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Nonlinear Threshold Effects of Institutional Quality on Capital Flight:
Insights From Bangladesh

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ABSTRACT

Over the years, capital flight is a major concern for the countries where institutional quality is severely deficient. Almost all the literature emphasized the role of institutional quality on development. However, a possible question still remains unsettled what would be the optimum or threshold level of institutional quality that would create a milieu of least possible capital flight. The purpose of this study is to find the threshold value of institutional quality indicators and its impact on the capital flight of Bangladesh. Using the ICRG and WGI governance data over the period 1989 to 2016, the nonlinear regression proved that up to certain threshold level of institutional quality, interest rate differential reduces while economic growth stimulates net capital flight (NCF) of Bangladesh. Additionally, up to a certain threshold, level of corruption and interest rate differential lower NCF while beyond that level no effect exists. However, none of those independent variables affects NCF whenever the role of government stability threshold is considered.

KEYWORDS

Capital Flight, Economic Growth, Emerging Countries, Institutional Quality, Non-Linear Threshold

INTRODUCTION

In the simplest form, capital flight can be defined as a short-term speculative capital outflow (Cuddington, 1986). However, what entails and consist of this definition, depend on how broadly or how narrowly we want to define the term. Tracking back to the most traditional definition, where Kindleberger (1937) defined capital flight as a transfer of real resource from one country to another motivated by the economic and political uncertainty. The inevitable mobility of capital in today's global economy has forced us to make some refinement to this traditional definition. In order to consider normal component of resident international activity like- foreign trade for change in inflation rate,

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or foreign investment for change in interest rate, we define capital flight as a capital export by the private nonbank sector (Cuddington, 1986).

Many countries suffer severely from capital flight in terms of reserve shortage, low national revenue in tax and tariffs. In developing countries, capital flight is a major obstacle for long term sustainable growth. Globally $829 billions of annual capital flight from developing countries are observed, while annual aid flow renders $104 billion (Baker, 2005). Therefore, it will be no surprise if developing country loses as much as 10% of GDP annually due to capital flight.

While capital flight can be seen as an outcome of individual agents profit maximizing incentives, the quantitative importance of such activity cannot be ignored. In addition to illegal transaction the opportunity cost of capital flight to the society is much higher than individual return (Schneider, 2003). Capital flight is thought as an outcome of failure in economic governance (Ndikumana, Boyce & Ndiaye, 2014). For instance, Gunter (2017) implied that acceleration of capital flight might lead to reduced government revenue, capital loss and increased foreign debt. Indeed, Researchers pointed out capital flight as a trap (Beja, 2007; Ndikumana, Boyce & Ndiaye, 2014). Countries with historical capital flight are more often than not found themselves in a cycle of chronic capital flight problem. As persistent capital flight weakens and demoralizes financial regulation and accountability, it erodes institutional competence and ultimately allows capital flight to exist forever. It is also very difficult to curve the tendencies once residents become used to it (Cuddington, 1986).

Moreover, Capital flight itself certainly is not a standalone economic problem. Capital flight brings economic instability in the country (Hasnul & Masih, 2016). Ndikumana, Boyce & Ndiaye (2014) considered capital flight as a symptom of structural problem. Investment diversion theory also directs that macroeconomic uncertainty in the country coupled with simultaneous favorable qualitative and quantitative situation in foreign countries encourage the outward capital flow from the country.

The very definition of capital flight provides us an in important insight about the reasons for capital flight. While the economic uncertainty or more precisely profit maximizing opportunity in foreign investment is widely studied, the political part is yet to explore. Good economic-performance discourages capital flight by instilling hope to the savers while poor economic indicators like low GDP and fluctuating inflation encourage capital flight. As political scientists and economists believe that there is significant association between economic performance and institutions (Saxena, Rishi & Cerra 2005), we assume thereby that institutional quality also have some direct linkage to the capital flight. Therefore, the main objective of this study is to test if institutional quality, i.e. good governance has any threshold effect on the level of capital flight of a country. Good governance is a measure of public institutional ability to ensure rule of law, accountability, and transparency. It also ensues political stability in the country. Good governance has been used in various studies as a prime determinant for economic growth. In our study we are improvising this idea to test whether it has any bearing in the capital flight problem. Absence of good governance represents a structural inefficiency or weakness of the government that hinders the economy to count the outflow of fund in a legal way.

Our study is conducted on arguably one of the fastest-growing developing country, Bangladesh. Bangladesh is not only a good representation of an emerging country; it also represents the chronic problem of high capital flight as a developing country. As figure 1 shows that the NCF in Bangladesh in not only positive in last few years, it also fluctuates significantly. From the graph it could also be observed that with arguably democratic government regime in recent past from late 2012 the capital flight of Bangladesh is significantly positive and remains much higher. The higher fluctuation specially in recent past draws our attention to delve more onto it and know the underlying reasons. This scenario of capital flight in Bangladesh have also been in focus point since the Global Financial Integrity reports severe Illicit financial outflow from Bangladesh along with many other countries in the world. In that report, many economists and policy makers state that institutional factors such as political turmoil, corruption, and improper rule of law are key factors inducing capital flight of Bangladesh. In addition to that, Bangladesh is also heavily dependent on foreign remittance. During the fiscal

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