are transfer mispricing, distorted transfer pricing and fake transactions (Baker, 2005). Those methods enable MNCs to exploit the asymmetries

that exist between high tax countries and low tax jurisdictions.

The illicit capital outflow is uncontrollable in many of the developing countries and emerging economies. Those countries suffer from poor governance, weak institutions, inadequate policies and poor legal enforcement. Such institutional weaknesses are reflected in lack of effectiveness in collecting taxes and tackling corruption (OECD, 2013). The guidance from international organizations recommends strengthening institutional quality to prevent tax evasion. The inability to collect the taxes impacts the amount of tax revenue the government is able to raise. This, in turn affects the resources to devote towards the services for the citizens and at the same time the amount of resources that is available to tackle tax evasion.

While tax evasion is not confined to a specific country, most of the literature focuses on USA and Western European countries due to data availability. Little explorative analysis has been conducted so far in emerging economies of East European ones. To this purpose, this study aims to test the relationships between illicit capital outflows and institutional quality and between illicit capital outflows and tax levels. These relationships are statistically assessed by using panel data regression on the group of Eastern European countries for the years 2004-2013. Empirical evidence suggests that illicit capital outflow increases with the level of taxation and is lower in contexts with better institutional quality. These results are robust to the use of several macroeconomic explanatory factors. In light of our findings (we?) speculate on the importance of cross-country coordination actions to improve the quality of the institutions not only domestically but also at the supranational level.

The paper is structured as follows: Section 2 discusses the relevant background; Section 3 describes the variables and presents the empirical framework; Section 4 concludes.

2. Relevant Background

2.1 Illicit Capital Outflow and Tax Level

According to Milton Friedman, corporations are artificial creations and as such can't have civic responsibilities. Their main obligation is to maximize the shareholders' profits, while working within legal framework of the country (Friedman, 1970). Students of transaction cost analysis and comparative political economy take this view even further and reason that corporations, in order to maximize their profits, might actually act in socially irresponsible way (Campbell, 2007). This is any action that is committed consciously and might cause harm to the stakeholders of the company and community within which they operate (Campbell, 2007) (Note 1).

Countries differ in levels of taxation and this can be an important factor in the process of business decision making with regards to potential locations of multinationals and their affiliates. Multinationals can reduce the amount of payable taxes if they locate economic activities in countries with low tax rates. The strategy to relocate from high to low tax jurisdictions is perceived as part of a tax minimization planning aiming to increase the profitability. Higher level of taxation relates to more tax avoidance activities. Therefore, in recent years the tendency to lower the level of the taxation across the

67

counties has not been a sporadic attitude. This occurs because it is perceived that taxation can influence the MNCs' behavior in relation to investment, tax avoidance, repatriation of profits and how their affiliates are financed.

Hence the first hypothesis we test is the following:

H1: Illicit Capital Outflow is higher in contexts with higher residential tax level

Empirical evidence suggests that the level of taxation might affect the assets allocation decision. Grubert and Mutti (1991) report that the 10% difference in local level of taxation accounts for the 1% difference in amount of local PPE (real productive assets) owned by American multinationals. Furthermore, Swenson (1998; cited in Hines, 1999) finds evidence that US taxation affects inward FDI undertaken by foreign investors establishing new plants, plant expansions, mergers and acquisition. High local taxes are negatively correlated with opening of the new plants and plants expansions. Mutti (2003), in examining the determinants of tax level and its changes across countries, finds that some countries with the initial higher level of taxation as well as small countries are more prone to lower their tax levels over the time. Still, setting the correct level of taxation requires careful investigation of the reasons why tax avoidance occurred on first place. This is because increased taxation and excessive regulatory obligations might drive the businesses out of the market, or push the businesses into a grey zone (Kenyon, 2007).

Excessive taxation can lead to both tax avoidance and tax evasion. Tax avoidance and tax evasion matter. Both activities create distorted competitiveness between the organizations that pay taxes and those that manage to avoid them, leaving the organizations that pay higher taxes in underprivileged situation of being less competitive (Keynon, 2007). Tax evasion matters also for the host country as the lower level of the revenue directly affects the level of public services provided to its citizens. A major proportion of MNC's trade is made up of transactions between entities that are part of the same multinational group often located in different tax jurisdictions. This supranational position can be exploited by the MNC by adopting creative ways of accounting to manifest profits in lower taxed places or hide it in the high tax jurisdictions.

There are two major ways how the MNC can shift the profit from high tax to lower tax jurisdictions.

The first includes the loans extending from the parent to affiliates used to finance the subsidiary. The interests generated and paid back to the multinational parent's company decrease the taxable income of the affiliate, and create taxable interests of the parent. In case of financing the affiliates by the equity funding, the profit is not taxed until repatriated back to home country. Empirical evidence shows a tendency to finance affiliates located in high tax jurisdictions by debt and use the equity funds in case of the low tax countries (Bartelsman & Beetsma, 2003; Hines & Rise, 1994).

The second is transfer pricing. This indicates the practice of arbitrary selecting the price for goods and services traded between controlled or related legal entities within an organization. The invoicing can cover loans, patents, trademarks and expertise or any other commodity that are jointly used. According to the survey carried by UNCTAD in 1995 80% of respondents believe that MNCs engage in the

transfer pricing to minimize fiscal burdens (Reuter, 2008, 2012). Transfer pricing can lead to distorted competitiveness between MNC and local firms. For this reason the OECD has introduced a set of guidelines defining the rules for the MNCs in relation to the pricing strategy and a set of guidelines for countries to effectively combat the problem. This implies the notion of 'arms-length' where intracompany transactions should be approached in the same way as transactions between unrelated parties. However, this creates the technical problems of detecting and defining the abnormality. Chan and Chow (1997) indicate that the same transactions which appear similar might indeed be different in terms of the underlying facts relating to the product quality or quantity. Additionally, the distorted prices of intangibles are more difficult to be detected than tangibles goods. Hines and Rise (1994) confirm the difficulties in detecting the abnormality in the prices as in many circumstances there exist no comparable product outside the firm. This is especially the case of intangible goods like the intellectual property, patents, trademarks, expertise or high tech intermediaries traded between the affiliates, or parent-affiliates. Taking this point further it should be considered that the price on invoices might not only be arbitrary set but that the whole invoices could also be completely falsified in order to minimize the taxable interest.

Transfer pricing enable to shift profits from the higher taxed to lower taxed jurisdictions as a result of minimizing the overall tax payment and maximizing its net profit. Transfer mispricing is, however, difficult to measure. Hence, many researchers focus on measuring profit shifting rather than transfer pricing. Bartelsman and Beetsma (2000) argue that different tax levels among the OECD countries might cause shift not only in the profits, using the accounting methods, but also in the real activities. In fact, Azemar (2008) shows how differences in the tax levels affect the allocation of investment abroad as well as how the profits, once generated, are reported back to the country. Also tax heavens are perceived to play a significant role in both tax evasion and tax avoidance (Hines & Rice, 1994). Hines (1991) highlights that correct policies implemented by countries might reduce the negative impact of low tax offshore locations. For instance, He points out that the Tax Reform of 1986 in USA has substantially reduced the possibilities and incentives to incorporate at those locations.

2.2 Institutional Quality and Illicit Capital Outflow

The level of the taxation is not the only factor determining whether corporations engage in tax avoidance. Countries also differ in terms of institutional quality including the quality of regulations, competition, political stability and infrastructure that might contribute towards the shaping overall investment climate of the country. A more effective system of property rights, a better quality of legal enforcement and state accountability can improve the market infrastructure within which economic agents can operate (La Porta et al., 1997, 1998). The second hypothesis we test in this paper considers the importance for institutional quality in mitigating illicit capital outflow.

H2: Illicit capital outflow is lower in contexts with better institutional quality

Solutions to global problems might be better addressed by global institutions. However, this action can be facilitated by the improvement of institutional quality at the country level. In other words, country's

69

institutions and policies play crucial roles in shaping the market environment. Pande and Urdy (2005; cited in Casson et al., 2010) indicate that the "institutional quality might cause poor countries and people to stay poor". Acemoglu (2001, 2003; cited in Cerra et al., 2008) argues that the poor institutions rather than poor macroeconomic policies are the main reason for the slow economic development. Institutions play a role in regulating the level and form of activities of the market players. Scott (2003; cited in Campbell, 2007) highlights that the institutions are necessary to ensure that organizations are responsive to the needs of other market players beside themselves. The importance of well-functioning institutions is reinforced by Campbell (2007) who suggests that in the absence of institutions regulating organizations' behavior, market participants are more likely to act irresponsibly.

According to North (1991) institutions are humanly devised constrains that has grown out of the need to minimize the uncertainty of exchange. Institutions create the incentive structure for the economy and indicate the directions of the economic growth of the country. Institutions participate in creation of the investment climate of the country, which forms the incentives structure for investors influencing the level of entrepreneurs in economy (Baumol, 1990). Baumol (1990) emphasizes the role of policymaking in allocating the entrepreneurs between productive and unproductive activities and stimulating their supply into the market. Institutional accountability, for instance through the quality of the legal enforcement, is another key factor. A well-functioning legal system seems to mitigate the negative impact of the heavy regulatory and tax burden. A more accountable legal system guarantees higher probability of detection of illegal activities and as such encourages the entrepreneurs to follow the formal path (Dabla-Norris et al., 2006).

The institutional quality is important to tackle the tax evasion problem. A well-functioning bureaucratic machine is important in its ability of tax collection. An effective tax collection system requires a bureaucratic apparatus to have the ability of contacting the potential tax payer and accessing the information about the level of his activities (Kenyon, 2007). The tax collectors must not only be able to obtain necessary information about the activities of an organization, but they also have the ability and resources to detect possible abnormal transactions. It is emphasized that in order to be effective such apparatus requires professionally trained experts to assess the problems (Kenyon, 2007). The importance of resources is reemphasized if the country needs to challenge MNCs in the international arena (Azemar, 2008). This problem is especially evident in developing countries characterized by a lower availability of resources to dedicate in the tax collection process (Azermar, 2010).

2.3 The Context of Analysis

The Eastern European countries represent an intriguing context of analysis due to the geopolitical transition that the region has been experiencing since the end of the Cold War. Specifically to our context of analysis we consider the following countries: Belarus, Bulgaria, Hungary, Poland, Romania and Ukraine. After the 1989, these countries experience in deep structural changes affecting both their formal institutions and their economic infrastructure. Their gradual opening to the global market economy and their regional integration within the European Union has been done not without

70

institutional and economic structural modifications. Even though these changes towards a more democratic regime, all countries present significant differences in terms of the quality of their political institutions and struggle with the post transition problems that relate to corruption, tax evasion and crime. Yet, to various degrees, some countries remained under the influence of Russia. For instance, both Belarus and Ukraine were incorporated in the Soviet Union and gained independence after 1991, while the remaining countries created the formation of satellite countries so called the Eastern Block.

The group is currently classified as transition economies with Poland, Hungary which are members of UE since 2004 and Bulgaria, Romania since 2007.

The term "transition economies" refers to undergoing structural transformations that intend to develop market-based institutions as well as changing the role and the set-up of the existing ones. The major change is observed in the economic approach shifted from a centrally-planned to a market-based system where the role of the market acts as engine of growth. This is accompanied by the development of financial sector which takes over the leading role in stabilizing the macroeconomic situation. The transition of the markets and institutions are correlated with extensive privatization and economic liberalization. This restructuring process has been implemented to different degrees in all countries of the Eastern Block. The changes are reflected in the state of institutions involved in the creation of the investment climate of the country

3. Data, Variables and Estimation Framework

We use country-level data for the period 2004-2013 from Global Financial Integrity (GFI), World Bank PricewaterhouseCoopers and OECD database for six East European countries including Belarus, Bulgaria, Hungary, Poland, Romania and Ukraine.

We model Illicit Capital Outflows as functions of institutional quality and corporate income tax level. Following the literature we also control for some key macroeconomic indicators such including GDP, GDP per capita, inflation, exchange rate and foreign direct investments (Azemar, 2010; Chan & Chow, 1997).

The measurement for the illicit capital outflows derives from the GFI, a non-profit international organization reporting on issues of illicit financial outflows in developing countries. The variable of Illicit Capital Outflow (ICO) is estimated by the GFI in millions of USD and consists of Trade Misinvoicing Outflows and Hot Money Outflows. The former refers to values on the invoice deliberately misreported to customs. The latter refers to flows of funds between countries aiming short-term profits on interest rate differences and/or anticipated exchange rate shifts (Note 2).
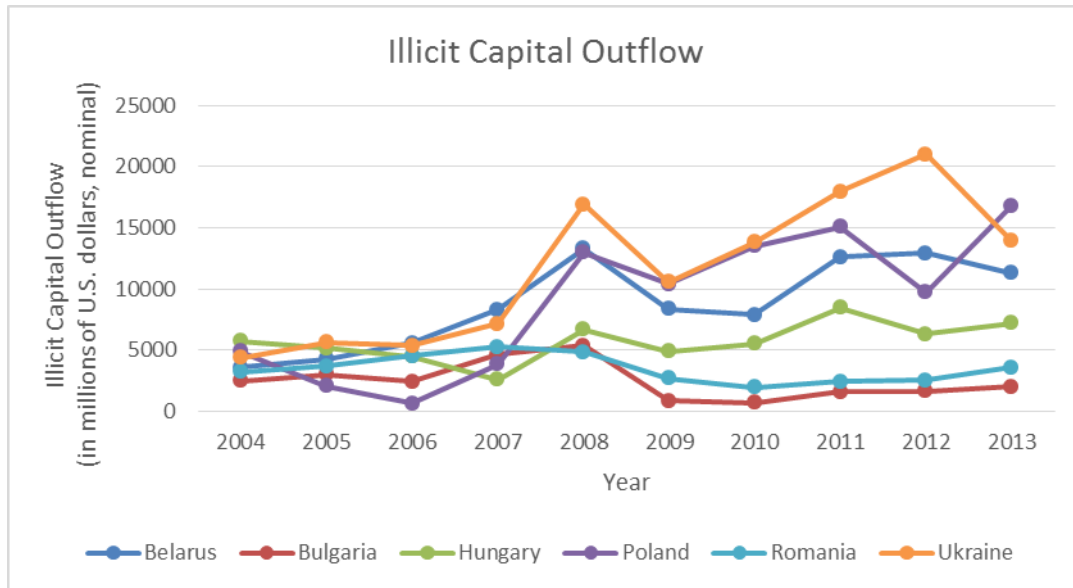
Figure 1. Illicit Capital Outflow

Figure 1 shows the trend of the Illicit Capital Outflow for the countries of interests during the period of analysis 2004-2013. We can observe how the ICO has increased in our sample over the years with highest outflow reported for the Ukraine and Poland and lowest for Belarus and Bulgaria. Peacks in the ICO occur for almost every countries in 2007-2009, during the period of the financial crisis.

Institutions create the incentive structure of the economy that evolves through time and which might lead to growth, stagnation or decline of the economy (North, 1991). Over the recent years, an increasing attention has been devoting to the importance of good institutions in reducing illicit and amoral phenomena (Andriani, 2016; Andriani & Sabatini, 2015; Torgler, 2005). The variable *Institutional Quality* is a composite indicator summing the score of five composite items from the World Bank Government including Voice and Accountability, Political Stability and Absence of Violence\Terrorism, Political Effectiveness, Regulatory Quality and Rule of Law. Table 1 shows that the correlations among these composite items is high ranging from 0.52 (between the item "political stability" and the item "voice and accountability") to 0.96 (between the item "rule of law" and "political effectiveness"). The correlations are all statistically significant at 1% statistical significant level.

"Voice and Accountability" captures the citizens' perception about the accountability of the democratic process in place in their respective country and electoral system.

"Political Stability and Absence of Violence\Terrorism" indicates the perception of the likelihood of political instability and/or politically-motivated violence, including terrorism. For instance, Zak (2006) emphasizes the importance the political stability in the investors' asset allocation decisions as predictor of capital flights.

Table 1. Correlation among the Composite Items of Institutional Quality

	Voice & Acc	Pol. Stability	Pol. Effect	Reg. Quality	Rule of Law
Voice & Acc	1.00				
Pol. Stability	0.52***	1.00			
Pol. Effect	0.89***	0.72***	1.00		
Reg. Quality	0.96***	0.61***	0.93***	1.00	
Rule of Law	0.89***	0.75***	0.96***	0.95***	1.00

*** $p < 0.01$.

"Political Effectiveness" reflects the perception about the effectiveness in formulating, implementing and then enforcing certain policies, as well as the effectiveness in providing public services, the degree of its civil service independence from political pressures.

"Regulatory Quality" reflects the perception about the ability of governments to formulate and implement sound policies and regulations that permit and promote private sector development.

"Rule of Law" captures the perception about the extent of the country legislative maturity. This indicates the strength and the stability of the legal system and in particular the quality of contract enforcement, property rights, the police, courts, as well as the likelihood of crime and violence. In this regard, Azemar (2010) highlights the importance of the "rule of law" as determinant of multinational income shifting.

The variable *Tax Level* derives from the PricewaterhouseCoopers and OECD database. Empirical evidence suggests that corporate tax level is taken in strong consideration from multinationals in asset allocation decisions (Clausing, 2003; Grubert & Mutti, 1991).

As mentioned earlier the other control variables considered for our reduce form model are *GDP, GDP per Capita, Inflation, Exchange Rate (Note 3), Foreign Direct Investments*. Following the literature these macroeconomics indicators are included to control for different factors including but not limited to the attractiveness of the market for the potential entrants, macroeconomics instability, incentives towards transfer pricing manipulations and net investment inflows (Azemar, 2010; Grubert & Mutti, 1991; Hines & Rise, 1994; Chan & Chow, 1997). All these indicators are derived from the World Bank Indicators database.

Table 2. Summary Statistics

Variable	Observations	Mean	Std. Dev.	Min	Max
Illicit Capital Outflow	60	8.55	.80	6.47	9.95
Institutional Quality	60	12.99	3.27	6.78	17.53
Tax Level (CIT)	60	18.78	5.00	10	30
Ln GDP	60	25.30	.80	23.86	26.99
Ln GDP per cap	60	8.73	.59	7.88	9.53

Ln FDI	60	22.36	1.17	18.91	25.04
Inflation	60	7.83	9.82	.89	59.22
Ln Exchange Rate	50	4.58	.07	4.40	4.75

Table 3. Empirical Analysis

Variables	Institutional Quality *Column I*	Tax Level *Column II*	Full Model *Column III*
Institutional Quality	-0.195** (0.085)		-.720** (0.200)
Tax Level		0.089*** (0.017)	0.091*** (0.031)
Ln GDP			1.326*** (0.317)
Ln GDP per Capita			2.064** (0.455)
Ln FDI			0.650** (0.083)
Ln Exchange Rate			-2.290* (1.086)
Constant	10.690 (0.987)	6.800 (0.344)	-38.724*** (9.237)
N. Obs.	40	40	30
R Sq. (Overall)	0.466	0.411	0.664

Note. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$; Standard errors in parenthesis. We use cluster-robust covariance estimator to deal with heteroskedasticity and non-equicorrelated errors over time, as in Andriani (2014) and Cameron and Trivedi (2005). The simple regressions follows a random effect estimation while the full model a fixed effect estimation

Table 2 shows the summary statistics of our variables. The empirical analysis depicted in tables 3 aims to test our hypotheses. The bivariate regressions (Column I and II) are conducted on the basis of a random-effect panel estimations approach while the full model (Column III) on the basis of a fixed-effect panel estimations approach as suggested by the Hauseman Test conducted. In our empirical analysis, all variables, except for *institutional quality*, *tax level* are converted into natural logarithms.

Recalling the hypotheses *H1* and *H2* illicit capital outflow is expected to increase with tax level and to reduce with institutional quality.

The results in Table 3 support both the hypotheses. Column I and Column II indicate that illicit capital outflow is lower in context with better institutional quality and increases with tax level. Column III shows that these results are robust to the inclusion of macroeconomic controls and to country characteristics. In Column III the estimations suggest that to a 1 point scale increase in institutional quality, corresponds a decrease in illicit capital outflow of about 72%. Still, an increase of 1% in tax

level is significantly correlated to an increase in illicit capital outflow of 9.1%.

4. Conclusions

Empirical evidence supports the hypotheses that illicit capital outflow increases with tax level and reduces in contexts with higher institutional quality. Our results, however, require considerable caution especially due to the small sample size. We mitigate this problem by using cluster-robust covariance estimators to deal with heteroskedasticity and non-equicorrelated errors over time, as in Andriani (2014) and Cameron and Trivedi (2005). Additionally, both bivariate and multivariate regressions seem to provide very similar findings. We strongly believe that our study should encourage a more consistent analysis focusing on developing and emerging economies. The use of data at the industry level along with macro data would conduct a more robust and sophisticated analysis able to capture the relationships between micro and macro dynamics, essentials for appropriate policy recommendations.

Nevertheless, in light of our empirical evidence, possible speculations can be expressed towards the importance of improving the institutional framework in the emerging economies and not only.

Illicit Capital Outflow has been at forefront of international agenda during recent years. Peter Gillespe (2012) estimates that every additional dollar in debt service means 29 cents less spending on public health and each $40,000 reduction in health expenditures translates into an additional infant death. Curbing the ICO is essential in the process of raising development indicators and tax evasion accounts for substantial part of that problem. The case of tax avoidance by multinationals provoked public outrage and surfaced at the G8 meeting creating a platform for a multilateral dialog. One of the outcomes of the meeting was to stress the importance of combating illicit capital outflow by increasing international cooperation and bringing more transparency into trade. Enhanced international cooperation would encourage the exchange of information between the countries and reduce the information asymmetries existing between countries and multinationals. To this purpose, a strategy of more consistent coordination actions could improve international and domestic regulations. In fact, evidence points out that the offshore tax heavens are the final destination only for part of the funds, remaining ends up on the bank accounts of the developed countries (Gillespe, 2012). Institutional quality is one of the main instruments that can mitigate illicit flows. Improvements in institutional quality should be considered not only at the domestic level but also and consistently at the supranational one. The consolidated political effort should lead towards confrontation of the tax heavens as well as towards the enforcement of Tax Information Exchange Agreements (TIEAs) and mutual legal assistance treaties (Reuter, 2012, p. 284).

Acknowledgements

References

Andriani, L. (2016). Tax Morale and Pro-Social Behaviour: Evidence from a Palestinian Survey. *Cambridge Journal of Economics*, *40*(3), 821-841. https://dx.doi.org/10.1093/cje/bev019

Andriani, L., & Sabatini, F. (2015). Trust and Prosocial Behaviour in a Process of State Capacity Building: The Case of the Palestinian Territories. *Journal of Institutional Economics*, *11*(4), 823-846. https://dx.doi.org/10.1017/S1744137414000575

Andriani. (2014). Is Acting Prosocially Beneficial for the Credit Market? *Review of Social Economy*, *72*(3), 354-378.

Azémar, C. (2008). *International Corporate Taxation and U.S. Multinationals' Behaviour: An Integrated Approach* (Discussion Paper (August)). Department of Economics, University of Glasgow, Glasgow.

Baker, R. W. (2005). *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System Wiley & Sons, New Jersey*.

Bartelsman, E., Roel, M., & Beetsma, W. (2003). Why pay more? Corporate tax avoidance through transfer pricing in OECD countries. *Journal of Public Economics*, *87*(9-10), 2225-2252. https://dx.doi.org/10.1016/S0047-2727(02)00018-X

Baumol, W. (1990). Entrepreneurship: Productive, Unproductive, and Destructive. *Journal Of Political Economy*, *98*(5), 893-921. https://dx.doi.org/10.1086/261712

Bretschger, L., & Hettich, F. (2002). Globalisation, capital mobility and tax competition: Theory and evidence for OECD countries. *European Journal of Political Economy*, *18*(4), 695-716. https://dx.doi.org/10.1016/S0176-2680(02)00115-5

Cameron, C., & Trivedi, P. K. (2005). *Microeconometrics. Methods and Applications*. Cambridge: Cambridge University Press. https://dx.doi.org/10.1017/CBO9780511811241

Campbell, J. (2007). Why Would Corporations Behave in Socially Responsible Ways? An Institutional Theory of Corporate Social Responsibility. *Academy Of Management Review*, *32*(3), 946-967. https://dx.doi.org/10.5465/AMR.2007.25275684

Casson, M., Giusta, M., & Kambhampati, U. (2010). *Formal and Informal Institutions and Development, World Development*, *38*(2), 137-141. https://dx.doi.org/10.1016/j.worlddev.2009.10.008

Cerra, V., Rishi, M., & Saxena, S. (2008). Robbing the Riches: Capital Flight, Institutions and Debt. *Journal of Development Studies*, *44*(8), 1190-1213. https://dx.doi.org/10.1080/00220380802242453

Clausing, K. (2003). Tax-motivated transfer pricing and US intrafirm trade prices. *Journal of Public Economics*, *87*(9-10), 2207-2223. https://dx.doi.org/10.1016/S0047-2727(02)00015-4

Crotty, M. (1998). *The foundations of social research: Meaning and perspective in the research process* (pp. 368-369). Los Angeles; London: SAGE.

Dabla-Norris, E., Gradstein, M., & Inchauste, G. (2008). What causes firms to hide output? The determinants of informality. *Journal of Development Economics*, *85*(1-2), 1-27.

https://dx.doi.org/10.1016/j.jdeveco.2006.05.007

De Boyre, M. E., Pak, S., & Zdanowicz, J. S. (2004). Money Laundering and Income Tax Evasion: The Determination of Optimal Audits and Inspections to Detect Abnormal Prices in International Trade. *Journal of Financial Crime*, *12*(2), 123-130. https://dx.doi.org/10.1108/13590790510624972

Forte, F. (1987). The Laffer Curve and the Theory of Fiscal Bureaucracy. *Public Choice*, *52*(2), 101-124. https://dx.doi.org/10.1007/BF00123872

Friedman, M. (1970). The Social Responsibility of Business Is to Increase Its Profits. *New York Times Magazine*, *33*(September 13), 122-126.

Gillespie, P. (2012). Why Africa Stays Poor: Continent bled by corrupt leaders and illicit capital flight. *CCPA Monitor*, *18*(8), 33.

Global Financial Integrity. (2016). *Average Annual Illicit Financial Outflows*. Washington D.C.: Global Financial Integrity. Retrieved August 6, 2016, from http://www.gfintegrity.org/issues/data-by-country/

Gray, D. (2004). *Doing Research in the Real World* (3rd ed.). University of Greenwich, London: Sage UK.

Grubert, H., & Mutti, J. (1991). Taxes, tariffs and transfer pricing in multinational corporate decision making. *Review of Economics and Statistics*, *68*, 285-293. https://dx.doi.org/10.2307/2109519

Grubert, H., & Slemrod, J. (1998). The effect of taxes on investment and income shifting into Puerto Rico. *Review of Economics and Statistics*, *75*, 365-373. https://dx.doi.org/10.1162/003465398557609

Harris, D. G. (1993). The impact of US tax law revision on multinational corporations, capital location and income-shifting decisions. *Journal of Accounting Research*, *31*(Supplement), 111-140. https://dx.doi.org/10.2307/2491167

Hines, J. R. (1991). The Flight Paths of Migratory Corporations. *Journal Of Accounting, Auditing & Finance*, *6*(4), 447-479.

Hines, J. R. (1999). Lessons from Behavioral Responses to International Taxation. *National Tax Journal*, *52*(2), 305-322.

Hines, J. R., & Rice, E. M. (1994). Fiscal paradise: Foreign tax havens and American business. *Quarterly Journal of Economics*, *109*, 149-182. https://dx.doi.org/10.2307/2118431

Hung Chan, K., & Chow, L. (1997). An empirical study of tax audits in China on international transfer pricing. *Journal of Accounting and Economics*, *23*, 83-112. https://dx.doi.org/10.1016/S0165-4101(96)00445-4

Kaufmann, D., & Kraay, A. (2002). *Growth without Governance*. Washington D.C.: World Bank. https://dx.doi.org/10.1353/eco.2002.0016

Kenyon, T. (2007). Tax Evasion, Disclosure, and Participation, in Financial Markets: Evidence from Brazilian Firms. *World Development*, *36*(11), 2512-2525. https://dx.doi.org/10.1016/j.worlddev.2007.11.010

77

La Porta, R., Lopez-de-Silane, F., Shleifer, A., & Vishny, R. W. (1997). Legal determinants of external finance. *Journal of Finance*, *52*(3), 1131-1150. https://dx.doi.org/10.1111/j.1540-6261.1997.tb02727.x

La Porta, R., Lopez-de-Silane, F., Shleifer, A., & Vishny, R. W. (1998). Law and finance. *Journal of Political Economy*, *106*(6), 1113-1155. https://dx.doi.org/10.1086/250042

Mutti, J. (2003). *Foreign direct investment and tax competition*. Washington: IIE Press.

North, D. (1991). Institutions. *Journal of Economic Perspectives*, *5*(1), 97-112. https://dx.doi.org/10.1257/jep.5.1.97

OECD. (2014). *Measuring OECD Responses to Illicit Financial Flows from Developing countries*. Paris: OECD. Retrieved September 14, 2016, from https://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf

Reuter, P. (2012). Draining Development? *International Bank for Reconstruction and Development/International Development Association or The World Bank*. Retrieved September 6, 2016, from http://www.elibrary.worldbank.org/doi/abs/10.1596/978-0-8213-8869-3

Torgler, B. (2005). Tax morale and direct democracy. *European Journal of Political Economy*, *21*(2), 525-531. https://dx.doi.org/10.1016/j.ejpoleco.2004.08.002

Ulsner, M. E. (2004). *Trust and Corruption*. New Institutional Economics, London: Routledge. Retrieved September 6, 2016, from https://www.abo.fi/fakultet/media/23741/uslaner.pdf

Vu Le, Q., Paul, J., & Zak, J. P. (2006). Political risk and capital flight. *Journal of International Money and Finance*, *25*(2), 308-329. https://dx.doi.org/10.1016/j.jimonfin.2005.11.001

World Bank. (2016). *The Worldwide Governance Indicators (WGI)*. Washington D.C.: World Bank. Retrieved August 6, 2016, from http://www.info.worldbank.org/governance/wgi/index.aspx#home

World Bank. (2016). *World Bank Indicators*. Washington D.C.: World Bank. Retrieved August 6, 2016, from http://www.databank.worldbank.org/data/home.aspx

Notes

Note 1. The author emphasizes importance of the institutional constraints that regulate the behavior of the market players and points that the deregulation of the financial sector of US economy created the incentives and environment that allowed organizations to act in more socially irresponsible way.

Note 2. More technical details about the illicit capital outflow measures computed by the GFI are available in http://www.gfintegrity.org/issues/data-by-country/

Note 3. Notice that this variable is being provided for five out of six countries therefore it is only included in first part of analysis.