

Conceptualizing Capital Flight: A Systems Perspective

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1. Introduction

It is generally agreed that understanding a problem is a major and most important step towards solving it. To better understand the problem of capital flight, we present a casual loop diagram (CLD) that integrates many of the available theories about capital flight in a cobweb of cause and effect relationship to holistically conceptualize this problem. The existing studies try to explain the problem from a single country perspective and try to identify its causes like indebtedness (Ndikumana and Boyce 2011), weak institutions and political systems including taxation and other laws (Schjelderup, Cappelen et al. 2009), and expropriation, inflation, or devaluations (Rojas-Suarez 1990). We draw analogy to the story of *the blind men and an elephant*¹ originated in India and observe that all these studies are partial representation of the system. We argue that CLD provides a necessary template to conceptually map the existing theories to fully understand the problem to develop a holistic, integrated and unified policy framework at global level. The objective of this effort is to provide a template to identify a comprehensive set of variables of relevance so that sovereign states agree to develop an integrated and unified measuring and reporting system like SNA of UN.

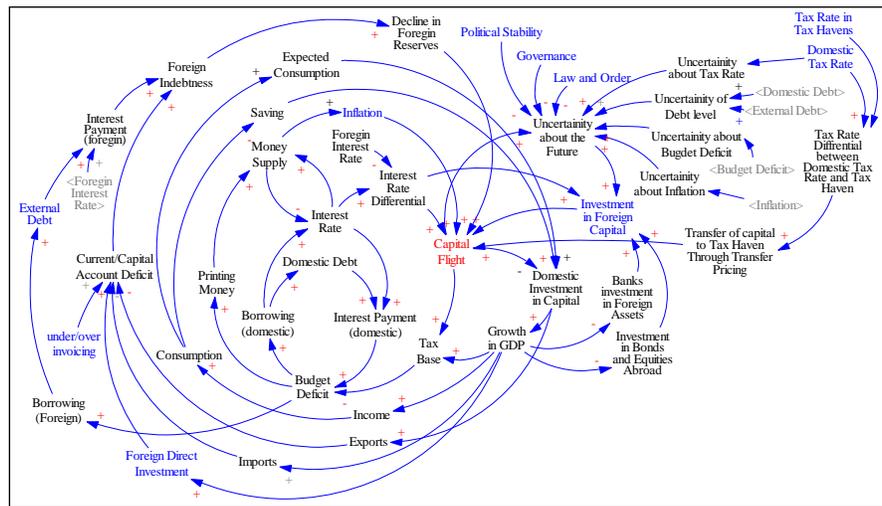
2. Causal Loop Diagram

Existing literature agrees on the socio-economic costs of capital flight to the sovereign states but lack of unified perspective constrains a unified policy response to better manage this problem. One must appreciate the complex network of feedbacks within and among different parts of an economy through a variety of channels (Rana 2003; Kraev and Akolgo 2005) and globalization makes this complexity multifold. The complexity of a system arises not from the number of components in the system structure but their interaction in feedback loops and delays (Sterman 2000). We embed different identified causes of capital flight to present their organic relationships found in literature (Rojas-Suarez 1990; Schjelderup, Cappelen et al. 2009; Ndikumana and Boyce 2011) as a CLD in Figure 1.

For example, it is argued that based on higher expected inflation residents will move their capital abroad because the domestic assets held by them will have less value due to higher inflation. But this is half of the truth because once capital flight is triggered it will shrink the tax base reducing the government revenue stream that will create budget deficit, and to fix this problem governments will take some monetary measures, they will either try to fix it by borrowing domestically which will cause the domestic interest rate to go up or they will print money, both of these measure will increase the money supply and increase money supply will make inflation

to go even higher next time around (Dooley 1988; Ajayi 1992; Anthony and Hallettbc 1992; Vos 1992). Another effect of reduction in tax base will be that the investors will expect future tax rate to go up creating a strong incentive for them to move their capital abroad.

Another main reason for capital flight is global differences in tax regimes, especially between tax havens and rest of the world. Literature tell us that investors move their capital abroad to countries with low tax rate but considering transfer pricing and over/under invoicing of large businesses having parent company registered in tax haven the problem magnifies manifold depriving the originating countries of large stream of tax revenues. The problem does not end here. The money that is transferred out of these countries through tax evasion and transfer pricing can come back as foreign direct investment (FDI) to take further advantages for example in developing countries low wages, low tax rate, some tax privileges or even cheaper natural resources. This is double looting because the money in the first place belong to the country which has been transferred to tax havens and later it comes to (possibly the same country) as FDI and again earn high returns on that investment due to privileges and cumulative capital again flows to tax havens hurting the host country twice in the process. Moreover, it is very hard to track the source of money because of secrecy in these tax havens.



blue and red are some variables identified in literature

Figure 1: Causal Loop Diagram

3. Conclusion

A number of different methods are used to measure the capital flight but they are more or less different variants of The World Bank's Residual method. Different studies have identified a number of different causes of capital flight. Nevertheless, we identify lack of unified information/reporting framework (like SNA) and a Capital Flight Index (CFI) that could be used as a single indicator for the measurement of capital flight as a major shortcoming in the existing efforts. We argue that CFI will not only provide a holistic explanation of the phenomenon rather than every country's own perspective but will also a comparable database of all countries and regions to help inform policy makers across the globe. We advocate an integrated global policy framework because the policies deemed best when considered in isolation (one country) are rendered inefficient when implemented in a complex feedback system and in combination of different best policies (many countries independently) (Sterman 2000).

As Albert Einstein rightly pointed out that “*any intelligent fool can make things bigger and more complex... It takes a touch of genius and a lot of courage to move in the opposite direction*”. This will be true for the CFI because it will make a single point focus for policy makers to measure the extent of capital flight from their own country. Policy maker will not be lost in technical details of different current models that are used until today but using CFI they can measure and benchmark their own target as they deem reasonable for the economy.

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¹ http://en.wikipedia.org/wiki/Blind_men_and_an_elephant