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Capital Flight: Estimates, Issues,  
and Explanations

John T. Cuddington

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

PRINCETON, NEW JERSEY

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## 1 INTRODUCTION

Large-scale capital flight is often mentioned as a prime contributing factor to the foreign-debt problem of developing countries. The term "capital flight" is laden with negative connotations and inevitably evokes suggestions for policy reform or short-run expedients such as capital controls. For example, according to the 1984 Annual Report of the Bank for International Settlements, "The external position in Latin America appears to have been severely aggravated by private-sector capital outflows" (p. 101). Commenting on this report, the *Economist* (June 23, 1984) concluded, "The [BIS's] careful prose implies that if the rich of Latin America brought home what they earned on their funk money their countries would not be in such a mess."

Motivated by the growing awareness of the capital-flight phenomenon (see, e.g., Diaz-Alejandro, 1984; Dooley *et al.*, 1986; Dornbusch, 1985; and Harberger, 1985), this study addresses the following questions:

- What is "capital flight" and how large is it?
- Why is capital flight thought of as "bad"?
- What are the underlying as well as proximate causes of capital flight?
- What policy reforms, if any, are appropriate for stemming capital flight?
- Is there any indication that capital controls, that is, regulations or legal prohibitions on capital outflows, can, in fact, choke off capital flight?

Chapter 2 provides estimates on the importance of capital flight for eight heavily indebted developing countries over the period 1974-82. It then compares the estimates to the growth in these countries' foreign indebtedness to get some idea of the relative magnitudes involved. Chapter 3 suggests a number of reasons why the presence of capital flight may be a policy concern, and Chapter 4 examines the relative importance of various economic determinants of capital flight in the countries studied. In light of this analysis, Chapter 5 considers the efficacy of capital controls. Chapter 6 concludes by stressing the importance of stable macroeconomic and financial policies if massive capital flight is to be prevented.

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This Study is a continuation and extension of a note entitled "Capital Flight and the Growth in External Debt" (November 1984, processed) that I wrote with Yoon Je Cho and Mourad Ezzine. The contribution of Cho and Ezzine to the country studies in this Study was substantial. Ezzine and Azita Amajadi provided efficient research assistance. Helpful comments were received from Cho, Vittorio Corbo, Jaime de Melo, Sebastian Edwards, J. Michael Finger, Alan Gelb, Julio Nogués, James Tybout, Carlos Urzua, and Alan Winters.

## 2 ESTIMATING CAPITAL FLIGHT

In any discussion of capital flight, a decision must be made on how broadly or narrowly to define the concept. Presumably, cumulative capital flight measured retrospectively cannot exceed the gross total of foreign assets held by domestic residents. But such a number is bound to be too large, because some claims on foreigners represent ordinary business activity, ranging from direct investment to normal levels of commercial export credit. Furthermore, some claims on foreigners are probably held as "cover" for liabilities to foreigners.

The term "capital flight" typically refers to short-term speculative capital outflows. It involves "hot money" that responds to political or financial crises, heavier taxes, a prospective tightening of capital controls or major devaluation of the domestic currency, or actual or incipient hyperinflation. Short-term capital flight can be executed not only by shifts in domestic portfolios toward foreign liquid assets but also by changes in trade credit. In the face of large international interest-rate differentials or imminent devaluation, for example, domestic firms will slash their trade-related borrowing denominated in foreign currency. At the same time, they may show increased willingness to engage in trade-related lending denominated in foreign currency. When this mechanism becomes excessive, it seems reasonable to label it "capital flight." Other, more ingenious methods of exporting capital abound, particularly in countries with regulations prohibiting the legal transfer of funds abroad. Recent reports in the popular press of the plundering of the Philippines by the Marcos family provide examples of how capital flight can take place and the many types of foreign assets into which capital may flee.

When the narrow "hot money" definition is used, capital flight typically refers to capital export by the private nonbank sector, although in some cases banks and official entities may also engage in it. Some authors define capital flight more broadly as the gross value of *all* capital exports from an economy, regardless of whether they reflect the purchase of foreign financial assets or real assets (such as real estate) or direct foreign investment by domestic residents. Some would even consider the massive emigration of highly trained professionals who fear financial or political collapse at home to be a form of capital flight, namely, human capital flight. The appropriate definition, of course, depends on the questions one wishes to address. In what follows, the term "capital flight" is reserved for short-term speculative capital outflows, while other capital exports will be referred to as "gross capital outflows."

Regardless of how broadly or narrowly one defines capital flight, assessing

its quantitative importance is difficult. This is true even in countries that impose no restrictions on capital outflows, because financial transactions are often reported imprecisely in countries' balance of payments. The measurement problems become more severe in countries with capital controls, because capital outflows must be concealed, and they show up only in the errors-and-omissions entry. Therefore, that entry must be used to estimate capital flight, which means measuring it *net* of unrecorded capital inflows rather than measuring the gross capital outflow.

Some forms of capital flight, such as smuggling or underinvoicing of exports and overinvoicing of imports, do not even show up in "errors and omissions." As long as the foreign-currency receipts from smuggled goods are kept abroad and cannot be observed by the domestic authorities, neither the outflow of goods nor the corresponding increase in domestic holdings of assets abroad will be recorded in the balance of payments. This is also true for exports and imports with "faked" invoices. The falsified valuation shows up in the balance-of-payments accounts. The difference between the faked amount and the true amount of the contract, which represents a capital outflow or inflow, is not recorded anywhere--in the trade accounts, in financial flows, or in errors and omissions.

It is possible to estimate capital flight effectuated by the underinvoicing of exports and overinvoicing of imports by using partner-country trade-data comparisons (see Bhagwati, Krueger, and Wibulswadi, 1974). Using our present methods, however, such capital flight escapes detection. Hence, our estimates of capital flight may be on the low side, particularly for countries that have highly distorted trade systems. In a recent study, Gulati (1985) uses partner-country trade data to estimate capital flight. His estimates of capital flight carried out by underinvoicing exports are reported in Appendix B; in some instances, it has averaged more than 20 percent of export earnings. (Gulati notes that, using his methodology, the definition of capital flight should be limited to *illegal* capital outflows.)

Despite these conceptual and measurement problems, some rough estimates of *net* capital flight are possible. We analyzed the capital accounts of the balance of payments for eight heavily indebted countries: Argentina, Brazil, Chile, Korea, Mexico, Peru, Uruguay, and Venezuela. In each case, we included the errors-and-omissions category in the measure of capital flight because of the widespread belief that errors and omissions largely reflect unrecorded short-term capital flows. We also included certain subcategories of the line item "other short-term capital, other sector" (i.e., excluding the official sector and money banks). A judgment on what to include in capital flight had to be made on a country-by-country basis using the descriptive footnotes in the IMF's *Balance of Payments Yearbook*. The objective was to isolate short-term capital movements that might reasonably be considered capital flight.

(The exact definition of capital flight for each country is given in the notes to Table 1.)

Table 1 provides estimates of capital flight for each of the countries considered. To get some indication of its relative importance, our measure of capital flight in each year from 1974 through 1982 is compared to the growth in each country's foreign debt in that year.<sup>1</sup> Two things are particularly noteworthy. First, the importance of capital flight varies tremendously from country to country. Argentina, Mexico, and Venezuela exhibit heavy capital flight over the period, while for Brazil, Chile, Korea, and Peru the aggregate amount of capital flight is insignificant. Second, the severity of capital flight has varied considerably from year to year, as the experiences of Peru and Uruguay illustrate. Although *cumulative* capital flight from Uruguay is moderately large, it is insignificant for Peru despite the heavy capital flight that occurred in 1974-76. Even if it has been small relative to the increase in foreign debt, as in the Peruvian case, capital flight may have had a significant effect at times on the authorities' ability to carry out macroeconomic policy. A third feature to note in the table is that capital flight seems to have become relatively more important in the late 1970s and early 1980s than it was in the early 1970s.

The estimates in Table 1 can be compared with the broader measure of capital outflows derived by Dooley *et al.* (1986) reported in Table 2. Their estimates are obtained by taking reported changes in foreign indebtedness from Federal Reserve Board records on the stock of foreign debt, which are based (to varying degrees) on both debtor and creditor reporting systems, and decomposing them into three sources: (a) the current-account deficit *less* the part financed by direct foreign investment (i.e., non-debt-creating inflows), (b) the change in total official reserve assets *less* gold, *plus* the net change in the foreign assets of commercial banks,<sup>2</sup> and (c) the residual. Items (a) and (b) are obtained from balance-of-payments statistics. The residual obtained when items (a) and (b) are subtracted from the change in foreign debt is treated as the capital outflow of the nonbank private sector;<sup>3</sup> hence Table 2's title, "Re-

<sup>1</sup> The change in external indebtedness is obtained from Dooley *et al.* (1986). Alternatively, it could have been calculated using the same *Balance of Payments Yearbook* data that were used to calculate our measure of capital flight. This would have had the advantage of consistency among data sources. For some countries, the cumulative value of the year-to-year changes in debt reported in the balance of payments falls considerably short of the total change in debt outstanding obtained from debtor and creditor reporting systems. In other cases, the former exceeds the latter. See Dooley (1986) for a comparison of the two approaches.

<sup>2</sup> Commercial banks' net foreign assets are added to those of the central bank on the grounds that the central bank directly or indirectly controls a large fraction of commercial banks' foreign assets in many developing countries.

<sup>3</sup> Dornbusch (1985, Table 8.3) uses a similar technique, but his residual includes net changes in official reserves. According to our definition of capital flight, the latter should not be included.

sidual Capital Outflows.”<sup>4</sup> In Dooley *et al.* (1986) and earlier drafts of this study, the term “gross capital outflows” was used. But the residuals calculated by Dooley *et al.* are sometimes positive and sometimes negative, so they cannot possibly be *gross* outflows. In fact, they reflect the *net* capital outflow or inflow not explicitly accounted for by the other two items. The same comment applies to the capital-flight estimates in Table 1. They, too, are a residual, because they use the errors-and-omissions item (as well as other line items) from the balance-of-payments accounts; they reflect capital flight *net* of unrecorded capital inflows. In years when incentives for capital flight are reversed, and in other instances as well, the latter may dominate, causing the figures in Tables 1 and 2 to become negative.

The estimates in Table 2 differ from those in Table 1 for three reasons: First, the residual capital outflows in Table 2 include long-term as well as short-term outflows. Second, they include outflows by deposit banks and the official sector (other than changes in foreign-exchange reserves), in addition to outflows by the nonbank private sector. The numbers in Table 1, by contrast, include in principle only short-term outflows by the nonbank private sector, although errors and omissions undoubtedly reflect in part long-term capital outflows. Third, the increase in foreign debt reported by Dooley *et al.* is sometimes quite different from the sum over time of debt-creating capital inflows recorded in the balance-of-payments statistics. The residual capital outflows in Table 2 are calculated using the *stock* figures on foreign debt. The capital-flight estimates in Table 1 implicitly use the debt-creating *flows* measured in the balance-of-payments accounts, because these data are used in arriving at errors and omissions.

The difference between the stock of debt and the cumulative flow of foreign borrowing is due to such things as reporting inaccuracy, minor valuation changes (which show up in the “stock” numbers but not in the cumulative flows), and the possibility of netting certain inflows and outflows inappropriately when relying on balance-of-payments reports. As Dooley (1986) shows, the two methods for calculating a country’s foreign debt yield similar estimates in the case of Brazil, while in the case of Argentina the total stock of foreign debt is considerably larger than that implied by the cumulative debt-creating inflows in the balance-of-payments statistics. Unrecorded military expenditure financed by foreign borrowing is said to be an important contributor to the discrepancy in the Argentinian case.

<sup>4</sup> A recent report by Morgan Guaranty (1986) estimates capital flight for eighteen developing countries using the Dooley *et al.* methodology.

TABLE I  
ESTIMATES OF CAPITAL FLIGHT  
(in millions of U.S. dollars)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	Total
<b>Argentina:</b>										
Capital flight	36	-163	266	-618	1,497	-1,693	2,301	8,680	4,978	15,285
Change in foreign debt	1,100	400	400	1,500	3,100	6,700	9,000	9,400	1,000	32,600
Capital flight/change in debt (%)	3	-41	66	-41	48	-25	26	92	498	47
<b>Brazil:</b>										
Capital flight	64	427	-496	618	-299	-1,227	351	390	379	206
Change in foreign debt	6,900	8,600	7,800	8,200	16,800	8,600	11,200	12,900	12,500	93,500
Capital flight/change in debt (%)	1	5	-6	8	-2	-14	3	3	3	0
<b>Chile:</b>										
Capital flight	47	-25	-252	-503	-250	-416	-482	-899	792	-1,988
Change in foreign debt	400	1,500	-200	0	1,700	2,100	3,200	4,700	2,000	15,400
Capital flight/change in debt (%)	12	-2	126	...	-15	-20	-15	-19	40	-13
<b>Korea:</b>										
Capital flight	-69	-453	-112	12	1,524	-516	-1,607	494	1,285	558
Change in foreign debt	1,700	2,700	2,000	2,400	4,300	5,300	5,500	5,900	3,800	33,600
Capital flight/change in debt (%)	-4	-17	-6	0	35	-10	-29	8	34	2
<b>Mexico:</b>										
Capital flight	1,272	1,285	3,331	917	517	1,447	4,826	11,510	7,558	32,662
Change in foreign debt	4,500	5,600	6,600	6,600	4,300	8,800	16,400	22,700	7,100	82,600
Capital flight/change in debt (%)	28	23	50	14	12	16	29	51	106	40

Peru:										
Capital flight	72	826	328	112	-51	13	187	-468	148	1,167
Change in foreign debt	1,100	2,400	1,300	1,000	800	600	600	900	2,000	10,700
Capital flight/change in debt (%)	7	34	25	11	-6	2	31	-52	7	11
Uruguay:										
Capital flight	82	38	13	-42	-159	5	-90	184	1,161	1,193
Change in foreign debt	30	122	50	114	-17	268	422	387	805	2,181
Capital flight/change in debt (%)	274	31	26	-37	(932)	2	-21	48	144	55
Venezuela:										
Capital flight	522	-155	-401	-1,736	-943	-2,354	3,366	5,013	7,464	10,776
Change in foreign debt	-1,900	600	-1,200	6,400	5,500	8,500	3,200	2,800	3,100	27,000
Capital flight/change in debt (%)	-27	-26	33	-27	-17	-28	105	179	241	40

NOTE 1: "Change in foreign debt" figures are from Dooley *et al.* (1986) except in the case of Uruguay, where figures are obtained by cumulating relevant capital inflows using *Balance of Payments Yearbook*.

NOTE 2: As described in text, capital-flight estimates are calculated in slightly different ways across countries, depending on the information contained in the descriptive footnotes in *Balance of Payments Yearbook*. The precise definitions are as follows:

Argentina: Net errors and omissions plus "short term, other sectors."

Brazil: Net errors and omissions.

Chile: Net errors and omissions plus "short term, other sectors."

Korea: Net errors and omissions plus "short term, other sectors."

Mexico: Net errors and omissions plus "short term, other sectors, other assets."

Peru: Net errors and omissions plus "short term, other sectors, other assets."

Uruguay: Net errors and omissions.

Venezuela: Net errors and omissions plus "short term, other sectors" plus "other bonds: assets."

TABLE 2  
RESIDUAL CAPITAL OUTFLOWS  
(in millions of U.S. dollars)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	Total
Argentina:										
Capital flight	800	0	-200	900	3,000	1,700	6,700	7,700	-400	20,200
Change in foreign debt	1,100	400	400	1,500	3,100	6,700	9,000	9,400	1,000	32,600
Capital flight/change in debt (%)	73	0	-50	60	97	25	74	82	-40	62
Brazil:										
Capital flight	300	3,000	-1,600	2,400	4,400	1,100	1,800	-200	200	11,400
Change in foreign debt	6,900	8,600	7,800	8,200	16,800	8,600	11,200	12,900	12,500	93,500
Capital flight/change in debt (%)	4	35	-21	29	26	13	16	-2	2	12
Chile:										
Capital flight	200	800	-400	-700	-800	600	-200	-400	900	0
Change in foreign debt	400	1,500	-200	0	1,700	2,100	3,200	4,700	2,000	15,400
Capital flight/change in debt (%)	50	53	200	...	-47	29	-6	-9	45	0

Korea:										
Capital flight	-300	300	300	1,100	2,600	300	-600	-3,100	5,300	5,900.
Change in foreign debt	1,700	2,700	2,000	2,400	4,300	5,300	5,500	5,900	3,800	33,600
Capital flight/change in debt (%)	-18	11	15	46	60	6	-11	-53	139	18
Mexico:										
Capital flight	1,600	1,100	3,500	4,300	800	2,800	7,100	8,200	6,900	36,300
Change in foreign debt	4,500	5,600	6,600	6,600	4,300	8,800	16,400	22,700	7,100	82,600
Capital flight/change in debt (%)	36	20	53	65	19	32	43	36	97	44
Peru:										
Capital flight	-100	1,400	300	-100	500	300	200	200	400	3,100
Change in foreign debt	1,100	2,400	1,300	1,000	800	600	600	900	2,000	10,700
Capital flight/change in debt (%)	-9	58	23	-10	63	50	33	22	20	29
Venezuela:										
Capital flight	-100	700	-300	-900	900	4,800	4,700	7,400	8,300	25,500
Change in foreign debt	-1,900	600	-1,200	6,400	5,500	8,500	3,200	2,800	3,100	27,000
Capital flight/change in debt (%)	5	117	25	-14	16	56	147	264	268	94

NOTE: Figures for Uruguay not available.

SOURCE: Figures derived from tables in Dooley *et al.* (1986). Underlying foreign-debt data from Federal Reserve files. Gross private capital flows calculated as a residual, as described in text.

### 3 WHY IS CAPITAL FLIGHT "BAD"?

Sao Paulo economist Stephen Charles Kanitz (1984) recently asked:

Why is it that when an American puts money abroad it is called "Foreign Investment" and when an Argentinian does the same it is called "Capital Flight"? Why is it that when an American company puts 30 percent of its equity abroad it is called "Strategic Diversification" and when a Bolivian businessman puts only 4 percent abroad it is called "Lack of Confidence"?

There is, of course, no reason why the simultaneous export and import of capital is necessarily undesirable. On the contrary, the simultaneous inflow and outflow may say that both domestic and foreign residents are pursuing the same conventional objective, which is to diversify portfolios internationally.<sup>1</sup> The fact that gross capital flows greatly exceed net flows may indicate a high degree of financial integration with world capital markets and the availability of opportunities for risk sharing. Similarly, long-term capital inflows may be offset by short-term capital outflows when financial intermediaries engage in maturity transformation at the international level. One might expect to see this pattern, for example, when examining capital flows between Canada and the United States; Canadian firms may borrow competitively priced long-term funds in the U.S. capital market at the same time that some Canadian citizens hold deposits at U.S. banks. The same explanation was often used in the late 1960s and early 1970s to account for the pattern of capital flows between the United States and Europe. The United States was considered "the world's banker."

These remarks suggest that capital outflows or, more precisely, simultaneous inflows and outflows are not necessarily a "problem" either for developing countries or for financially sophisticated industrial countries. Why then is capital flight thought of as "bad," that is, as *prima facie* evidence that some sort of policy intervention is needed? There are several possible answers.

#### *Capital Flight Destabilizes Interest Rates and Exchange Rates and Reduces Monetary Control*

The usual objection to speculative capital flows is that they are destabilizing.<sup>2</sup> This point is often made when discussing "hot money" flows among the

<sup>1</sup> Khan and Ul Haque (1985) have recently used intertemporal optimization to show how the simultaneous occurrence of capital inflows and capital outflows may be a consequence of different perceptions of expropriation risk among domestic and foreign residents.

<sup>2</sup> There is a vast literature on whether or not speculation is destabilizing, including Milton

world's financial centers, but it is also relevant for countries with less developed financial systems. When there is political or financial instability or when major changes in macroeconomic policy are anticipated, mobile capital will move quickly from the risky country to a safe haven. These movements induce large and rapid adjustments in interest rates and exchange rates, perhaps with considerable exchange-rate "overshooting." If the central bank intervenes in an attempt to stabilize the exchange rate, foreign-exchange reserves may be exhausted and the domestic money supply may contract sharply.

In making a case that capital flight is bad and should therefore be controlled by "appropriate" policy action, interventionists presume that these consequences of capital flight inflict welfare losses on the economy as a whole. Not only will capital flight exacerbate existing economic distortions in the short run, but it may also have adverse implications in the long run. Several of these are discussed below.

It should be emphasized that the implicit premise underlying assessments of this sort is that capital flight is caused by factors beyond the policymaker's control. In many cases, however, capital flight is a direct private-sector response to ill-conceived or poorly executed domestic policies. In such circumstances, it would be more appropriate to condemn the controversial policies than the capital flight.

It is difficult to appraise the welfare implications of capital flight caused by inflationary macroeconomic policies, political instability, or a lack of confidence. Were it not for the threat of capital flight, governments might be tempted to adopt even worse monetary and fiscal policies.<sup>3</sup> The loss in welfare from these imprudent policies might be even greater than the loss attributed to capital flight. The ability of private capital to "vote with its feet" may prevent politicians from eroding national wealth by adopting policies favoring special-interest groups at the expense of the country as a whole.

### *Capital Flight Reflects Discrepancies between Private and Social Rates of Return*

Another implicit premise underlying most discussions of capital flight from developing countries is that the social rate of return on capital invested in developing countries is higher than on capital invested in industrialized countries. Capital is presumably scarce in developing countries, so that a flow of capital from developing countries should impair the efficient worldwide allo-

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Friedman's 1953 classic. More recent contributions include Driskill and McCafferty (1980), Krugman (1979), and Kohlhagen (1979).

<sup>3</sup> The growing literature on the time consistency of government policies attempts to incorporate such constraints on policymakers into macroeconomic models with rational expectations.