1. Capital Flight and Capital Controls in Developing Countries: an Introduction

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WHY CAPITAL FLIGHT?

This book concerns capital flight in developing countries: How big is it? What causes it? How are we to interpret it? What are its effects? What can be done about it? The core of the book consists of seven case studies of capital flight from developing countries (Brazil, Chile, China, South Africa, Thailand, Turkey and a set of Middle Eastern and North African countries) connected by a common methodology used to estimate capital flight. These case studies are sandwiched between several chapters, including one debunking the myth that capital account liberalization is necessarily good for economic growth and income distribution, and several chapters at the end that offer some solutions to the problem of capital flight that affects so much of the developing world. This chapter briefly introduces the book.

First, however, is the matter of definition. When people hear the term 'capital flight' they think of money running away from one country to a money 'haven' abroad, in the process doing harm to the home economy and society. People probably have the idea that money runs away for any of a number of reasons: to avoid taxation; to avoid confiscation; in search of better treatment, or of higher returns somewhere else. In any event, people have a sense that capital flight is in someway illicit, in someway bad for the home country, unless, of course, capital is fleeing unfair discrimination, as in the case of the Nazi persecution. These commonsense ideas are also roughly what we mean by capital flight. It turns out, however, that it is quite difficult to transform this commonsense meaning into rigorous, economic definitions, data and analysis. (See Beja, Chapter 3, for an extensive discussion of this issue.)

There will be much discussion in what follows about the proper definition of capital flight, and, indeed, whether the term can be usefully defined at all. For now, though, we will define capital flight this way:[1] capital flight is the transfer of assets abroad in order to reduce loss of principal, loss of return, or loss of control over one's financial wealth due to government-sanctioned activities. Fears of wealth confiscation, increases in taxes on wealth or the

imposition of regulations that limit the prerogatives of wealth holders are examples of the types of government activities we have in mind. Hence, capital flight consists of international capital flows that are trying to escape government controls or the consequences of government policies. From this perspective one can immediately see an important theme running throughout this book: capital flight is an inherently political phenomenon involving the role of the government and the prerogatives of those – usually the wealthy – with access to foreign exchange. As a result, the issue of capital flight necessarily involves the political economy of class power, conflict and the state.

This definition, however, immediately raises a fundamental problem: since the definition involves the motives for capital outflows, it is inherently difficult, if not impossible, to measure accurately, given the obvious difficulty economists have in identifying actors' reasons for engaging in certain activities. For that reason, we have to use a proxy for capital flight, an imperfect measure that captures as much as possible the phenomenon we are trying to understand. Indeed, one of the unique contributions of this book, described in more detail below, is that the case studies develop a common measure of capital flight across a number of countries, facilitating comparisons across time and space.

The measure we will use – the residual measure – tries to calculate unrecorded net outflows of capital from developing countries.[2] The use of unrecorded flows captures the notion that, by our definition, capital flight involves the attempt by wealth holders to avoid government policies. Apart from purely technical or logistical issues of data collection, if the wealth holders were not trying to avoid government policies, then presumably they would not engage in capital flows that would be unrecorded. Of course, there might also be cases where wealth holders are motivated by the desire to avoid the effects of government-sanctioned policies and send funds through recorded channels. So, in some cases, capital flight will consist of recorded and unrecorded outflows. We, however, calculate capital flight using only unrecorded outflows. Therefore, it is important to understand that our measure, based on unrecorded flows, is a minimum estimate of capital flight. It is a floor on the likely degree of capital flight occurring in the episodes we study.

In some cases, the difference between our minimum estimates and the likely actual amount of capital flight might be substantial. For example, if one is evaluating an episode in which capital flees abroad because the central bank is trying to lower interest rates to generate more employment, and there are no or very laxly-enforced capital controls, then virtually all net capital outflows, measured or not, constitute capital flight by our conception. Where capital controls are tight, then the unmeasured flows will capture the bulk of the capital flight. In short, in some cases, all capital outflows are capital

flight. In others, unrecorded outflows are the best measure.

This suggests that the correct measure of capital flight is likely to vary by episode and raises the question as to whether it is really meaningful to adopt one approach to measuring capital flight for a broad range of countries as we have done here. Of course, there are trade-offs associated with any decision about uniformity in order to enable comparisons across countries, versus idiosyncratic measurement, which makes it difficult to make comparisons but delivers more precise measures for each country. We have chosen the uniformity approach in this book under the hypothesis that much can be learned from these comparisons. (See also Schneider 2003.)

Why Study Capital Flight?

The question remains, why should we study capital flight? We argue in this book that capital flight is important because it can have significant social costs; it is also a barometer of the sovereignty of government policy versus that of class privilege and it relates to the impacts of important economic policies such as financial liberalization. We address all these issues, in different ways and to different degrees, in the chapters that follow.

Social Costs

Capital flight has been both sizeable and costly in many developing countries in recent decades. The estimates in our case studies suggest that capital flight has ranged from less than 1 percent of GDP in Iran to over 60 percent GDP in Kuwait, for example. Capital flight can be costly where capital or foreign exchange is scarce, as is often the case in developing countries. The loss of scarce capital and foreign exchange potentially leads to a loss of investment in countries that are in great need of more infrastructure, plant and equipment, and human capital. Since capital is likely to be more scarce in developing countries than in developed ones, social returns to investment in many developing countries are likely to be higher at home than abroad.

In poor countries, the marginal social benefits of investment are likely to be considerably higher than the private benefits, at least in those cases where the economy functions reasonably well. On the other hand, if wealth holders take capital abroad, then presumably they have calculated that the private returns are higher abroad. This divergence between social and private returns will be especially significant where capital flight accompanies increases in foreign borrowing. In that case the society is incurring foreign debt not to increase domestic investment which could create jobs and raise productivity at home, but, rather, to enrich people abroad. As Boyce and Ndikumana show (see Chapter 13) in these cases, and often at the behest of the IMF, paying foreign debt service will likely involve cuts in social

spending or increases in taxes on the poor to make up for the scarce foreign exchange that is fleeing through capital flight. This can have serious social costs in terms of forgone consumption, and social investment by those who are most needy or most productive.

As this last example suggests, the efficiency costs of capital flight are likely to be accompanied by other costs. As our definition of capital flight suggests, capital flight is often fleeing perceived increases in taxation, or increased control over private wealth. Thus, capital flight is likely to have negative impacts on equality, with wealthy citizens escaping higher taxation, or lower after tax returns at home, while poorer citizens face higher taxation and cuts in social services. In addition, if capital flight contributes to financial crises, it can impose further costs in the form of unemployment and slower economic growth. Like the costs of capital flight itself, these crises often impose disproportionately high costs on the poorer members of society. With capital flight induced financial crises, then, capital flight imposes a double whammy on the poor (Jayadev and Lee, Chapter 2). Moreover, among the poor, it is often the most vulnerable – often women and children – who bear the greatest burden.

‘Capital Strike’ and the Prerogatives of Wealth

These economic costs of capital flight provide sufficient reason to study the subject. Still, they do not exhaust the rationale for this book. For as I said earlier, capital flight is an inherently political phenomenon replete with issues related to the state, class and conflict. This becomes clearest when one considers that capital flight can be a powerful political weapon against government policies that threaten the wealth or the prerogatives of the rich. In this role, capital flight has sometimes been called ‘capital strike’ evoking the idea that capital as a class goes on strike against undesired taxation or regulatory policies (Crotty 1993; Crotty and Epstein 1996). In this regard, capital flight raises large and important issues of political economy. When does the sovereignty of capital undermine the sovereignty of the state? To what extent has financial ‘globalization’ undermined the ability of governments to implement economic policies that wealth holders oppose? What are the political, economic and distributional implications of this exertion of ‘one dollar, one vote’ as opposed to ‘one citizen, one vote’?

From this perspective, capital flight and policies to reduce them raise profound political questions. For libertarians, there can be no such thing as capital flight: private control of capital, as private property, is an inalienable right, and any movement of it, no matter what the purpose, is legitimate. For most others, however, the right of states to regulate private property for the common good is clear, and the real debate concerns matters of degree and circumstance. Within this latter framework, the differences, nonetheless,

remain significant. What some may see as capital flight undermining the sovereignty of governments to tax for legitimate and desirable social purposes, others may see as wealth holders teaching the government a useful lesson about the limits of government policy (see Lessard and Williamson 1987).

This issue arises in ways that are invisible to many: what if the government simply wants to lower interest rates to achieve full employment and wealth holders flee? Is that capital flight or a harmless portfolio decision? What impact will such 'capital movements' have on the ability of governments to make economic policy? From our perspective, such movements of capital do represent 'capital flight'. But our capital flight numbers provide a very conservative estimate of such movements: We will only identify these capital flows as capital flight if they are 'unrecorded'. Hence, apart from technical recording issues, we will only record that capital taken abroad in a hidden form, perhaps because it is illegal, or perhaps because it goes against social norms, or perhaps because it might be vulnerable to economic or political threat. Remember that our estimates provide minimum estimates of capital flight and might not pick up capital flight motivated by lower interest rates, except in the case where capital controls or other regulations would otherwise limit it.

Policy Impacts of Financial Liberalization

Interest in capital flight waxes and wanes. It was an important issue in the inter-war period (Kindleberger 1987) and, after a period of lying relatively dormant, then leaped to the fore with the traumatic 'Third World Debt Crisis' of the early 1980s. Dozens of articles and several books were published at that time, many of which demonstrated that in a number of countries, including Venezuela and Brazil, capital flight represented high proportions of increases in foreign borrowing (Lessard and Williamson 1987).

In the 1990s interest waned again, partly because it appeared that capital returned to several countries in which flight had previously been substantial. This return prompted a number of economists to conjecture that financial liberalization, and neo-liberal policies more generally, would lead to a repatriation of capital flight, and reduce further flight. Indeed, the notion that governments and policies more favorable toward large wealth holders would reduce capital flight is plausible. What this view missed, however, was the link between financial liberalization, financial crisis and capital flight. The Mexican, Russian and Asian Financial crises of the mid- and late 1990s, accompanied as they were by large amounts of capital flight, returned the phenomenon to the radar screens of economists and policy makers. Likewise, in this book, a matter of continuing interest will be precisely this nexus: what is the relationship between financial liberalization, financial

crises and capital flight? In view of the dominant neo-liberal advocacy of financial liberalization, this set of questions becomes a further reason to study capital flight.

THE BOOK

The book is divided into three sections. Part 1 sets the stage for the case studies with a chapter on the impacts of capital account liberalization on income distribution and growth, by Kang-Kook Lee and Arjun Jayadev; the other chapter, by Edsel Beja, Jr., gives an in-depth overview of various measures and definitions of capital flight and a detailed description of the methodology used in the case studies of this book. Part 3 of the book, with chapters by James Boyce and Léonce Ndikumana, Eric Helleiner and Gerald Epstein, Ilene Grabel and Sundaram Kwame Jomo present possible remedies for the capital flight problem including debt forgiveness in the face of capital flight, capital controls and international cooperation to identify and repatriate capital flight.

If Part 1 sets the context, and Part 3 elaborates on solutions to the problems identified, Part 2 contains the book's core: seven case studies on capital flight from developing countries. Using a common definition and the 'residual method' of capital flight calculation, these chapters measure and discuss capital flight from Brazil, Chile, China, South Africa, Thailand, Turkey and the Middle East. Overall, these countries represent a broad range of cases geographically and in terms of experiences. While they are all semi-industrialized countries, these cases represent five continents and a range of economic types, from fairly free market economies like Chile, to strongly state-guided countries like China.

Setting the Stage

This book concerns capital flight in the 1980s and 1990s, the period of the rise of neo-liberalism. Among its key tenets is the liberalization of financial markets, including markets for international capital. This obviously sets a particular stage for the dynamics of capital flows and capital flight. In Chapter 2, Kang-kook Lee and Arjun Jayadev present a survey and new evidence on two key issues related to capital account liberalization: the impact of capital account liberalization on economic growth and the impact on income distribution, in particular, the share of income going to labor. Using various cross-country econometric models and indices of financial openness (including one newly developed by them), they find little evidence that capital account liberalization has positive effects on growth. Capital account openness provides no significant stimulus to growth even in the

presence of typically proposed preconditions. By contrast, there is a persistent negative correlation between capital account liberalization and labor's share of national income, providing some support for the notion that labor's bargaining power is reduced when capital is more mobile.

Chapter 3 in this section, 'Capital Flight: Meanings and Measures' by Edsel L. Beja, Jr, is a comprehensive discussion and detailed presentation of the standard approaches to defining and measuring capital flight. This chapter not only presents important background information on the methods used by the authors of this book's case studies, but it will also be of great help to future researchers studying capital flight.

Case Studies: A Variety of Questions and Approaches

Although all the authors use the same methodology in deriving their quantitative estimates of capital flight, they ask a variety of questions about their estimates. Some of the chapters focus primarily on the determinants of capital flight while other chapters look at the impacts of financial liberalization. Others focus on political uncertainty and income distribution. Some chapters also investigate the costs of capital flight in terms of forgone output and investment. One author uses a comparative approach to understanding the deep structural determinants of capital flight. Yet another focuses primarily on the lessons that capital flight have to teach about class and political dynamics. Hence, one of the great strengths of this book is the common approach to measuring capital flight, combined with a richness of substantive discussions about the phenomenon.

The Cases

South Africa

Seeraj Mohammed and Kade Finnoff discover that capital flight in South Africa was relatively high, reaching, on average, almost 7 percent of South Africa's GDP. Paradoxically, there seemed to be more capital flight during the post-apartheid period, despite attempts by the government to adopt capital-friendly policies. The authors explain that distrust of government remains significant, and will likely stay so as long as inequality and poverty remain at high levels. Loosening of capital controls by the government has given wealth holders more opportunities for flight. The authors also suggest that the high levels of capital flight there may involve racial prejudice as well. Political and economic uncertainties are only part of the story. Mohammed and Finnoff argue that there are also structural factors involved: South Africa's mineral-based economy leads to highly concentrated wealth; this high concentration of wealth in a highly porous financial setting makes moving money offshore very easy.

Turkey

In their study of capital flight from Turkey, Anil Duman, Hakki C. Erkin and Fatma Gül Unal find that capital flight from 1971 to 2000 was comparatively low as a percentage of GDP (0.32 percent) but oscillated rather strongly (between 3 percent and 6 percent). The focus of their chapter is to identify the determinants of Turkish capital flight and explain the oscillations. The period between 1971 and 2000 was economically momentous for Turkey, with rather large changes in economic policy taking place during this period. Unlike a number of authors who have focused on net capital flight as being the most important measure of economic cost, Duman, Erkin and Gul Unal find that in the Turkish case it was the movements in and out that were most costly: they destabilized the Turkish economy and contributed to financial crises. They also find that, contrary to much mainstream writing, capital flight continued despite financial liberalization, a trend that was also observed in South Africa.

Thailand

Edsel L. Beja, Jr., Pokpong Junvith, and Jared Ragusett explore capital flight in Thailand from 1980 to 2000. They calculate that capital flight was very high in Thailand throughout most of the 20-year period, often over 10 to 15 percent of GDP in the 1990s. Indeed, they calculate that capital flight from Thailand has been so substantial that from 1985 on, Thailand has actually been a net creditor: there are more Thai-owned assets (capital flight) held abroad than Thai residents have borrowed from abroad. Of course, since this capital flight is hidden, this astonishing fact is not well known.

The authors study several other issues. They find that there is a link between capital inflows and capital flight: the more inflows there are, the greater the level of capital flight. They also find that financial liberalization and crises contribute to capital flight. In a new finding, they also discover that financial liberalization leads to greater volatility of capital flight. So, as in the Turkish study, it is not just the level of capital flight that is important, but also its volatility. Finally, the authors break new ground in this book by estimating the cost of capital flight in terms of forgone investment in the Thai economy: they find that the cost is large.

Chile

In 'A Class Analysis of Capital Flight from Chile, 1971–2001' Burak Bener and Mathieu Dufour focus on the political and power issues associated with capital flight, using capital flight as a lens through which to view the evolution of the political economy of Chile. As such they are not as interested in discovering the determinants of capital flight or in assessing the costs, as in the previously discussed chapters, but, instead, use capital flight as a window into the dynamics of class power in Chile during this

tumultuous period. They argue that since capital flight, at its core, is an attempt to evade social control over one's assets, they believe the conflict among different claimants on these assets, which is one aspect of the struggle for dominance among classes, to be an interesting focus for their analysis. In describing the history of Chile's political economy through the lens of capital flight, they identify four key factors that can help to explain capital flight from Chile: the extent of capital inflows, the state of domestic investment opportunities, capital controls and political risk. Using these factors, Bener and Dufour explain the ups and downs of capital flight from Chile. They find that economic crises and political instability contributed to a high level of capital flight, whereas the capitalist class preferred to stay in Chile as long as it felt secure and had good relations with the government.

Brazil

Deger Eryar's chapter on Brazil is important because Brazil was very highly in debt during the period under analysis, 1980 to 2001. Given its high foreign indebtedness, Brazil's capital flight clearly has costs in terms of lost foreign exchange needed to service debt. Eryar organized his analysis around different 'accumulation strategies' followed by the Brazilian authorities at various times. Many changes in strategy contributed to instability, which, Eryar argues, contributed to capital flight. Neo-liberal strategies of financial liberalization fared no better than other strategies. Eryar concludes by arguing that the only solution to capital fight is to generate more rapid economic development in Brazil. Like some of the other authors, he calls for the use of capital controls.

Middle East and North Africa

In this chapter, Abdullah Almounsor presents the first estimates of capital flight in Middle Eastern and North African countries. The analysis employs a development comparative approach to the countries of the region. In particular, it relates capital flight of each country to the model of development pursued. Resource-based industrialization states register the largest amount of capital flight, amounting to more than 273 billion of 1995 USD with accumulated interest earning capital flight of more than 935 billion of current USD. On the other hand, state-led development economies and balanced economies of the Middle East and North African (MENA) region show large negative capital flight of 102 and 112 billion 1995 USD, respectively. Capital flight under the first model is assisted by natural resource exporting rents, the capitalist orientation of most economies of the model and the monarchial character of most of their political systems. In contrast, capital flight under the last two models is driven by large negative trade misinvoicing and assisted by the inward-looking strategies of the two models, one-party or militarily controlled governments as well as the signifi-

cant capital controls characterizing the two models.

China

There have been numerous studies of China's capital flight, and Chunxiang Li, Andong Zhu, and Gerald Epstein present another one in this book. They find a similar pattern in capital flight found by other research, and, like others, find that it is extremely high, roughly 10 percent of GDP, and rather substantial relative to foreign direct investment (FDI). They discuss the interesting paradox that emerges from these findings: how can China have performed so brilliantly despite having such high levels of capital flight? Part of the answer is that a substantial amount of the capital fight is 'round-tripped', that is, it returns to China as foreign investment. The other part of the answer, emphasized by the authors, goes against the conventional wisdom, however. Whereas other authors blame the capital flight on government interference in the economy, including capital controls, the authors of this chapter suggest that it is government controls and management, including management of the capital account, that can help to explain massive Chinese economic growth, despite the high levels of capital flight. Fewer controls might have reduced capital flight in a statistical sense, but it is unlikely that they would have raised economic growth above its already blistering level.

Solutions

Given the persistent and in some cases rather larger levels of capital flight reported by these authors, what can be done to reduce the flight and the costs associated with it? Eric Helleiner gives the historical background to the development of arguments for capital controls. He shows how in the Bretton Woods Agreements, Keynes and White believed that controls of capital flight could only work if receiving countries helped the losing countries identify flight capital. The financial sector strongly opposed such rules and they were never passed. Helleiner suggests that now, with parts of the world still recovering from the Asian financial crisis and with heightened concern about the financing of terrorism and drugs, the powers that be might be more open now to rules and institutions to facilitate international cooperation to identify and recover flight capital than they have been in the last several decades.

Gerald Epstein, Ilene Grabel and Sundaram Kwame Jomo identify a broad set of policies, which they term 'capital management techniques', that can help regulate capital inflows and outflows. Many of these are simply prudential measures; others are strict controls over the capital account. They present several case studies that show that capital management techniques can be successfully applied and can help to stop capital flight.

In the final chapter of the book, James Boyce and Léonce Ndikumana discuss yet another strategy for dealing with accumulated foreign debt in the

face of large outflows of capital. They show that when stocks of capital flight are taken into account, many sub-Saharan African countries are actually net creditors, not net debtors, as the standard analysis suggests! The problem of course is for these governments to get control over the capital flight assets, something which is very difficult. Instead, Boyce and Ndikumana suggest that governments implement the doctrine of odious debt. This doctrine states that governments should be allowed to cancel their debts if these had been acquired by dictators or others whose interests run counter to the bulk of the population. They argue that in many sub-Saharan African countries, this doctrine might well apply.

CONCLUSION

In the age of financial liberalization, capital flight, far from disappearing, has in fact remained high and even increased: this is the message of this book. Reducing capital flight and its costs in developing countries is a difficult challenge, but it is one worth trying to meet. Ultimately, promoting economic development and fighting capital flight must go hand in hand. The neo-liberal approach appears to be unsuccessful at doing either; it is time for something different, perhaps, even, for some of the ideas contained in this study.

NOTES

1. Boyce (1992).
2. We based our method on the work of Boyce and Ndikumana (2001).

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