Corruption, costs, and family: Chinese capital flight, 1984–2014

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A B S T R A C T

Since 1984, the foreign debt of the Peoples' Republic of China has increased at a greater rate than would be explained by changes in the country's current account, foreign direct investment and reserve holdings. This pattern is consistent with large-scale outflow of financial capital, commonly referred to as capital flight. Since 2005, capital flight has accelerated reaching $425 billion (plus or minus $60 billion) in 2014 alone. This study provides three estimates for capital flight from China for the period 1984 through 2014 using both Cuddington's balance of payments and more inclusive residual measures. These measures are adjusted to reflect the legitimate assets of the Chinese banking industry, mis-invoicing of China's trade with its major trading partners (especially Hong Kong), exchange rate changes, and the failure of official debt data to capture certain bank transactions. Based on these estimates, it is concluded that capital controls have little long-term effect on the volume of capital flight, Hong Kong is increasingly a pipeline for capital flight from the mainland, and that 'traditional' explanations do not apply to China's capital flight over the last decade. Finally, corruption, transaction costs, and facilitating migration are considered as possible explanations of the recent acceleration of Chinese capital flight.

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1. Introduction

Since the late 1970s, the People's Republic of China (PRC) has experienced rapid economic growth fueled - in part - by a sharp increase in foreign direct investment (FDI). However, there is evidence that the China has not only experienced large-scale capital flight but that this flight is accelerating (see Wu, 1993, Prybyla, 1994, Gunter, 1996 and 2004, Wu & Tang, 2000, Zhu, Li, & Epstein, 2005, and Sharman, 2012). As a result, China has the largest accumulated capital flight among the top fifteen developing countries (Kar & LeBlanc, 2013, Table 4, p. 13.).

What is capital flight? One definition is: "...an outflow of funds from a country motivated by an adverse change in the country's economic, political or social environment." (Gunter, 2008, p. 434) Some researchers use a narrower definition. Epstein (2005, p. 3) states that: "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." Dornbusch posits two types of capital flight. The first is motivated by the fear of discrete losses as a result of expected major changes in the exchange rate, political

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1 In 1997, Hong Kong was formally reincorporated back into the People's Republic of China. However, consistent with "one country, two systems", Hong Kong continues to report balance of payments data separately from the rest of the People's Republic. For the purposes of this paper, "China" will refer to the People's Republic of China minus Hong Kong.

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risk, financial repression, and tax considerations. The second type, referred to as “low level capital flight” takes the form of a steady outflow motivated by tax considerations or the inability to diversify a portfolio in the developing country’s capital market (Dornbusch, 1990, pp. 4–5).

The scale and variance of capital flight are sources of concern since such flight may contribute to an unnecessary increase in a country’s foreign debt, undermine the tax base, and result in a net real capital transfer out of the country (Kar & Freitas, 2012; Khan & Haque, 1985). National authorities almost always consider capital flight to be a crime.

Previous studies of Chinese capital flight have attempted to estimate the volume of capital flight as well as seek explanations for its size and growth. Roache and Maziad (2013) discuss the implications of Chinese capital flight for financial stability and the international use of the Chinese currency, the Renminbi (RMB). They report People’s Bank of China estimates of $60–$80 billion a year of unreported capital flows for the period 2008–2011 (pp, 106–107). These results are roughly the same as the unadjusted residual measure estimated in this paper. Sharman (2012) posits that transaction costs were the major determinant of capital flight while rejecting criminal activities and tax arbitrage as explanations.

Kar and Freitas (2012) estimated gross Chinese capital flight for 2000–2010. Their study identifies the commodity groups most susceptible to trade mis-invoicing and discusses in detail the role of round-tripping2 as a motivation for Chinese capital flight. Shih (2011) focuses on the effects of the severe concentration of wealth in the Chinese economy. He argues that this concentration means that a relatively small percentage of the Chinese population could be responsible for the rapid growth in capital flight.

Zhu et al. (2005) not only provided estimates of capital flight for the period 1982–2001 but also examined why large-scale capital flight from China had less of a negative impact than expected. Gunter (2004) estimated capital flight from China for the period 1984–2001 and discussed various explanations including high domestic financial transactions costs, inappropriate exchange rates, the entrepôt role of Hong Kong, and political uncertainty. Wu and Tang (2000) provide several estimates of Chinese capital flight based on three different estimates of China’s external debt. They then examine the implications of capital flight for the value of the Yuan and the Chinese economy in general. Cai in his 1999 study of outward foreign direct investment noted that the growing amount of corruption might be an important determinant of capital flight (pp. 857–858). Sicular (1998) used Gunter (1996) capital flight estimates in her study of capital flight and foreign investment in China. She focused on the mystery of why China was simultaneously experiencing large amounts of inward foreign capital investment and outward capital flight. She concluded that an important component of an explanation was the different incentives faced by foreign and domestic investors.

This current paper extends Gunter (2004) in several ways. First, the same techniques for estimating capital flight and adjusting these estimates for the effects of legitimate foreign bank assets, trade mis-invoicing, and incomplete foreign debt coverage are used to produce estimates of Chinese capital flight for an extended period, 1984–2014. Second, the reported international reserves and foreign debt of China are adjusted to reflect exchange rate changes. Third, a variety of possible determinates of Chinese capital flight are considered including: an over-valued exchange rate, political and economic uncertainty, capital controls, corruption, an unusual pattern of transaction costs, and capital flight to finance migration.

2. Measuring capital flight

The methods of capital flight are limited only by human ingenuity. It can range from carrying a briefcase full of currency across a border to sophisticated financial transactions involving offshore havens such as the British Virgin or Cayman Islands. Each method incorporates a three-way tradeoff among security, secrecy, and return (Walter, 1985). It is this tradeoff that makes it possible to estimate capital flight since completely secret transactions are not favored since such transactions tend to have negative returns and little security. However, because some capital flight is never suspected, the capital flight estimates developed below underestimate the true volume of capital flight from China.

Is it more useful to estimate gross or net capital flight? Kar and Freitas (2012) focus on gross capital flight arguing that it is the outflow of capital that is most relevant both for understanding the effects of capital flight on the source country as well as developing policy responses. However, gross capital flight (usually described as gross excluding reversals or GER) ignores the effects of possible repatriation of flight capital. This leads to exaggerated estimates of accumulated flight capital. Also, as discussed below, while most policies that reduce capital flight also encourage repatriation; there are some – such as capital controls – that tend to reduce capital flight while discouraging repatriation.

The use of GER also runs into empirical problems. As discussed below, one of the data difficulties in estimating the effect of trade mis-invoicing on capital flight is that exports may be recorded by the exporting country in one period while the corresponding import is recorded by the importing country in the next period. In the case of Chinese exports, this would lead to apparent over-invoicing of exports – consistent with capital repatriation - in the earlier period followed by under-invoicing of exports – consistent with capital flight - in the latter period. Excluding the first case while including the second would bias the results in the direction of higher capital flight. Of course, if China were the importer, the same situation occurs with the years reversed.

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2 An example of round tripping would be if a Chinese portfolio holder illegally moves funds from the PRC to a fund in Singapore and then authorizes the fund to invest these funds back into the PRC. One motivation of round tripping is to capture subsidies or tax exemptions intended for FDI.
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