

THE SOCIOLOGICAL REASONS FOR CAPITAL FLIGHT

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## TABLE OF CONTENTS

I. Introduction .....	1
II. Capital Flight.....	2
A. Brief Description.....	2
B. The Cause -- Juxtaposition.....	4
1. What is Juxtaposition? .....	4
2. Psychological Effect of Juxtaposition.....	5
3. Capital Flight Effect of Juxtaposition.....	7
.....C. The Effects of Capital Flight	9
.....D. What about the Success Stories?	15
III. Conclusion .....	18
REFERENCES .....	20
ENDNOTES .....	22





## **THE SOCIOLOGICAL REASONS FOR CAPITAL FLIGHT**

### **I. Introduction**

Development literature identifies several key elements necessary for economic growth. One of these elements is capital accumulation. A particularly pernicious threat to capital accumulation is capital flight. One branch of the literature seeks to explain the why of capital flight -- why do asset holders in developing countries transfer their investments to developed countries? So far this branch of the literature largely dwells on identifying the highly measurable, profit maximizing motives of capital holders.

Explaining capital flight in less quantifiable sociological terms, this paper takes quite a different tact. The thesis is that capital flight and its effects cannot be understood outside of the broader sociological setting of the juxtaposition of two vastly different economies. The acute juxtaposition of poor countries with fast-paced, developed countries causes investment infrastructure to be oriented towards investment in the developed world and causes capital holders to psychologically focus on the developed world. The implications of this juxtaposition are that both the root causes and the effects of capital flight are much broader than realized so

that such a pervasive problem can only be offset by concerted measures orchestrated on several fronts. The existing, quantitative analysis does not reach this conclusion.

## **II. Capital Flight**

### **A. Brief Description**

Not simply accompanying the globalization of production and trade but far outpacing it is the globalization of financial movements. There are two aspects of the globalization of money. The first aspect is that in large quantities investors now move capital across borders in order to make direct investments. The phenomenon began in a large way with the privatization of third-world government debt in the 1970s and spread in the 1990s to the enormous investments in private business in certain developing countries.<sup>1</sup> The role of such movements of money was key in both the so-called miracle of the Asian Tigers as well as in the collapse of the Asian Tigers.<sup>2</sup>

The second aspect of the globalization of money is the capital flight phenomenon. Capital flight plays a major role in current financial globalization just as it has during any period of internationalization of finance.<sup>3</sup> We defined capital flight as any cross-border transfer of money when the transfer is motivated either by the desire to flee a weak currency's limited investment

opportunities or by the desire to secret money away from government authority. This flow of money is invariably in the direction of the developed world, often, however, by way of tax haven countries. The first type of capital flight, that motivated by desire to flee, ebbs and flows with the fortunes of the particular source country.<sup>4</sup> The second, that motivated by desire to secret away, is a constant.<sup>5</sup>

Although capital flight literature is in an early stage, virtually all the literature agrees that an enormous amount of capital flows into the developed world from LDCs.<sup>6</sup> That the problem is serious is accepted despite large gaps both in measuring its size and in describing its cause. Measurements vary widely, are largely irreconcilable, and inaccurate.<sup>7</sup> What the literature has identified is a continual flow of money that surges greatly during political or economic troubles of a particular country.<sup>8</sup> For example, from 1976 to 1981, Argentina, Venezuela, and Mexico experienced massive bouts of capital flight while undergoing economic problems.<sup>9</sup> Normally these countries always experience a lesser amount of capital flight. We will say more about capital flight a little later.

The perspective of this paper is to assume the literature's description of the size of capital flight and the predominant

secreting-away motives driving it. Then this paper builds on the literature by explaining both why capital is transferred with such ease and why capital holders are so quick to use this capital flight means of maximizing profits, secreting away money.

## **B. The Cause -- Juxtaposition**

### **1.**

#### **What is Juxtaposition?**

The modern tide of capital flight is traced to one common source or cause -- the vast difference in vitality between two juxtaposed economies. The difference between LDCs and fast-paced, developed economies is far greater now than ever before in history.<sup>10</sup> Not only is the difference greater, but also the juxtaposition is acute because of the nature of the modern world economy. Economies of the world are now closely linked, the transportation of goods in world trade is highly developed. World travel is highly developed. Communication, also. But most importantly, international capital markets are highly developed. The effect of this acute juxtaposition of two vastly different worlds is first psychological and then financial. It is human nature that everyone's eyes and thoughts are drawn to the success stories, the fast-paced, developed economies, so that a psychological effect is had. From this psychological effect, the financial effect flows.

People put both their confidence and their money in that which they admire -- fast-paced, developed economies.

2.

### **Psychological Effect of Juxtaposition**

The most obvious effect of such an acute juxtaposition is psychological. The excitement especially present around financial centers and high-tech development projects of fast-paced, developed economies at times seems almost tangible.

Corporations are growing rapidly, developing new products, conquering new territories, expanding market share, and acquiring rivals or other businesses. Morale is high. The future seems limitless. Science fiction writers are spoken of as prophets rather than as story tellers.

In the modern world, this enthusiasm is not lost on the population of poorer economies. Great economies of scale exist in radio, television, and videotape diffusion and distribution so that even some of the poorest populations are aware of the glamour and prosperity of the West -- as portrayed by Hollywood anyway.

They know of the success of the developed world. The US entertainment industry no doubt greatly enhances the successful image of the developed world. But more importantly, those in leadership roles always know of this image. Many have studied or

traveled in the developed world and speak its languages.

This focus of attention on fast-paced, developed economies has effects on LDC economies. These effects are real. Corresponding to the enthusiasm for undertakings in a fast-paced, developed economy is a lack of enthusiasm for any undertaking in a LDC economy. Sometimes just the perception that an economy or industry is weak can be devastating. Certainly, prestige is a real thing. Talented workers do opt for one firm over another, one location over another simply because of prestige.

One common US phenomenon brings a parallel insight to these psychological effects. In the United States, exist areas that do not much participate in neither the prosperity nor the enthusiasm of a fast-paced, developed economy. However, because of geographic location, the juxtaposition is even more acute than with foreign LDC economies. The apparent hopelessness of these areas as seen through high crime, violence, and drug abuse rates is disproportional to the degree of poverty that exists. Not to trivialize US poverty, but in objective measurements the poverty of foreign countries is often greater. Yet the poor of these foreign regions do not seem quite as frustrated as in the United States. To a large extent, the depths of this frustration results from the acute juxtaposition to a prosperous economy and the resultant

psychological effects. However, this frustration is also caused by other reasons, cultural reasons and the indignant nature of US unemployment.

3.

### **Capital Flight Effect of Juxtaposition**

The above observations concerning the psychological effects of juxtaposition may strike one as containing much truth, but "how could the psychological effect of juxtaposition explain the existence of large capital flows?" These psychological effects set in the world economic structure, as it now exists, produce another effect, very real and often measurable. This other effect is capital flight.

Let us resume our description of present-day capital flight. Five reasons account for the volume of capital flight in modern times -- and the flow is indeed enormous. First, the means of transferring funds are readily available. An extensive international finance system is in place making private investment in the developed world both safe and efficient.<sup>11</sup>

Second, telecommunications and air transportation make it easy to keep track of foreign investments. Telephones allow investors to keep in touch and monitor US investment with ease. Through television and the print media, an investor can keep abreast of

happenings in the developed world. Third, knowledge of and dissemination of information about financial centers, especially New York and London, mean greater confidence in the investment process. Fourth, the ubiquity of the U.S. dollar means that often one need not convert one's holdings before transferring it. Substantial portions of third-world liquid assets are already held in US dollars or other major currencies.<sup>12</sup>

And fifth, the spread of capitalism and the increase in the number of large capital holders alongside the rise of the welfare state mean great taxation of these large capital holders and so greater motive to avoid taxation by secreting away money.<sup>13</sup> The phenomenon is acute in LDCs: as is well known, income and wealth distribution in LDC economies is quite skewed. In other words, LDCs expropriate domestically held capital, largely through taxation; the holders of domestic capital effectively avoid expropriations by transfer to the developed world.<sup>14</sup> Thus, the nature of LDC tax systems and custom encourage investment in fast-paced, developed economies.<sup>15</sup> LDCs rarely tax foreign income of their citizens. Thus, these capital holders find great financial rewards in moving capital abroad. Significantly, the expropriations avoided are often indirect as well -- the expropriations which result from inflation and exchange rate

fluctuations.

Earlier, we defined capital flight as any cross-border transfer of money when the transfer is motivated either by the desire to flee a weak currency's limited investment opportunities or by the desire to secret money away from government authority. The five reasons for the current flow of capital flight can be seen as explaining why the two motives are currently so strong.

In addition, a sixth reason explains why these motivations are so strong, a non-quantifiable reason, a reason hovering around the other five lubricating and exhorting them to action – the psychological effect of juxtaposition. Therefore, considering the sociological setting in which LDC capital holders find themselves - a psychological mind-set of fascination with the developed world and an investing infrastructure pointing towards the developed world -- how surprising can capital flight really be? how dependent is the phenomenon on the narrow welfare maximization analysis? If the expropriation threat were curtailed, would not capital tend to flow out of LDCs for the sociological reasons alone? Those in a position to move capital across borders, are they not only under the spell of fast-paced enthusiasm, but also are they not acutely familiar with investments in the developed world.

### **C. The Effects of Capital Flight**

The thesis of this paper, that capital flight is caused to a great degree by sociological reasons, is also seen in the effects capital flight has on LDC economies. Obviously, capital accumulation is directly and profoundly affected by capital flight. A well-known economist has summed up the effect: "Simon Kuznets emphasizes . . . . major differences [exist] between underdeveloped countries today and the now advanced countries when they began their industrialization: . . . . the inequality in the distribution of income is wider today than in the past, but not in a way that favors accumulation of productive capital . . . ."<sup>16</sup> The effect on slow pattern economies is devastating. This conclusion is generally consistent with that reached by the majority of economists. W. Arthur Lewis, who reached the opposite conclusion, stated:

Our study originates from interest in the proposition that the upward movement of those already on the escalator [, fast-paced, developed economies,] helps to pull more and more countries into the moving company. This proposition is not obvious, and its opposite -- that it is the enrichment of the rich that impoverishes the poor -- is perhaps even more widely held in one form or another.<sup>17</sup>

Others have noted the above described effects also although they

have not always attributed them to capital flight. For example, one book describes "special problem areas" resulting from "centripetal forces that favor growth of the heartland [, fast-paced, developed economies,] at the expense of the hinterland [, LDC economies]".<sup>18</sup>

Two main effects are had on capital accumulation, thus impeding important mechanisms of capital accumulation. First, capital invested abroad is not available for local investment.<sup>19</sup> Not only is the capital itself not available, but also the credit it could produce through the money multiplier effect is not available. Therefore, the money removed from an economy shrinks the money supply by five times the original amount. So banking systems are severely crippled by capital flight.<sup>20</sup> Money deposited into a nation's banking system commonly allows the money supply to increase fivefold: a twenty percent reserve requirement allows banks to loan the rest; the eighty percent loaned out is redeposited, eighty percent of which is re-loaned. This continues until the money lent has increased by fivefold. Money, then, withdrawn from one banking system to be deposited into a second has both a positive and a negative multiplier effect -- the first economy will have no fivefold increase in money supply normally associated with deposited profits while the second economy will see the

fivefold increase even though no underlying economic activity generated the deposited profits. The first economy will not be able to maintain normal economic growth, the second will have the means of rapid growth<sup>21</sup> -- banks will be poised to support the demand for loans needed to finance growth.

This effect is had even where significant production is occurring in the third-world economy. The profits of production -- for example, profits from selling oil for export -- will not stimulate local growth since they are not deposited locally. The small, elite cadre of owners, managers, and technocrats will achieve individual prosperity through investment in developed economies. Thus, their prosperity is not linked to local conditions.

In addition, the money supply becomes unstable. "This instability is, as a matter of fact, much higher than that which is usually observed in the developed countries and would in itself make of monetary programming an enterprise highly difficult to realize with any degree of accuracy over time."<sup>22</sup>

Second, capital flight harms capital accumulation by harming the exchange rate mechanisms of the LDC economies. The harm comes about in the following way. In the rush to invest liquid capital abroad, capital accumulated in both the local currency and foreign currencies, usually the US Dollar, must be sent abroad.

That accumulated in the local currency must first be converted into the currency of the fast-paced, developed country. The large number of those seeking to invest abroad in this manner places downward pressure on the local currency. Confidence in the local economy is diminished all the more. The desire to invest abroad becomes so great that investors willingly pay a premium to do so: they sell their local currency holdings at even greater discounts. The large size of the discount is evidence of how high they esteem investment in the developed world. As the local currency falls, imports become more expensive causing inflation that, in turn, places even more downward pressure on the local currency. Inflation further erodes confidence in the local economy.

Two readily observable trends in LDC economies are consistent with the above-described effect of capital flight. Firstly, since the local currency has been discounted so much, the preference is to conduct business in US dollars so that dollars often circulate widely in slow-pattern economies. Secondly, the loss in confidence in local currencies is so great that the change in the exchange rate usually far surpasses the inflation rate.<sup>23</sup> Those able to invest abroad, those most captivated by the spell of the developed world, necessarily have less confidence in the local economy than those who have no choice but to operate only in the

local economy.

Besides harming capital accumulation, capital flight harms the other key elements of economic growth, political stability and technological advancements. The great harm capital flight does to capital accumulation has its effect on confidence -- confidence in political and business leaders, in the nation, in individual undertakings, and in oneself. Political turmoil often erupts in what may have been a stable political environment. Even the most well-prepared and well-intentioned leader is left helpless. The technological advances at hand are impossible to implement in the face of such great economic and political turmoil.

Of course, other factors beside capital flight contribute to the stagnation of LDC economies. "Appropriate technology" for manufacturing must develop.<sup>24</sup> For example, the extraction of petroleum from many third world countries does not benefit the local economy much since employment is minimal, skilled personnel are brought in from other countries, and the employment is usually located in sparsely populated areas.<sup>25</sup> Another example is the tendency of the capital holders in the third world to "sterilize [the capital] by hoarding, luxury consumption or low productivity investment outlays." Such use does not contribute to growth.<sup>26</sup> But such factors do contribute to the sociological background of

capital flight.

#### **D. What about the Success Stories?**

Another logical step in the analysis of this paper remains. Why did not such a formidable obstacle to capital growth as juxtaposition and the resulting capital flight prevent all economies from breaking into the fast-paced, developed pattern? Why has Japan done so? And later South Korea, Taiwan, and Singapore, etc.? The answer to these questions strongly supports the thesis of this paper since the success of all these economies is quite consistent with the thesis.

The answer is that the reasons for capital flight, especially the sociological reasons, were largely absent. We know quite a bit about the Japanese economy, so let us concentrate on it. Its success is so great and began so early that much has been written about it. Japan accumulated much capital during its transition to a fast-paced, developed economy. Unlike many other success stories, such as Australia, where the source of capital accumulation was from abroad, Japan's source was from within.<sup>27</sup> Why did not the small, initial, tentative Japanese capital accumulation flee abroad? The juxtaposition present now did not exist. Two facts explain the juxtaposition's absence. First, Japan had isolated itself from the rest of the world especially from the West. It had little

contact with the West and had never been a colony of the West. So it was not linked to an international banking network, nor did its wealth holders possess western business contacts or even much knowledge of the West.<sup>28</sup> Second, the gap between Japan in its LDC days, roughly before 1920, and the then existing fast-paced, developed economies was not near as great as such gaps are now.<sup>29</sup> So the pull on capital was not so strong. Its political stability is well documented. In more recent times, it began with the Meijing Era in 1868 and continued to the present. In addition, economists have found that Japan implemented at first small technological advances in the silk industry and agriculture and eventually built up to the large industrial advances of recent decades.<sup>30</sup> Finally, it possessed other characteristics that the development literature considers important to success such as a stable population, relatively dense in regions.

On the other hand, South Korea has not the history of political stability and isolation from its neighbors. However, during the Korean war its people and political system pulled together to meet the outside threat. Thus, it quickly obtained political stability. But most importantly it was at center stage of world affairs. During the height of the cold war, its competition with North Korea became a sort of competition between champions of two political systems.

The free world, especially the United States, acted as a sort of mentor for the Korean economy. Much foreign capital flowed into South Korea,<sup>31</sup> and the war time government was able to keep tight control of the economy including the control of capital outflows.<sup>32</sup> So the capital accumulation characteristic was to a large part thrust upon it. Technological advances were quickly implemented under these conditions. The population characteristics were present as well. The bulk of the population is densely located in one small region. Taiwan's is a similar story.

Although having many of the elements of the above success stories, the success of several other small Asian countries is attributable to a different circumstance. Such nations, Singapore and Hong Kong for example, have made themselves tax and banking havens. As havens, they have achieved a certain amount of capital accumulation. In the area of finance, they have far reaching bank secrecy laws. So they benefit from the capital flight phenomenon. Much of the money fleeing LDC economies, evading taxes, or being laundered, flows through their banks on its way to the West.<sup>33</sup> A certain amount of this money stays in the haven countries, at least enough to be the basis of entry into the fast-paced, developed world.

Can their success be emulated? No, since their success can only

be achieved by a few; by definition, not everyone can be a haven. Even the success of Japan cannot be emulated under present world conditions, however. Japan's method of isolating itself is incompatible with the extensive international trade and communications network of the present world. The economic difficulties of Cuba over the last thirty years is one story of how difficult it is for even the most determined government to control unilaterally capital flight through regulation and force.

### **III. Conclusion**

A reading of development literature points to the almost universally held view that capital accumulation is a necessity to development. Especially in recent years, the literature has defined the capital flight danger to capital accumulation. With this background as premise, this paper asks whether sociological conditions play a role in capital flight in recent times. Not disputing the welfare maximizing, mathematically based models which explain the actions of LDC capital holders, the sociological considerations place such models in context. The sociological considerations explain why legal controls aimed at capital flight are not so effective. The financial practices of LDC capital holders are not to be altered by using prohibitions to narrow their financial choices. Especially since the psychological attractiveness of

investing in the developed world pushes capital holders to circumvent prohibitions.

This argument that sociological considerations explain much capital flight is bolstered by a brief look at economies which increased their income and so "succeeded." The capital holders of such successful economies always had the same narrow welfare-maximizing incentives to invest abroad to a certain degree. However, they did not exist in the same sociological setting. That is, they did not always have access to the mechanisms of foreign investment; nor were they always under the mesmerizing influence of the developed world.

All this indicates that unilateral attempts to stop capital flight will meet with little success, a conclusion not necessarily reached by looking only at the narrow profit maximizing motives behind the capital flight phenomenon.

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