

ILLICIT FINANCIAL FLOWS AND CORRUPTION - THE ACTUAL MAJOR PROBLEM

Associate Professor Ph.D. Ivan LUCHIAN

International Institute of Management IMI-NOVA, Republic of Moldova

E-mail: luchian_ivan@mail.ru

Researcher Victoria IORDACHI

National Institute of Economic Researches, Republic of Moldova

E-mail: timush_v@yahoo.co.uk

Abstract: *Illicit financial flows represent a form of capital circulation at local and international level, forming the circulation of financial assets of dubious origin. Their generators are various multinational corporations, corrupt officials, tax evaders, criminal entrepreneurs, etc. Illicit financial flows have diverse forms, including capital flight, money laundering, informal flows and classified financial entities such as tax havens, coming from different areas - shadow economy, tax evasion, and corruption. Conducted studies have shown a strong bilateral link between illicit financial flows and corruption. Corruption generates illicit financial flows and contributes to legalization of illicit money by different money laundering schemes at local and international level. Studies also demonstrated the importance as a catalyst of the quasi-corruption phenomenon. Both corruption and illicit financial flows have a negative impact on economic development, especially in developing countries. With a high level of poverty, countries annually illegally lose financial resources that could help solve their internal problems. As an eloquent example, this article relates the case of the Republic of Moldova. Endemic corruption of systemic character has a destructive economic, financial and social influence in Moldova, favouring the illegal money exodus.*

Keywords: *illicit financial flows, capital circulation, capital flight, tax evasion, corruption, bank system.*

JEL Classification: *F21, F32.*

1. Introduction

Illicit financial flows have a negative impact on the economy, especially in developing countries, as they reduce tax revenues to finance public services that could have been invested in growth-driven reforms and social investment projects. Illicit financial flows also reduce foreign exchange reserves, thus inhibiting economic growth and the ability of nations to invest in infrastructure and business.

Another destructive impact that could be mentioned is that these flows impede the normal promotion of monetary and foreign exchange policy as they constantly influence the demand and supply of national and foreign currency on the domestic market, increasing inflation and destabilizing the exchange rate, as well as the currency reserves of the country. And in case of their amplification, illicit financial flows are transformed into financial crisis' factors for small economies.

In addition, as beneficiaries of illicit financial flows become richer, they can exert greater influence on policies in the countries in which they operate. This can reduce the ability of governments to adopt transformation policies. Illicit financial revenues reduce tax collection, cancel investments, undermine trade, aggravate poverty and increase income gaps.

2. The necessity of studying the problem

According to experts from the Global Financial Integrity, the estimated volume of illicit flows in 2014 ranged from 2 to 3,5 trillion USD (GFI, 2017). The total volume of illicit outflows of money from developing countries was estimated at 620 billion USD in 2014, while the illegal inflows from developing into developing countries reached more than 2,5 trillion USD (Spanjers and Salomon, 2017).

The combined volume of illicit financial flows from 2005 to 2014 amounted to 14,1% -24,0% of the total amount of trade in developing countries for that period. The annual growth rates of these flows were between 8,5% and 10,1% over the period (GFI, 2017).

At the same time, in 2014, outflows oscillated from 620 to 970 billion USD, while the inflows – from 1,4 to 2,5 trillion USD (GFI, 2017).

The problems of illicit financial flows are amplified by the corruption phenomenon, which statistically can be argued by the following data:

- According to the calculations made by Tax Justice Network, in 1998-2013, shadow economy representatives together with corrupt officials appropriated and washed about 25 trillion USD. This amount, on which the global financial oligarchy is parasitizing, registers about 50% of the global GDP.

- According to the World Bank calculations, corruption evades from 10% to 30% of the money, which is allocated to finance large investment projects around the world. The study conducted in 127 countries has shown that every seventh operation has become the object of money-laundering schemes. Generally, bribery, abuse of service mandates, theft, and clientelism annually lead to a loss of 3,1 trillion USD, which represents 5,1% of global GDP (Le Bushe, 2016) .

- UN studies show that the global economy's losses due to corruption amounted to 2,6 trillion USD. At the same time, IMF specialists have estimated the total amount of bribes paid in 2015 in a volume of 1,5 - 2 trillion USD, which accounts for around 2% of global GDP.

- In the developing world, the annual amount of bribes received ranges from 20 to 40 billion USD, which represents about 15-30% of the World Bank's official development assistance (OECD, 2014).

- About 15% of global GDP circulates annually through public contracts between the Government and the private sector, and according to international statistics, corruption costs would represent around 20% to 25% of the procurement budget.

- Corruption along with economic crime is becoming an increasingly powerful means of redistributing property and capital, including those of criminal and shadow origin. Economic losses caused by corruption amount between 5% and 50% of some countries' GDP. For example, in Russia these losses amount about 20 billion USD per year. Russia's law enforcement bodies say that criminal structures in some branches (oil, gas, rare metals) spend up to 50% of their profits for bribing civil servants.

All these mentioned facts determine the importance of studying the phenomenon of synergy between illicit financial flows and corruption.

3. Essence of illicit financial flows

Illicit financial flows are illegal movements of money or capital from one country to another. GFI classifies this movement as an illicit flow when the funds are illegally earned, transferred, and/or utilized (GFI, 2017). These flows may involve some gains through legitimate means, such as the profits of a legitimate business, but the money is transferred abroad without being subject to taxation. Illicit outflows are generally provoked by deficiencies in governance, political instability and corruption.

Reed and Fontana (2011) differentiate the following cross-border illicit flows:

- *Informal flows.* Not all informal flows are illicit. Many cross-border flows are transferred in form of legitimate remittances sent home by workers from abroad via unofficial bank systems. Such systems are frequently used due to their simplicity in operating, difficulties faced by people in opening bank accounts or

because the beneficiaries of these flows do not have bank accounts (McCusker, 2005).

➤ *Capital flight.* The term "capital flight" is often used as a synonym for illicit flows. However, capital flight is generally understood as fundraising abroad to ensure a better return or to protect revenues often in response to an unfavourable event or climate in the country of origin. The transfer of funds may be legal or illegal (Kant, 2002). The first, for example, occurs where an investment fund transfers assets from domestic government bonds to safer government bonds in another country, the capital flight will be recorded in the registries of the transferring entity, and the related payments investment can be returned to the country of origin. The illegal withdrawal of capital tends not to be registered and usually comes from illegal activities - illicit flows.

➤ *Money laundering* is a process of disguising the source of income derived from crime to make it appear legal. Money laundering is a specific legal concept that only includes the income of a set of criminal offenses that are defined by the laws of a particular country. Money from other offenses cannot be considered as the object of money laundering in that country, although these funds could be illegal in essence. This is important from a practical point of view because the money laundering regimes suffer from the fact that the range of offenses that can be based on money laundering varies from one country to another and does not always include corruption and tax evasion. Otherwise, the fight against illicit flows and money laundering might tend to encourage over-reliance on anti-money laundering to combat illicit flows.

➤ *Illicit financial flows related to offshore jurisdictions*, which mean legal jurisdictions that ensure the secrecy of entities that do not actually operate in their own space (Murphy, 2009). The secrecy is ensured by a series of regulations for entities that do not normally physically reside in the jurisdiction itself. These include laws that allow a low level of transparency in the establishment and accounting of corporate entities, the creation of trusts whose real beneficiaries remain anonymous, zero or low tax rates and minimal exchange of tax information with other tax jurisdictions, banking secrecy and barriers to trade information in criminal matters. Reduced or zero tax rates are not the only attraction of such locations, especially for the laundering of corruption revenues. Often the obscurity of property associated with these jurisdictions is the most appealing feature for their clientele. In this context, the notion of *quasi-corruption* is used - an activity to create conditions and contribute to the increase of the economic efficiency of the traditional corruption activity. The basic peculiarity of quasi-corruption is the catalysis of crisis processes within economic systems. Also, an important feature of quasi-corruption is the complexity of its discovery by traditional methods, as it is not related to direct and immediate cash flow relationships, although ultimately it generates illicit cash flows in the financial process redistribution within the criminal world.

The researcher Peter Reuter (2017) has distinguished groups of people who usually are engaged in activities, which generate illicit financial flows:

(1) *Multinational corporations.* Studies have shown a direct relation between corrupt behaviour, lobbying and abusive transfer pricing behaviour and the activity of multinational corporations in developing countries in lower tax jurisdictions.

(2) *Corrupt officials.* They can get bribes through various activities, such as the charging of rights that should be freely available, improper assignment of contracts, extortion for failure to apply appropriate criminal sanctions. Some authors assume that

only high-ranking corrupt officials receive illicit income that is sufficiently important to merit the transfer of funds abroad.

(3) *Tax evaders*. Activities that generate financial flows are legal. Illegality is exclusive to hiding them for tax purposes. Tax evaders may be individuals or private companies.

(4) *Criminal entrepreneurs*. Drug traffickers, smugglers and illegal entrepreneurs on the market can generate large incomes. There is a reasonable question if they generate financial outflows from developing countries as important as illegal inflows because most of their revenue is generated in high-priced markets.

4. The ratio between illicit financial flows and corruption

Illicit financial flows constitute an important part of *the illicit (shadow) finances*, which represent the totality of economic relations related to the formation, distribution and redistribution of money between different economic subjects, which are not reflected in the official statistics, are not controlled by the Government, are hidden and geared towards meeting the economic interests of some groups of economic subjects or politicians.

Shadow finances comprise:

◆ *Grey finances* based on legal transactions, but with some illicit forms in their performing (for example tax evasion, hiding undeclared revenues, barter);

◆ *Extra-legal finances*, which are not covered by legal rules, not reflected in official statistics and proven from activity that is not accounted in reports and contracts. On the other hand, this may be the activity that violates the rights of other economic agents and is not regulated by legislation - financial pyramids, the lobbying of certain economic agents, the concealment of important economic information (for example, limiting the number of participants within public acquisitions and so on);

◆ *Fictitious finances*, for example, related to mistakes about state order, public procurement, and the reflection of non-existent activity in financial reports;

◆ *Criminal finances* related to financial results of activity that is prohibited by legislation.

Between illicit financial flows and corruption a bilateral connection is attested. On the one hand, corruption activities generate illicit financial flows. On the other hand, corruption occurs at the stage of legalizing illegally obtained means. Bribing, trafficking, and misappropriation may compromise the functioning of anti-money laundering schemes.

Corruption is related to money laundering in one of the following ways:

• *As a source of income (for example, in the form of bribes) that constitute illicit funds to be washed*. There is a great deal of evidence about the extent of embezzlement of public resources in developing countries. A common denominator of these cases is how illicit proceeds of corruption have been channelled into bank accounts in foreign countries, usually jurisdictions with a high level of banking secrecy, and in all cases large sums of money have been recovered after having left power. Fighting illicit flows clearly has potential in addressing corruption at this level.

• *As means of facilitating illicit funds' creation, through the corruption of tax administrations, so that they ignore tax evasion or other financial obligations*. The most obvious example is where a tax administration official receives a bribe to make either a "favorable" interpretation of tax regulations that lowers the tax burden on a person / company or fails to recognize direct tax evasion.

• *As means of allowing an illicit flow as such through the corruption of institutions with anti-money laundering obligations*, for example, where the anti-money laundering entities collaborate with clients in failing to fulfil these obligations (for example, a bank officer does not notify suspicious transactions to competent authorities because he receives

bribes from persons involved in activities that generate illicit funds or where financial investigation units are prevented from fulfilling their role and are compromised by politicians (for example, they are not independent sufficient legal powers or resources), implying that the political system itself suffers from a systemic problem of spreading corruption.

An important issue is the detachment of illicit financial flows generated by legal tax evasion activities, through which the taxpayer circumvent the law by resorting to an unforeseen contribution in the law and thus the activity being tolerated or even unobserved. This form of evasion is possible when the law is incomplete or inadvertent. It occurs when a certain part of the income or wealth of some persons or social categories is evaded from taxation due to the way in which tax legislation sets the establishment of the taxable object. Taxpayers find certain means and by exploiting the legal shortcomings they "legally" circumvent the tax provisions, wholly or partially avoiding the payment of taxes, precisely because of this insufficiency of legislation.

In some countries, like the Republic of Moldova, the possibilities of legal tax evasion are deliberately created in the interest of certain individuals or corporate groups, either as a result of political corruption or because of the desire of tax administration representatives to provide legal management of the tax burden against corrupt remuneration. Fiscal amnesties are also attributed to this category if they are carried out as a result of the political order, and they are capable of substantially damaging tax discipline among taxpayers. In their expectation, taxpayers no longer pay taxes, but use state money for their personal purposes, and the public finance system loses the capacity to obtain them.

6. The problem of illicit financial flows and corruption in Moldova

Between 2004 and 2013, the volume of illicit capital flows in our country registered 9,1 billion USD, according to the study "Illicit Financial Flows in Developing Countries: 2004-2013", conducted by the Global Financial Integrity (GFI) research and consultancy in the United States. In 2014, GFI estimated 1,1 billion USD as the total volume of illicit financial outflows from the Republic of Moldova (GFI, 2017; Spanjers and Salomon, 2017).

Thus, according to the rating of Global Financial Integrity (2015), Republic of Moldova ranked 77th among 149 countries in terms of the volume of illegal flows withdrawn from national economy.

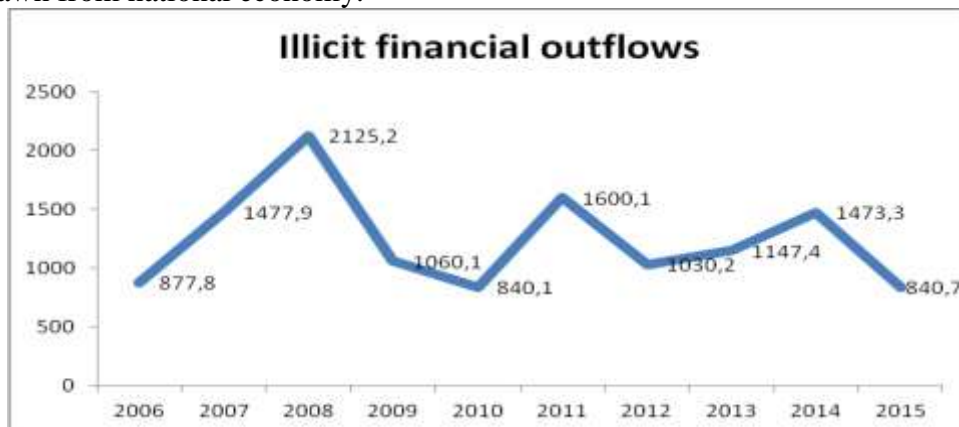


Figure no. 1. The volume of illicit financial outflows from the Rep. Moldova, in million USD (current prices)

Source: calculated by authors in base of data from www.nbm.org

According to data from the National Balance of Payments of Moldova, the largest cross-border outflows containing shadow components and which are affecting the country's macroeconomic indicators are generated by the following items: Net exports of services; remuneration of employees; investments from revenues; secondary revenues; net acquisition from financial assets. Data on the total volume of illicit financial outflows are given in Figure no. 1.

In the Republic of Moldova the phenomenon of capital flight can be produced both legally and illegally. ***Within the official export of capital, government receives a certain income, and reinvestment of profits also occurs. But within an illegal outflow of capital, the country does not receive any income.*** Alongside with the illegal export of capital from Moldova, there is a counter-movement (illegal inflow of capital) from other countries: for the purpose of penetrating into industries with a rapid turnover of capital and enterprises where it is most easy to avoid paying taxes; money laundering and their use within the privatization of the public sector of the economy; access to cheap sources of labour (Iordachi, Petrova and Clichici, 2017).

There are two important sources of illicit financial flows in the Republic of Moldova: the shadow economy and corruption.

In the Republic of Moldova, the share of the shadow economy in GDP in 2000 (34.6%) decreased in 2007 (20.6%), then in 2008 - 2011 it was almost at the same level - about 22%. In 2013, it stopped at 23.1%. In the first half of 2014 the share of the shadow economy in GDP increased till 24.6%. Traditionally, in the shadow segment the first place is held by agriculture - 60% (it is to mention that previous years it reached 76% and even 84%), the second position is represented by hotels and restaurants - 42% and the third place - trade - 30%.

The shadow economy generates large amounts of cash payments. Thus, in 2009 the volume of cash was 6,5 billion Lei, which practically tripled - to 18 billion Lei. Currently, it has been reduced to more than 15 billion Lei, in connection with the events on the money market (the National Bank of Moldova tightened monetary policy), but it is still high.

In the Republic of Moldova tax evasion is also an important problem. Thus, tax evasion accounts for 33% of GDP, which is equivalent to 40 billion Lei or over 2 billion Euro. And the smuggling of goods through Transnistria, which is considered the black hole of the Moldovan economy, leaves the budget without estimated revenues of over 1 billion Lei. It is, to a certain extent, related to the existence of corruption, which also generates significant illicit financial flows.

The investigation conducted by Transparency International - Moldova has shown that in 2014 the total amount of bribes paid exceeded 1.27 billion Lei, which is or more than 1.1% of GDP. Households paid bribes in the amount of 899 million Lei, and the representatives of the business community - 387 million Lei. Thus, the annual losses to the Republic of Moldova from corruption in 2016 amounted to between 8% and 13% of GDP or about 11.8-17.7 billion Lei.

The direct losses of the public finance system (or the respective annual income of the corrupt individuals) in 2016 constituted 1.1% - 2% of GDP or 1,5 – 2,7 billion Lei. Thus, the direct losses due to corruption constituted 3.1% - 5.6% of the National Public Budget.

Considering the fact that the acquisitions' value in Moldova reached nearly 7,6 billion Lei in 2016, the estimated corruption costs in public acquisitions reached 1,5 billion Lei.

According to a statement made by the former head of the National Anticorruption Center, Viorel Chetaru, made in the Parliament of Moldova in December 2015, during 2015, the total volume of the bribes reached 860 million Lei (in 2014 - about 891 million

Lei). However, according to some experts, this sum includes only real static amounts that have been detected, so the real volume is much higher. Thus, according to the approximate calculations, the annual volume of corruption expressed in Lei would reach at least 10 percent of GDP, being more pronounced in the last 3 years. The volume of corruption, based on the experts' estimates during 2009-2016 reached about 28-30 billion Lei.

During 2009-2015 there was an amplification of the phenomenon of quasi-corruption within the legislative and regulatory bodies of the Republic of Moldova, manifested through *the degradation of the banking supervision system, including the approval and the amendment of some legislative acts by the central authorities of the Republic of Moldova, which has resulted in the attraction of the banking system to international money laundering schemes.*

In 2013 information in mass media sources was disseminated on the involvement of Moldova-Agroindbank in money laundering schemes. Only in the first half of 2012 Moldova-Agroindbank carried out money laundering operations in the amount of about 100 million Lei, being penalized only by 100 thousand lei.

During 2012-2014 the domestic bank system was a transit zone of financial flows from the CIS countries towards the rest of the countries, most towards the EU. Also, during the mentioned period inflows from CIS countries were 35 times higher than outflows to this region.

In 2013, inflows to the banking system of the Republic of Moldova amounted to 65.5 billion USD, being in parity with the outflows, while in 2015 decreasing by 10% and in 2016 these flows reduced till 30.4 billion USD.

The passive attitude of the central authorities, the existence of administrative uncertainties in the application of anti-money laundering legislation, and corruption in the judicial sphere have allowed the Moldovan banking system to be transformed into a money-laundering machine.

In this context, international money laundering schemes have been remarked, with the common name "Laundromat", with the participation of Moldindconbank, where through the clients' accounts nearly 8 billion USD were transferred. Also, in 2016 it was found that the controlling stake of this bank was owned by a certain group of dubious shareholders who were acting as a whole (RISE Moldova, 2017).

Generally, the *Laundromat* provided a total amount of 21 billion USD from Russia, which was washed by phantom companies and legalized by Judicial Judgments in the Republic of Moldova. All these schemes were performed during 2011-2014, being involved 732 banks from 96 countries and 5000 companies, which received money. It is also to mention that during the mentioned period the efficiency of supervision authorities' activity essentially decreased, thus allowing the banks' capturing by the dubious investors.

In 2011, the first information about the attempt to take over a 28% stake from Moldova-Agroindbank and its transfer to off-shore companies, following a fake, arbitrary dispute in Russia, appeared. Also, off-shore companies tried to force 78% of Universalbank shares and 5% from Victoriabank.

In 2012, a raider attack took place over the Banca de Economii a Moldovei (BEM), after which 18.5% of shares were transferred to other owners. During September 2012 and September 2013, forced and accelerated decapitalisation of BEM took place, directed by certain decision-making centres, aiming to determine the state to surrender control over BEM. In September 2013, the state illegally surrendered the majority package free of charge, through a scheme that was imposed outside the country. This resulted in the BEM's involving in the regional laundry room of financial resources, that have been embezzled by budget funds in Russia. In 2014, a stronger core of the scheme took place, with the handing over of a significant package of shares to influential groups in the

Russian Federation (partly made by ceding the first 25% of BEM shares from VEB Kapital).

After that, the equivalent of one billion Dollars was stolen through dubious currency schemes and transactions conducted at BEM, Unibank and the Social Bank. This was possible since in June 2014, in the absence of special supervision established by the National Bank of Moldova at BEM, the aggressive attraction of bank deposits from the population with the highest interest rates offered in the banking system and the subsequent request of emergency credits from the NBM. At the same time, in July and September 2014, the banking and financial legislation was amended, and by granting the Government guarantee, legal premises for emergency lending by the NBM to commercial banks in difficulty were created. Subsequently, in November 2014, in a secret meeting, the government decided to allocate 9,6 billion Lei from the NBM to BEM, the Social Bank and Unibank. According to banking experts, this decision contravenes legislation, as no authority has been set up to declare crisis situations and the crisis has not been formally announced.

On September 26th, 2016, by taking responsibility, the Government of the Republic of Moldova decided to convert the debt created as a result of bank fraud into state debt, which had the following consequences:

- Tripling the domestic state debt from 7.2 billion Lei at the beginning of 2016 to over 22 billion Lei by the end of 2016;
- Budgetary costs of extinction and service of the 13.34 billion Lei in a total amount of 25 billion Lei over the next 25 years.

We have recently witnessed legal measures to penalize participants in money laundering schemes. At the same time, however, it must be recognized that *the process of recovering stolen assets is very difficult, and the central authorities obviously delay the penalization of all persons who are responsible as a result of bureaucratic-administrative measures*. On the other hand, it is to mention the legislative efforts that have been made during 2015-2017 regarding the de-offshoring of the banking sector.

7. Conclusions and recommendations

➤ The most damaging effects of illicit flows related to corruption cannot be captured solely in numerical or financial terms. An appropriate analysis of the phenomenon of cross-border capital movement, including shadow components, in national statistical practice should not be seen only as a methodological or technical issue, it should be a key factor in improving the quality of the macroeconomic and forecasting analysis in improving the efficiency of regulating the capital movement.

➤ Corruption related to illicit financial flows can cause political and social instability, even damage, through undermining state institutions - banks, other financial centres, the police, and the judicial system and in such a way creating further impediments to investigate these flows and combat the phenomenon. In time, fiscal institutions also contribute to corruption by maintaining the power of corrupt political and economic elites.

➤ Without significant anti-corruption measures on national levels, the Republic of Moldova will continually expose itself to the risks of corruption and illicit financial flows. It is necessary to create efficient Financial Intelligence Centres and anti-corruption bodies to combat the corruption phenomenon and limit illicit financial flows. Other measures that would be appropriate to be implemented in Moldova are:

- ⇒ Training staff in the relevant public sector authorities to promote the technical skills needed for investigation capacity to tackle economic crimes.
- ⇒ Supporting institutions and business community to build political commitment.

- ⇒ Conducting risk assessments to identify the largest source of illicit financial flows to be able to stop or reduce funds that fuel it.
- ⇒ Strengthening the anti-money laundering mechanisms and institutions to prevent illicit flows from leaving their financial systems in the first place.
- ⇒ Improving the information sharing with other jurisdictions and institutions to encourage and support the Government's efforts of investigating corruption and managing returned assets.

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