

# The Revolving Door? External Debt and Capital Flight: A Philippine Case Study

JAMES K. BOYCE\*

*University of Massachusetts, Amherst*

**Summary.** — In recent decades the private citizens of a number of Third World countries accumulated substantial external assets via "capital flight" at the same time their governments incurred large external debts. This paper proposes a classification of hypothetical linkages between capital flight and external debt disbursements, and examines the strength of these linkages in the Philippines during 1962-86. Econometric analysis and anecdotal evidence indicate that large sums of capital flowed into and out of the Philippines through a financial revolving door. On this basis I conclude that there is scope for political and legal challenges to the legitimacy of a substantial fraction of the country's external debt.

## 1. INTRODUCTION

The accumulation of external debt by Asian, Latin American, and African countries in the 1970s and 1980s was accompanied in many instances by substantial "capital flight." Morgan Guaranty Trust Company (1986) estimated, for example, that 18 Third World countries experienced \$198 billion in capital flight during 1976-85. At the same time, the total external indebtedness of these countries rose by \$451 billion.<sup>1</sup>

The coexistence of these massive capital flows in opposite directions is of interest on both practical and theoretical grounds. "It is unrealistic to call upon the support of voluntary lending from abroad, whether public or private, when domestic funds are moving in the other direction," US Treasury Secretary James Baker stated at the 1985 World Bank/International Monetary Fund annual meeting in Seoul. "If a country's own citizens have no confidence in its economic system, how can others?"<sup>2</sup> Similar sentiments have been expressed by commercial bankers, who describe themselves as "understandably reluctant to provide fresh funds unless the debtors put a stop to the capital flight."<sup>3</sup>

In the indebted Third World countries such as the Philippines — where the public is understandably reluctant to accept cuts in living standards to free resources for debt service — one often finds a rather different perspective on the implications capital flight. If external borrowing financed the accumulation of external assets by private citizens, the question naturally arises

of why the government, and through it the populace at large, should be shouldered with the burden of continued debt service. The late Carlos Diaz-Alejandro (1984, p. 379) was among the first to draw attention to this view from the South: "This situation reduces the political legitimacy of efforts to service the external debt; indeed, it has generated a crisis of legitimacy for the role of the private sector in Latin American development."

Underpinning these very different conclusions are equally different understandings of the causes of capital flight. In the Baker-banker view, Third World governments themselves bear most of the blame for capital flight. These governments' irresponsible and misguided policies — notably exchange rate overvaluation, financial repression, and inflationary fiscal and monetary policies — have driven rational investors to more favorable climates. Third World debt critics, by contrast, place the main onus upon the irresponsible policies of the official and private creditors. They note that external loans provided vital financial support to the very regimes, many of them unpopular dictatorships, whose policies are now deplored after the fact by the bankers. Moreover, they suspect that the "international private banking" departments of large commer-

\*The author is grateful to Jerry Epstein and Martin Ravallion for comments on an earlier draft of this paper, and to Lyuba Zarsky, Annette Balaoing, and Lynn Duggan for research assistance.

cial banks actively encouraged and facilitated capital flight.<sup>4</sup>

In the Baker-banker view capital flight is a reason for creditors *not* to lend, since it leads to diminished debt-servicing capacity. In the critics' view it was lending itself which provided the motive and means *for* capital flight. By the first logic we might expect a negative correlation between net external debt disbursements and capital flight — across countries and over time, more capital flight leads to less lending. By the second logic we would expect a positive correlation — more lending leads to more capital flight.

An econometric test of these competing predictions is presented below for the Philippines during 1962–86. Before turning to the Philippine case, however, it is useful to distinguish among the different interpretations which can be placed upon a positive correlation between debt disbursements and capital flight.

## 2. LINKAGES BETWEEN EXTERNAL DEBT AND CAPITAL FLIGHT

In a textbook world in which “capital is capital,” money would move across borders in response to international differences in rates of return and risk. Favorable conditions in any given country would attract foreign and domestic investment alike; unfavorable conditions would repel foreign investment and trigger resident capital outflows. The result would be a negative correlation between debt-creating inflows and resident outflows. Capital flight would be lowest in those years in which foreign borrowing was greatest, and vice versa.

When in real-world settings the opposite occurs, such that capital flight is larger in years of greater lending — how is this to be explained? Answers to this question can be grouped into five categories:

### (a) *Indirect linkages*

The explanation favored by bankers, at least in their public statements, is that debt disbursements and capital flight bear no direct causal relation to each other. Rather, both are results of a common set of exogenous factors, notably poor economic management by the debtor government. The Morgan Guaranty Trust Company (1986, p. 15) declares, for example, that the simultaneous occurrence of debt accumulation and capital flight in Third World countries “was no coincidence,” since “The policies and track

records that engendered capital flight also generated demands for foreign credit.”

This line of reasoning seems plausible as an explanation for a positive cross-sectional correlation between external borrowing and cumulative capital flight, both measured over an appropriately long interval. Over a decade or two, irresponsibly governed country A may witness more public-sector demand for external credit, and more private-sector propensity for capital flight, than prudently governed country B. This is far less convincing, however, as an explanation for a positive time-series correlation between annual debt disbursements and capital outflows in a given country, since the time frame for the relevant “policies and track records” is clearly longer than a single year.

Moreover, while this line of reasoning may help to explain the *demand* for external borrowing, it leaves open the question of why foreign creditors were willing to *supply* large sums of money to governments whose own residents were voting no confidence by shifting their capital abroad. As Pastor (1990, p. 7) remarks, “If the ‘investment climate’ in a country is negative enough to push out local capital, why would savvy international bankers extend their own capital in the form of loans?” Either the creditors were not so savvy, or they faced risks and returns systematically different from those perceived by residents.

### (b) *Direct causal linkages*

The latter possibility lies at the heart of explanations which posit direct causal linkages between debt and capital flight. Direct linkages can be classified into four groups on the basis of (i) whether the direction of causality runs from debt to capital flight, or vice versa, and (ii) whether one simply provided the *motive* for the other, or whether it also provided the *means*.

Figure 1 summarizes these linkages. Explanations in which the causality runs from debt to capital flight can be divided into those in which external borrowing motivates residents to shift their own capital abroad (for example, by generating expectations of exchange rate devaluation or fiscal crisis), and those in which the borrowed funds are themselves transferred abroad. I shall term these “debt-driven” and “debt-fueled” capital flight, respectively. Similarly, explanations in which the causality runs from capital flight to debt can be divided into “flight-driven external borrowing,” in which the export of capital generates an economy-wide demand for replacement funds, and “flight-fueled external borrowing,” in

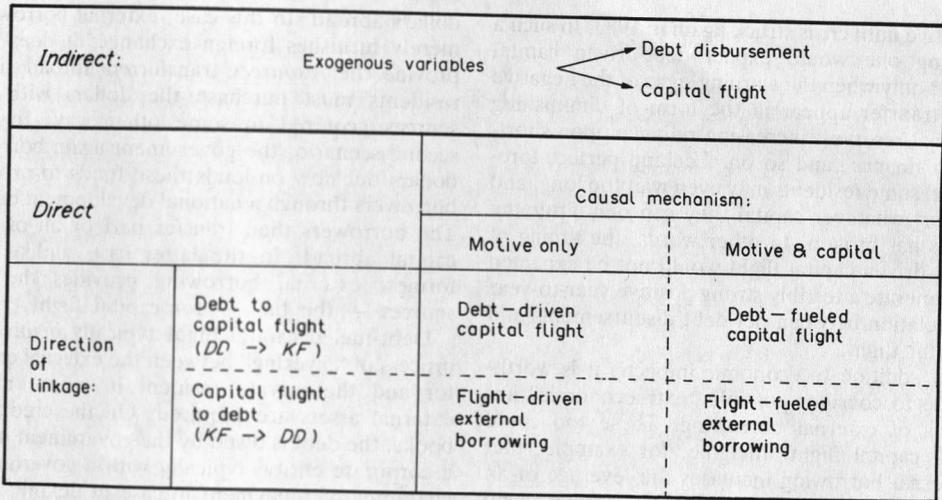


Figure 1. Linkages between debt disbursements and capital flight.

which residents who exported capital then "borrow" their own money back.

In each variant, capital flows in both directions as if through a revolving door. Pursuing this analogy, we can think of *debt-driven* capital flight as a case in which Mr. Dollar arrives through the revolving door, and Mr. Peso upon seeing him anticipates trouble and decides to leave. In *debt-fueled* capital flight, by contrast, Mr. Dollar enters, attends to a few formalities discussed below, and then slips out again. In *flight-driven* external borrowing, Mr. Peso leaves and Mr. Dollar is invited to take his place. And in *flight-fueled* external borrowing, Mr. Peso steps out and then comes back dressed as Mr. Dollar. Let us examine each scenario more closely.

#### (i) *Debt-driven capital flight*

"Debt-driven" capital flight refers to capital which flees a country in response to the economic circumstances attributable to the external debt itself.

Consider the impact of external borrowing upon the exchange rate. In the short run, the capital inflow increases the supply of foreign exchange, applying upward pressure to local currency. If, however, this debt is incurred for purposes which are unlikely to generate adequate foreign exchange for repayment, then in the long run an opposite pressure will result. When the net transfer (new borrowing minus amortization and interest payments on past loans) turns negative, increased demand for foreign currency (compared to the no-borrowing counterfactual)

will depress the value of the local currency. The rational response for any asset holder who can do so at reasonable cost is to dollarize when the local currency is artificially inflated in the expectation of its eventual decline.<sup>5</sup> Since this dollarization further increases demand for foreign exchange, the pressure for devaluation gets an additional boost from self-fulfilling expectations.

Similarly, external borrowing temporarily eases the pressure upon government to tax residents either overtly or through the "inflation tax." Further down the road, however, domestic assets holders may expect exceptionally onerous taxes in the wake of an eventual debt crisis. "Taxes" can here be considered as a broad range of regulations which reduce the value of domestic financial assets (Dooley, 1987, p. 79). The desire to avoid such taxes in the future provides a further motivational link between debt inflows and capital flight.

External funds may also preempt favorable investment opportunities, or drive down domestic interest rates, "crowding out" domestic capital and pushing it overseas.<sup>6</sup>

Note, however, that debt-driven capital flight need not be hasty, particularly if the major impetus comes from anticipation of future consequences of the debt accumulation. The net transfer seldom alternates sign in successive years. Rather, a number of years of positive net transfers typically precedes a number of years of negative ones. In the Philippines, for example, the net transfer was positive during 1963-70, briefly dipped below zero in 1971 in the wake of a balance-of-payments crisis, and then remained

positive until crisis struck again in 1983. In such a setting one would expect debt-driven capital flight only when the warning signs of the negative net transfer appear in the form of diminishing official reserves, increasing reliance upon short-term finance, and so on. Lacking perfect foresight, some residents may even wait too long, and export whatever capital they can only after the crisis has broken. In other words, the timing of debt-driven capital flight would not be expected to generate a terribly strong positive year-to-year correlation between net debt disbursements and capital flight.

In addition to economic impacts, it is worthwhile to consider possible "extraeconomic" impacts of external borrowing. These too could spur capital flight. Imagine, for example, that external borrowing increases the leverage of an avaricious tyrant and his greedy cronies, who control the borrower government. Imagine, further, that they employ this leverage to wrest control of assets and markets from their rivals in the national economy, using a combination of legal, quasi-legal and illegal methods. The resulting increase in "expropriation risk" may well propel further capital flight. These hypothetical circumstances, not dissimilar to those faced by Filipino capitalists under the Marcos regime, might strengthen the phenomenon of debt-driven capital flight. But again the relevant time frame would extend well beyond a single year. A strong year-to-year correlation implies that other, tighter linkages were at work.

#### (ii) *Debt-fueled capital flight*

In "debt-fueled" capital flight, the inflow of external resources provides both the resources and a possible motive for capital flight. The same individual borrows external resources and then transfers part or all of his or her assets abroad. Debt directly fuels capital flight. In some cases the fuel is fungible, as in Pastor's (1990, p. 7) example in which "an investor could draw a publicly-guaranteed external loan cheaply and ship his/her own resources abroad to acquire foreign assets." In other cases, as described by Henry (1986, p. 20) the money never enters the country. The money is borrowed and immediately deposited in a foreign bank, possibly the same one making the loan, so that "the entire cycle is completed with a few bookkeeping entries in New York" or other financial centers.

To differentiate between debt-driven and debt-fueled capital flight, it is useful to contrast two scenarios. In the first, the government borrows dollars (or any other hard currency) and then sells them to its own residents. Some of the buyers then legally or illegally transfer these

dollars abroad. In this case, external borrowing merely furnishes foreign exchange; it does not provide the resources transferred abroad since residents must purchase the dollars with resources acquired in some other way. In the second scenario, the government again borrows dollars but now on-lends these funds to private borrowers through a national development bank. The borrowers then transfer part or all of this capital abroad. In the latter case, unlike the former, external borrowing provides the resources — the fuel — for capital flight.

Debt-fueled capital flight typically involves a process of "layering" between the external creditor and the private resident in whose name external assets are acquired. On the creditor's books, the debt is owed by the government or by a corporate entity, typically with a government guarantee of repayment in case of default. The external assets, by contrast, are in the names of individuals: government officials who siphoned part of the proceeds of the loan, or private residents who borrowed in the name of a firm. The holder of the external asset thus is not identical to the holder of the external liability. Yet in practice the same individual is engaged in both transactions.

This legal discrepancy is by no means coincidental. Public guarantees posed a "moral hazard" for both creditors and borrowers. Insured against the risk of default, neither party had an incentive to minimize it. Creditors might have been more reluctant to finance capital flight if repayment were the sole responsibility of the individual flight capitalist. With the debt in the name of the government, or secured by government guarantee, the creditors could draw comfort from their faith that "countries do not go bankrupt."

For the flight capitalist, meanwhile, the evasion of responsibility for eventual repayment of the external loan was often a key element in the transaction's rationale. It is not likely that the capitalist could turn a profit by borrowing money from a bank and then redepositing there or in another bank, for banks derive their own profit from the opposite spread between interest rates. It is conceivable that some borrowers were astute enough to identify lucrative overseas investment opportunities which permitted retention of a profit spread after repayment, but it is doubtful that all flight capitalists possessed such acumen. In many cases, the principal motive for debt-fueled capital flight was the opportunity to exploit the legal dichotomy between the holder of the liability and the holder of the asset. Whenever there are opportunities for the acquisition of private assets by means of public debts,

"rational" profit maximizers can be expected to seize them.

Debt-fueled capital flight could generate a rather strong year-to-year correlation between net debt inflows and capital flight. Unlike debt-driven capital flight, the causal relation is not mediated by changing perceptions of the economic and political environment. Nor are the lags between the borrowing and flight likely to extend over a period of several years. Rather the loan is obtained for the intended purpose of capital flight, and the borrower may well be anxious to consummate the circuit expeditiously, while the window of opportunity is open. Mr. Dollar's round trip through the revolving door is likely to be quick.

(iii) *Flight-driven external borrowing*

We now turn to causal linkages running in the opposite direction, from capital flight to external borrowing. Here too we can distinguish between the case in which the link is solely motivational (here termed "flight-driven" external borrowing) and that in which flight capital directly provides the resources which reenter the country ("flight-fueled" external borrowing). Let us start with the former.

The demand-side of flight-driven external borrowing is straightforward. The drain of domestic resources through capital flight generates demand for replacement funds on the part of the government and private sectors.

Why are external creditors willing to meet this demand, when local residents are not? The answer is likely to be found in different risks and returns facing resident and nonresident capital, rather than in different perceptions of the same risks and returns. An inflation tax, for example, will erode the returns to holders of fixed-interest domestic-currency liabilities, whereas nonresidents who hold claims denominated in foreign currency are unaffected.<sup>7</sup> Foreign creditors may also enjoy a "comparative advantage" in risk mitigation thanks to the "direct or indirect sanctions" they can bring to bear upon the borrower (Lessard, 1986, p. 16). If so, they may believe that "domestic assets held by residents are effectively subordinated to sovereign external obligations in the case of a fiscal crisis" (Lessard, 1987, p. 99). Systematic differences in the risk-adjusted financial returns to domestic and external capital could also arise from disparities in taxation, interest-rate ceilings, and risk-pooling capabilities (Lessard and Williamson, 1987b, pp. 215-218).

Such differences can be expected to lead to "offshore financial intermediation," by which foreign creditors provide fresh loans as domestic

capital is exported, in effect transforming resident capital into nonresident capital. This process in turn can intensify debt-driven capital flight, since "the substitution of foreign funds backed by international leverage for resident savings may increase the likelihood of crises and the relative exposure of (the remaining) resident holdings of domestic assets" (Lessard, 1987, p. 98). A vicious circle is set in motion, in which debt and capital flight feed upon each other.

(iv) *Flight-fueled external borrowing*

In flight-fueled external borrowing, Mr. Peso flees and then reenters the country in the guise of Mr. Dollar. The flight capitalist seeks to arbitrage the yield and risk differentials between resident and external capital, by engaging in a series of transactions sometimes known as "round-tripping" or "back-to-back loans." Resident capital is dollarized and deposited in an overseas bank, and the depositor then takes a "loan" from the same bank (for which the deposit may serve as collateral).

As in the case of offshore financial intermediation, government guarantees provide a crucial part of the rationale for back-to-back loans. As Khan and Ul Haque (1985, p. 625) remark:

To the extent that the investor believed that foreign debt implicitly carried a government guarantee, he was assured that, if the domestic firm or enterprise went bankrupt or was expropriated, the foreign lender's claim would be assumed by the government. Savings held abroad would obviously not be at risk, so that the investor was protected if he relied as much as possible on foreign borrowing. Given this scenario, the domestic investor was behaving in a completely rational fashion.

In many cases, of course, the government guarantees have been explicit.

A further motivation for flight-fueled external borrowing is the concealment of the sources of funds from present or prospective government authorities. This was the main objective of the pioneer of back-to-back loans, US organized crime financier Meyer Lansky, who developed the technique in the 1930s as a means to launder funds in Switzerland.<sup>8</sup> In this respect back-to-back loans have a motivational dimension beyond more general offshore financial intermediation. The laundry service not only bleaches out systematic yield differentials, but also removes the stain of the money's origins.<sup>9</sup>

Which of the two causal linkages from capital flight to external borrowing is more likely to generate a strong positive correlation between their year-to-year variations? It seems reasonable to hypothesize that flight-fueled external borrow-

ing generates the tighter link, since the causal relation is again not mediated by other economic variables, and accordingly the interval between the flight and borrowing may be shorter.

### (c) *Some implications*

The distinctions drawn above have been often blurred in the recent literature on Third World debt and capital flight. The debt-to-flight linkage has been described, for example, as a "liquidity effect," in which "the availability of foreign exchange enables capital flight to take place" (Lessard, 1987, p. 99). This formulation could encompass both debt-fueled and debt-driven capital flight.<sup>10</sup> Yet the two have quite different implications.

The "fuel" linkages — debt-fueled capital flight and flight-fueled external borrowing — imply that international creditors bear a large share of responsibility for the debt crisis. Knowingly or unknowingly, they colluded in transactions whereby public debts were transformed into private assets, and vice versa, transactions which come perilously close to what is commonly understood as fraud. The "drive" linkages place the creditors in a relatively favorable light; they may have lent unwisely, but they did not act unethically.

Members of the banking community would prefer to be viewed as slightly soft-headed providers of "easy money," rather than as operators of a toll booth at the revolving door:

It is . . . a gross distortion to claim, as some have done, that the "private banking" departments of some lending banks were deliberately seeking the money that their loan departments were putting out; rather, the point is that easy money contributed to lax policies, especially exchange overvaluation, which provided the incentive for private capital outflows.<sup>11</sup>

The distinction here is precisely that between debt-fueled and debt-driven capital flight.<sup>12</sup>

The linkages between external debt and capital flight sketched above are not mutually exclusive. On the contrary, they may be mutually reinforcing. Capital flight may be both driven and fueled by external borrowing and vice versa. Econometric analysis can test for the presence of direct as opposed to indirect linkages, since a positive year-to-year correlation between net debt disbursements and capital flight would indicate the former. Econometric analysis may also shed light upon the relative importance of the different hypothetical direct linkages, by examining timing and causality. Such an analysis is presented below for the Philippines.

## 3. CAPITAL FLIGHT FROM THE PHILIPPINES

The Philippines, with an outstanding external debt of \$28 billion in 1986, is among the 10 most heavily indebted countries in Asia, Africa, and Latin America. Cumulative capital flight from the Philippines during 1962–86 totalled \$10.4 billion in nominal terms; in real terms this amounted to \$13.5 billion in 1986 dollars, equivalent to 48% of the country's external debt outstanding in 1986.<sup>13</sup> When the stock of capital flight in this period is calculated with imputed interest earnings (using the short-term US Treasury bill rate) the cumulative total is \$19.9 billion, equivalent to 70% of the external debt.<sup>14</sup> As a fraction of external debt, Philippine capital flight appears to have exceeded that of Brazil, South Korea, and Indonesia, but to have been less than that of Argentina, Venezuela, Malaysia, and possibly Mexico.<sup>15</sup> In this respect, then, the Philippine case was not atypical of the major debtor countries.

The most widely known instances of capital flight from the Philippines involve ex-President Marcos, his family, and their close associates. Estimates of the amount of capital exported by Marcos and his associates vary widely. Press reports in July 1988 indicated that Marcos had offered to repatriate \$5 billion to the Philippines in return for the right to return to the country and be exempt from criminal prosecution.<sup>16</sup> But Philippine capital flight was not restricted to the ruling family and their friends. The first finance minister in the successor Aquino government remarked that "every successful businessman, lawyer, accountant, doctor, and dentist I know has some form of cash or assets which he began to squirrel abroad after Marcos declared martial law in 1972 and, in the process, frightened every Filipino who had anything to lose."<sup>17</sup> Moreover, the data reported below indicate that Philippine capital flight has a long history, predating not only martial law but Marcos's initial assumption of the presidency in 1966.

Guarantees and on-lending by government institutions were the major avenues for external borrowing by the Philippine private sector. "The creditors, in general, considered the Philippines to be a very high risk country," former Philippine Finance Minister Cesar Virata testified before a Congressional hearing in 1987, "and they would not like to lend to the private sector without government guarantee."<sup>18</sup>

Many of these guarantees were what Rosendo Bondoc, the former president of the Philippine Export and Foreign Loan Guarantee Corporation, termed "behest guarantees," issued at

the express instructions of President or Mrs. Marcos.<sup>19</sup> Asked whether he considered rescinding a guarantee on a loan he knew to have been diverted into capital flight, Bondoc explained: "In the light of the instructions being given, it was either follow or . . . You know it was an autocratic rule."

Similarly, much of the external credit on-lent to the private sector by the Development Bank of the Philippines (DBP) and the Philippine National Bank were "behest loans," issued on the instructions of the Marcoses. In an extraordinary 1983 memorandum to President Marcos and Prime Minister Virata, Jose Tengco, Jr., the Acting Chairman of the DBP, listed that institution's exposure to "behest accounts" amounting to 28.2 billion pesos (equivalent to \$2.54 billion at the average 1983 official exchange rate). Nearly a quarter of this exposure (6.6 billion pesos) was in the form of guarantees; the remainder was DBP loans, much of which represented on-lending of external borrowings.<sup>20</sup>

A governor of the Development Bank of the Philippines recounted the following example of debt-fueled capital flight to a journalist:

Persons seeking the loan would just come around here and say that we need 100-200 million dollars for this project which looks viable. It's not viable but Marcos says it is viable. When he says that then it better be viable. For instance, we were recently sent an account for 65 million dollars that we are supposed to pay. Now, apparently this money was supposed to have put up a steel mill, a factory . . . So we asked to see where the factory is, and to this day, after several months, nobody has found it. In short, this factory does not exist.<sup>21</sup>

Similar problems afflicted the other major government on-lending institution, the Philippine National Bank (PNB). "Kickbacks are apparently the name of the game in the expansion of the sugar industry here," the *Far Eastern Economic Review* reported in 1976:

Whether or not the new [sugar mill] centrals make any money may be of little consequence to the owners. The investors who are favoured generally have to put up only about P2.5 million (US \$333,330) for centrals costing \$65 million. The remainder is loan money from or guaranteed by the Government-owned Philippine National Bank (Wideman, 1976).

A senior Japanese government official told the *Review* that the kickbacks averaged 12% of contract prices, or \$7.8 million on a \$65 million sugar mill.

Such anecdotal evidence suggests direct linkages between external borrowing and capital flight in the Philippines. The statistical analysis reported in the following section provides strong support to this hypothesis.

#### 4. A MODEL OF PHILIPPINE CAPITAL FLIGHT

The relationship between the timing of capital flight and of net external debt disbursements is depicted in Figure 2. The solid line represents the annual change in the Philippine external debt (*DD*).<sup>22</sup> The broken lines represent two alternative measures of capital flight. The first (*KFA*) is a "residual" estimate in which capital flight is

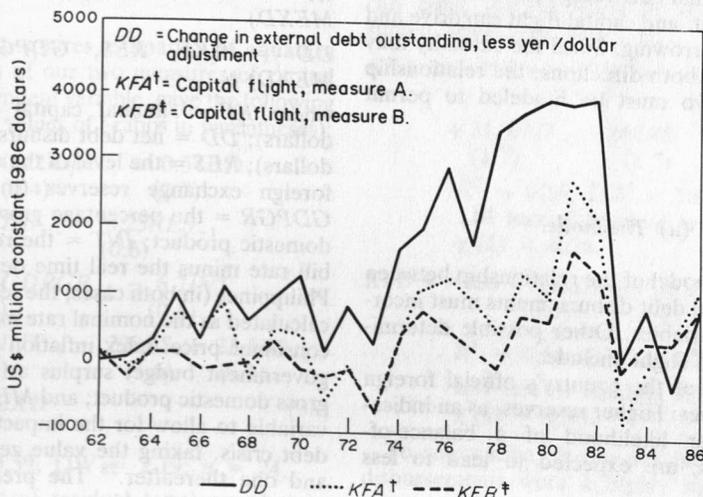


Figure 2. External debt inflows and capital flight, the Philippines, 1962-86.

calculated as the increase in external debt outstanding minus the sum of the current account deficit, the net direct investment outflow, and the increase in official reserves.<sup>23</sup> The second (*KFB*) is a narrower "hot money" measure of capital flight, comprising net errors and omissions and certain private, nonbank short-term capital movements reported in the balance of payments. Both include an adjustment for the net effect of misinvoicing of exports and imports (see Boyce and Zarsky, 1988). All variables are expressed in constant 1986 dollars.

Conceptually, the hot money measure of capital flight is excessively narrow, since long-term assets such as equities, bonds, and real estate may be relatively close substitutes for short-term assets. Moreover, the official balance-of-payments statistics (from which net errors and omissions in the hot money measure are drawn) often appear to understate external borrowing as reported elsewhere. This too imparts a downward bias to the resulting estimates of capital flight. It is nevertheless used as an alternative in the statistical analysis which follows, as a check on the sensitivity of the results to the methodology employed for the measurement of capital flight.<sup>24</sup>

A positive correlation between net debt disbursements and capital flight is apparent from the figure. The simple correlation between debt inflows and the broad measure of capital flight is 0.77; that between debt inflows and the narrow measure is 0.69.

There are plausible *a priori* grounds to expect a positive correlation between capital flight and debt-creating capital inflows, as discussed in Section 2. External borrowing can both drive and fuel capital flight, and capital flight can drive and fuel external borrowing. Since the causality may run in either or both directions, the relationship between the two must be modeled to permit simultaneity.<sup>25</sup>

#### (a) *The model*

A complete model of the relationship between capital flight and debt disbursements must incorporate other variables. Other possible determinants of capital flight include:

(i) The level of the country's official foreign exchange reserves: Higher reserves, as an indicator of a lower likelihood of a balance-of-payments crisis, are expected to lead to less capital flight.<sup>26</sup>

(ii) The rate of growth of gross domestic product: Higher growth, and the associated

opportunities for investment, could be expected to result in less capital flight.

(iii) The difference between international and domestic real interest rates: A larger real interest rate gap would be expected to induce more capital flight.

(iv) The government budget surplus or deficit: As a signal of the likelihood of a fiscal crisis, a higher surplus (or lower deficit) would be expected result in less capital flight.

Each of these variables could also affect the level of debt disbursements. Higher foreign exchange reserves, interest rate differences, and budget surpluses could be expected to lead to lower demand for external capital and to greater supply; the direction of the net effects, if any, would hence depend upon the relative importance of supply and demand in determining the amount of external borrowing. The net effect of GDP growth is also uncertain — higher growth would presumably boost private investment demand (and perhaps supply), but public sector demand for external credit could be countercyclical.

In addition, the Mexican near-default of August 1982 had a drastic effect upon the supply of external credit from commercial banks in subsequent years. In the Philippine case, this crisis was followed by the assassination of Senator Benigno Aquino in August 1983. As new lending dried up and the net transfer (new lending minus debt service payments) turned negative, the country was plunged into its worst balance-of-payments crisis in its postwar history.<sup>27</sup>

A general model incorporating these variables is:

$$KF = f(DD, RES, GDPGR, INT, BS, MEXD) \quad (1a)$$

$$DD = f(KF, RES, GDPGR, INT, BS, MEXD) \quad (1b)$$

where *KF* = annual capital flight (in 1986 dollars); *DD* = net debt disbursements (in 1986 dollars); *RES* = the level of the country's official foreign exchange reserves (in 1986 dollars); *GDPGR* = the percentage growth rate of gross domestic product; *INT* = the real US Treasury bill rate minus the real time deposit rate in the Philippines (in both cases, the real interest rate is calculated as the nominal rate minus the relevant consumer price index inflation rate); *BS* = the government budget surplus as a percentage of gross domestic product; and *MEXD* = a dummy variable to allow for the impact of the Mexican debt crisis, taking the value zero prior to 1983 and one thereafter.<sup>28</sup> The predicted effects of each of these variables are summarized in Table 1.



Table 1. Predicted effects of independent variables in debt-capital flight regressions

Independent variable	Dependent variable DD		
	KF	Demand	Supply
KF		+	+
DD	+		
RES	-	-	+
GDPGR	-	?	+
INT	+	-	+
BS	-	-	+
MEXD	+	+	-

A fairly general initial dynamic specification of this model is:

$$KF = a_0 + a_1KF_{-1} + b_0DD + b_1DD_{-1} + cRES_{-1} + dGDPGR_{-1} + e_0INT + e_1INT_{-1} + f_0BS + f_1BS_{-1} + gMEXD + v_t \quad (2a)$$

$$DD = a'_0 + a'_1DD_{-1} + b'_0KF + b'_1KF_{-1} + c'RES_{-1} + d'GDPGR_{-1} + e'_0INT + e'_1INT_{-1} + f'BS_{-1} + g'MEXD + v'_t \quad (2b)$$

Owing to possible simultaneity, only lagged values of *RES* and *GDPGR* are included in the equations, and for the same reason only the lagged value of *BS* appears in equation (2b). Simultaneity between *KF* and *DD* is addressed below by the use of instrumental variables.

#### (b) Estimation of the determinants of capital flight

Ordinary least-squares estimation of equation (2a), using each of our two measures of capital flight as the dependent variable, gave the following results (absolute values of *t*-ratios in parentheses):

$$KFA = -15 - 0.12KFA_{-1} + 0.54DD + 0.07DD_{-1} - 0.25RES_{-1} - 35.8GDPGR_{-1} - 6.7INT + 14.4INT_{-1} - 228BS + 22.5BS_{-1} - 433MEXD \quad (3a)$$

$$\bar{R}^2 = 0.59; DW = 2.19; n = 24.$$

LM test of residual serial correlation:  $\chi^2(1) = 1.32$ .

$$KFB = -708 - 0.13KFB_{-1} + 0.39DD + 0.11DD_{-1} - 0.31RES_{-1} + 62.9GDPGR_{-1} + 2.8INT + 27.3INT_{-1} - 243BS + 617BS_{-1} + 590MEXD \quad (3b)$$

$$\bar{R}^2 = 0.63; DW = 2.31; n = 24.$$

LM test of residual serial correlation:  $\chi^2(1) = 2.87$ .

On elimination of the less significant variables, we obtain the following estimates:

$$KFA = -303 + 0.62DD - 0.30RES_{-1} + 21.0INT_{-1} - 218BS \quad (4a)$$

$$\bar{R}^2 = 0.69; DW = 2.20; n = 24.$$

LM test of residual serial correlation:  $\chi^2(1) = 0.29$ .

$$KFB = -412 + 0.25DD + 16.3INT_{-1} - 176BS \quad (4b)$$

$$\bar{R}^2 = 0.70; DW = 2.05; n = 24.$$

LM test of residual serial correlation:  $\chi^2(1) = 0.04$ .

The models performed well on various diagnostic tests.<sup>29</sup> To check for simultaneity bias, an instrumental variables estimator (*DD\**) was tested. Using the lagged variables and the Mexican crisis dummy variable as instruments, a similar result was obtained:

$$KFA = -218 + 0.87DD^* - 0.57RES_{-1} + 31.9INT_{-1} - 167BS \quad (5a)$$

$$\bar{R}^2 = 0.56; DW = 1.67; n = 24.$$

LM test of residual serial correlation:  $\chi^2(1) = 0.76$ .

$$KFB = -360 + 0.22DD^* + 15.2INT_{-1} - 170BS \quad (5b)$$

$$\bar{R}^2 = 0.54; DW = 1.75; n = 24.$$

LM test of residual serial correlation:  $\chi^2(1) = 0.45$ .

To summarize, the results indicate that debt disbursements were a highly significant determinant of Philippine capital flight during 1962-86. Greater borrowing went hand-in-hand with

greater capital flight. This result implies the existence of what in this paper are termed "debt-fueled" and "debt-driven" capital flight. In addition, the real interest rate differential, government budget surplus or deficit and, in the case of the broad capital flight measure, the level of official reserves, had moderately significant effects with the expected signs.

(c) *Estimation of the determinants of net debt disbursements*

What of the reverse linkages, from capital flight to debt? Estimation of equation (2b), using each of our measures of capital flight, yields the following results:

$$\begin{aligned}
 DD = & 529 - 0.03DD_{-1} + 0.57KFA & (0.1) & (2.4) \\
 & + 0.14KFA_{-1} + 0.94RES_{-1} & (0.4) & (3.2) \\
 & - 118GDPGR_{-1} + 24.9INT & (1.1) & (1.3) \\
 & - 46.3INT_{-1} + 32.3BS_{-1} & (2.2) & (0.2) \\
 & - 1190MEXD & (1.5) & (6a)
 \end{aligned}$$

$$\bar{R}^2 = 0.81; DW = 2.47; n = 24.$$

LM test of residual serial correlation:  
 $\chi^2(1) = 6.06.$

$$\begin{aligned}
 DD = & 960 - 0.02DD_{-1} + 0.81KFB & (0.1) & (2.2) \\
 & + 0.08KFB_{-1} + 0.96RES_{-1} & (0.2) & (3.4) \\
 & - 166GDPGR_{-1} + 18.6INT - 56.4INT_{-1} & (1.7) & (1.0) & (2.8) \\
 & - 10.6BS_{-1} - 1885MEXD & (0.1) & (2.6) & (6b)
 \end{aligned}$$

$$\bar{R}^2 = 0.81; DW = 2.40; n = 24.$$

LM test of residual serial correlation:  
 $\chi^2(1) = 5.52.$

Using instrumental variables estimators ( $KFA^*$  and  $KFB^*$ ), again based upon the lagged variables and  $MEXD$ , and eliminating variables whose estimated coefficients are not significantly different from zero, the serial correlation is eliminated and the equations collapse to:<sup>30</sup>

$$\begin{aligned}
 DD = & 108 + 0.84KFA^* + 0.71RES_{-1} & (2.6) & (3.4) \\
 & - 34.6INT_{-1} - 361MEXD & (2.2) & (1.0) & (7a)
 \end{aligned}$$

$$\bar{R}^2 = 0.79; DW = 2.23; n = 24.$$

LM test of residual serial correlation:  
 $\chi^2(1) = 0.49.$

$$\begin{aligned}
 DD = & 557 + 1.74KFB^* + 0.50RES_{-1} & (2.4) & (1.7) \\
 & - 41.5INT_{-1} - 1011MEXD & (2.6) & (2.3) & (7b)
 \end{aligned}$$

$$\bar{R}^2 = 0.78; DW = 2.21; n = 24.$$

LM test of residual serial correlation:  
 $\chi^2(1) = 0.48.$

These results indicate that debt disbursements were significantly and positively affected by capital flight. Taken with the results reported in equations (5a) and (5b), this supports the hypothesis that the causal linkages between debt and capital flight do in fact run in both directions. In addition, debt disbursements were positively related to the (lagged) level of official reserves, suggesting that, at least in this respect, supply-side factors drove the credit market, since higher reserves were presumably associated with a greater willingness to lend but with a lesser need to borrow. Similarly, the negative impact of the Mexican debt crisis upon subsequent disbursements is clearly a supply-side phenomenon.<sup>31</sup> The negative sign on the lagged interest rate differential suggests, however, that demand-side considerations also influenced the level of external borrowing.

In sum, statistical analysis of the relationship between net debt disbursements and capital flight in the Philippines during 1962-86 indicates that the two were strongly linked. Larger debt disbursements led to greater capital flight, and more capital flight led to larger debt disbursements. While neither capital flight nor debt can be completely explained in terms of the other, our analysis suggests that this vicious circle was an important feature of the financial interactions between the Philippines and the world economy in recent decades, interactions which culminated in the country's continuing debt crisis. The Philippines was probably not unique in this respect.<sup>32</sup>

The fact that debt disbursements and capital flight are most strongly correlated with each other's values in the same year suggests that they not only *drove* each other by providing motives, but also *fueled* each other by providing capital for the reverse flow. In other words, external resources did not simply "crowd out" or scare off domestic capital, nor did capital flight simply create a vacuum into which external capital was pulled; rather, the same capital circuted in both directions through the revolving door.

## 5. CONCLUDING REMARKS

The Philippines, like many other Third World countries, simultaneously experienced large outflows of private capital and rising external indebtedness in recent decades. The relationship between capital flight and external borrowing is open to a variety of interpretations. Indirect linkages, in which both borrowing and flight are caused by other factors such as economic mismanagement by domestic authorities, could contribute to a positive cross-sectional correlation between debt and capital flight in a multicountry sample. But a strong, positive time-series correlation in any given country, as reported above in the case of the Philippines, suggests the existence of direct causal linkages.

The fourfold classification of direct linkages between external debt and capital flight proposed in this paper is based upon the direction of causality and upon whether the linkage is limited to motivations or also extends to the provision of capital involved. The results of an econometric analysis of Philippine data support the hypothesis that debt-fueled capital flight and flight-fueled external borrowing — involving circular movements of the same capital through a financial revolving door — were important aspects of the Philippine experience.

This finding has important implications for the political legitimacy of the Philippine external debt. The present Philippine government and the citizenry at large might well wonder why they should bear the cost of repayment of debts not of their making, from which they derived no benefit. Their situation today resembles a "case where the contractor absconds with the mortgage money, the banker who helped him take it out now comes to collect from the owner of the empty lot, and no one will lend the lot owner any more money because his 'debts' are too high" (Henry, 1989, p. 82).

Rather than continue to service the entire debt, the Philippines might instruct the creditors to seek repayment from the owners of the private external assets which are the real counterpart of a substantial component of the public external debt. Felix (1985) proposed compulsory mobilization of foreign private assets for debt service, arguing that creditor banks and governments might collaborate in this unorthodox endeavor so as to collateralize otherwise uncollectible debts. Pastor (1990) notes the practical problems of implementing such a plan: identification of assets, the banks' reluctance to damage relations with private clients, and the political resistance from holders of foreign assets. In addition, unless such a plan were implemented on a worldwide

scale, it could be evaded by shifting assets to third countries.

The Philippines and other debtor nations could, however, capitalize upon the debt-flight connection in another fashion. Rather than seeking to recapture the flown capital, either by luring it home (which, as Pastor notes, amounts to ceding veto power over national economic policy to wealthy elites) or by impounding it abroad, governments could tell their creditors: Resources permitting, we will scrupulously repay all loans, or portions thereof, which were used for *bona fide* investment or consumption in our country; however, until such time as you furnish evidence of such use, we shall assume no obligation to repay.

Such a move could claim a legal basis in the "doctrine of odious debt," which holds that for sovereign debt:

An interest which a creditor possesses in a debt must, in order to constitute an acquired right protected by international law, be an interest in funds utilized for the needs and interests of the State. Any debt contracted for other purposes is a debt intrinsically "hostile to the interests of the territory" (O'Connell, 1967, p. 459).

The landmark application of this doctrine occurred nearly a century ago, in 1898, when the United States seized control of the Philippines and Cuba in the Spanish-American War. At issue was the Cuban external debt accumulated under Spanish rule. At the Paris peace conference, the US authorities contended that this debt had not been incurred for the benefit of the Cuban people, that it had been contracted without their consent, that the creditors must have appreciated that the purpose of the loans was to finance "the continuous effort to put down a people struggling for freedom from the Spanish rule," and that "the creditors, from the beginning, took the chances of the investment."<sup>33</sup>

The legal circumstances under which the doctrine of odious debt can be applied are far from unambiguous. In particular, there is considerable room for different interpretations as to whether and to what extent its application requires proof that the creditor was aware of the ultimate use of the loan proceeds.<sup>34</sup> "On this topic politics assume dominance over legal analysis," O'Connell (1967, p. 460) concludes, "and for this reason the only exact test of whether or not a debt is odious is the extent to which it is unbeneficial to the population of the territory it burdens."

The debts foisted upon the Philippine government via debt-fueled capital flight and flight-fueled external borrowing were unquestionably

"unbeneficial to the population." Hence there is considerable scope for legal and political chal-

lenges to the legitimacy of a significant fraction of that country's external debt.

#### NOTES

1. The countries included were Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, India, Indonesia, Malaysia, Mexico, Nigeria, Peru, Philippines, South Africa, South Korea, Thailand, Uruguay, and Venezuela. For other estimates, see Dooley *et al.* (1986), Dooley (1986), Cumby and Levich (1987), Khan and Ul Haque (1987), and Pastor (1990).

2. *Treasury News*, October 8, 1985, cited by Gulati (1988, p. 165).

3. De Vries (1986, p. 6). Cunningham (1988, p. 76) likewise remarks: "The debt crisis represents an unwillingness of former creditors to reinvest in an economy (i.e., roll over the debt). Capital flight represents precisely the same decision, though made by domestic residents rather than international lenders. Thus, when one sees foreign capital unwilling to invest in an economy, one might also expect to see domestic capital make the same decision. Capital flight and the debt crisis go hand in hand, but making the relationship out to be anything more than axiomatic is extremely misleading."

4. For contrasting views on the commercial banks' role in capital flight, see Henry (1986) and Walter (1987, p. 115).

5. Conesa (1987, p. 55) advances this explanation for his finding of a positive association between capital flight and debt disbursements in Argentina and Mexico: "The excessive supply of credit to a country without an adequate and efficiently implemented growth strategy only overvalues national currency and acts as a provider of counterpart funds for local citizens who then deposit their money abroad."

6. For a model incorporating this possibility, see Diwan (1989).

7. In some cases, residents are permitted to hold dollar-denominated assets domestically. The protection against inflation afforded by dollar-indexed instruments is often incomplete, however, as demonstrated for example in Mexico in 1982 (see Zedillo, 1987, p. 182). Moreover, other risks such as internal debt repudiation are not mitigated by mere dollarization.

8. Lansky's clients also reaped a fringe benefit: interest payments on the "loans" were tax-deductible (Naylor, 1987, pp. 21-22).

9. In practice, financial laundry services can be costly. For discussion, see Walter (1987, pp. 105-109, 119-120). One European banker estimates that much of the \$600 billion deposited by foreigners in Swiss banks receives negative interest returns, implying that

depositors "were willing to pay a substantial premium for security" (Lessard and Williamson, 1987a, p. 83).

10. Similar ambiguity surrounds the use of the word "finance," as, for example, in the statement that "large external debt increases have been used to finance the private accumulation of foreign assets" (Gulati, 1988, p. 168). In domestic contexts the verb "finance" means providing resources, usually on credit, as when an individual obtains a mortgage to finance the purchase of a house. The above passage therefore may appear to refer to debt-fueled capital flight. In this instance, however, the author means something else: "Central banks have been borrowing abroad and *selling* foreign currency to domestic residents who simply purchase external assets with the obtained foreign exchange" (Gulati, 1988, p. 169; emphasis added). This scenario may represent debt-driven capital flight (if motivated by economic and political circumstances attributable to the debt itself), but it is not debt-fueled by our definition since domestic resources are exchanged for the hard currency.

11. Pedro-Pablo Kuczynski, Co-Chairman of First Boston International, in Lessard and Williamson (1987a, p. 192).

12. Note that debt-fueled capital flight is not necessarily redeposited in the same bank which lent the money. Moreover, it is conceivable that officers in a bank's lending division could operate in ignorance of the deposit-taking activities of the same bank's "international private banking" division. Thus, in reply to the allegation that his bank facilitated capital flight through the provision of "private banking" services to residents of major debtor countries, a senior research officer of Morgan Guaranty Trust Company "protested his ignorance of the actions of other parts of the bank and averred that Morgan would compete in whatever banking field it was legal to do so" (Lessard and Williamson, 1987a, pp. 198-199).

13. Nominal total from Boyce and Zarsky (1988, Table 4, p. 208); real total calculated by converting annual flows into 1986 dollars, using the US wholesale price index as reported in IMF (1987, pp. 698-699). Other sources give comparable nominal estimates of Philippine capital flight: Morgan Guaranty Trust Company of New York (1986, p. 13) reports \$9 billion during 1976-85; Dooley (1986, p. 17) reports a total of \$8.0 billion as of 1983; and Khan and Ul Haque (1987, p. 4) report \$8.4 billion during 1974-82.

14. For details, see Boyce and Zarsky (1988).

15. This statement is based upon capital flight estimates reported by Morgan Guaranty Trust Company of

New York (1986, p. 13), Dooley (1986, p. 17), and Khan and Ul Haque (1987, p. 4). None of these other estimates include adjustments for trade misinvoicing, which could affect the rankings.

16. "Marcos Bids \$5 Billion to Return to Philippines," *Los Angeles Times*, July 26, 1988.
17. The late Jaime Ongpin, quoted by Shaplen (1986, p. 61).
18. Official minutes of the testimony of Cesar Virata before the Philippine House of Representatives Subcommittee on Monetary, Credit and Financial Matters, August 26, 1987, p. IV-1.
19. Official minutes of the testimony of Rosendo Bondoc before the Philippine House of Representatives Subcommittee on Monetary, Credit and Financial Matters, October 2, 1987, pp. VII-1, VIII-4, and IX-1.
20. J. R. Tengco, Jr., "Memorandum for His Excellency, President Ferdinand E. Marcos, Thru Prime Minister Cesar E. A. Virata, Subject: Action Program for the Rehabilitation of DBP," November 25, 1983.
21. Jose Mari Velez, speaking in the television program "In Search of the Marcos Millions," *Frontline* Transcript No. 511 (1987), Public Broadcasting System/WGBH-Boston.
22. The data on changes in external debt outstanding are adjusted for yen/dollar currency valuation effects, so as to more accurately reflect net disbursements; for details see Boyce and Zarsky (1988).
23. This is the measure of capital flight most widely used in the recent literature; see, for example, Diaz-Alejandro (1984, pp. 362-363), Sachs (1984, p. 397), the Bank for International Settlements (1984, p. 101), and the World Bank (1985).
24. A potential drawback of the residual method (used to construct the broader measure, *KFA*) is that any measurement errors in the debt variable are passed on to the capital flight variable. If such errors are substantial, this could give rise to a spurious correlation between the two variables. Statistical results obtained using the narrow measure can thus provide a check upon those using the broader measure. The "hot" component captured by the narrow measure, however, may not be perfectly representative of flight capital as a whole.
25. Granger-type tests for the direction of "causality" suggest that the linkage running from debt to capital flight is the stronger, but the cutting power of the tests is limited by the fact that the statistical association is predominantly contemporaneous. Details available from the author.
26. See, for example, Conesa (1987). Note that this expectation is unambiguous only for private owners of capital. In the hypothetical case in which public officials engage in capital flight by diverting resources from government coffers, higher reserves might permit *more* capital flight.
27. Some analysts (e.g., Cuddington, 1987, p. 90) have used a real effective exchange rate variable as an additional determinant of capital flight, taking upward movements to indicate an "expectation that the domestic currency is soon to be devalued." This entails the assumption that there exists an equilibrium exchange rate which persists through time. There is no tenable basis for such an assumption. Upward movements in the real effective exchange rate could occur owing to upward shifts in the equilibrium rate itself. For this reason, the level of official reserves would seem to be a more appropriate indicator of expected devaluation.
28. Net debt disbursement is calculated as the change in external debt outstanding, with an adjustment for yen/dollar exchange rate effects; for details, see Boyce and Zarsky (1988). Time deposit rate in the Philippines is from unpublished Central Bank of the Philippines data provided to the author. All other data are from the International Monetary Fund's (1987) *International Financial Statistics*. The data file is available from the author.
29. Lagrange multiplier tests for second- and third-order residual serial correlation, Ramsey's RESET test for functional form misspecification, and LM tests for normality and heteroscedasticity (see Pesaran and Pesaran, 1987) were also performed. Details on test results are available from the author.
30. Third-order autoregressive error models, estimated by the Cochrane-Orcutt method, gave similar results with the difference that the estimated coefficient on  $GDPGR_{-1}$  remained moderately significantly (and negative).
31. For a discussion of the importance of supply-side factors in commercial bank lending to the Third World, see Darity (1986).
32. Conesa (1987) and Cuddington (1987) report a positive correlation between debt disbursements and capital flight in Mexico, Argentina, and Uruguay. Pastor (1990), in a pooled analysis of eight Latin American countries, finds that "capital availability" (defined as the ratio of net long-term capital flows to GDP) bore a significant positive correlation to capital flight in countries without capital controls (Argentina, Mexico, Uruguay, and Venezuela), but not in countries with capital controls (Brazil, Chile, Colombia, and Peru). Our findings for the Philippines, which had capital controls for much of the period under review, suggest that controls are not an either-or proposition but rather extend along a continuum in terms of their strictness and efficacy. The Philippines appears to have been situated near the low end of this scale.
33. Quoted in O'Connell (1967, pp. 459-460) and Hoeflich (1982, pp. 53-55).
34. O'Connell (1967, p. 459) states that this is a "dangerous" doctrine, which if not limited "tends to be

expanded as States seek a pretext for avoiding obligations which otherwise would be imposed upon them," and notes that one legal authority suggests that to justify its invocation a successor state "should be required to prove, first, that the debt was contrary to the interests of the population of all or part of the absorbed territory and, secondly, that the creditors were aware of this. Once these two things have been proved . . . the onus is upon the creditors to show that

the funds have in fact been utilized for the benefit of the territory." Citing the same authority, however, Frankenberg and Knieper (1984, p. 434) argue that the burden of proof should fall upon the creditor: "[T]he creditor (or supplier) would first have to show evidence that the credit (or supply) was used or was supposed to be used in the debtor country's national (developmental) interest."

## REFERENCES

- Bank for International Settlements, *Fifty-Fourth Annual Report* (Basle: BIS, 18 June 1984).
- Boyce, J. K. and L. Zarsky, "Capital flight from the Philippines, 1962-1986," *The Journal of Philippine Development*, Vol. 15, No. 2 (1988), pp. 191-222.
- Conesa, E. R., "The flight of capital from Latin America," Mimeo (Washington, DC: Inter-American Development Bank, 1987).
- Cuddington, J. T., "Macroeconomic determinants of capital flight: An econometric investigation," in D. R. Lessard and J. Williamson (Eds.), *Capital Flight and Third World Debt* (Washington, DC: Institute for International Economics, 1987), pp. 85-100.
- Cumby, R., and R. Levich, "On the definition and magnitude of recent capital flight," in D. R. Lessard and J. Williamson (Eds.), *Capital Flight and Third World Debt* (Washington, DC: Institute for International Economics, 1987), pp. 27-67.
- Cunnington, T. J., Review of "Hot money and the politics of debt," *Bankers Magazine* (January-February 1988), pp. 74-77.
- Darity, W., Jr., "Did commercial banks push loans on the LDC's?" in M. P. Claudon (Ed.), *World Debt Crisis: International Lending on Trial* (Cambridge, MA: Ballinger, 1988), pp. 199-225.
- De Vries, R., "LDC Debt: Debt Relief or Market Solutions?" *World Financial Markets* (New York: Morgan Guaranty Trust Company of New York, September 1986), pp. 1-11.
- Deppler, M. and M. Williamson, "Capital flight: Concepts, measurement, and issues," *IMF Staff Studies for the World Economic Outlook* (August 1987), pp. 39-58.
- Diaz-Alejandro, C. F., "Latin American debt: I don't think we are in Kansas anymore," *Brookings Papers on Economic Activity*, No. 2 (1984), pp. 335-389.
- Diwan, I., "Foreign debt, crowding out and capital flight," *Journal of International Money and Finance*, Vol. 8 (1989), pp. 121-136.
- Dooley, M. P., "Comment," in D. R. Lessard and J. Williamson (Eds.), *Capital Flight and Third World Debt* (Washington, DC: Institute for International Economics, 1987), pp. 79-81.
- Dooley, M. P., "Country-specific risk premiums, capital flight and net investment income payments in selected developing countries," Research Dept. Memorandum DM/86/17 (Washington, DC: International Monetary Fund March 11, 1986).
- Dooley, M. P., W. Helkie, R. Tryon, and J. Underwood, "An analysis of external debt positions of eight developing countries through 1990," *Journal of Development Economics*, Vol. 21, No. 3 (1986), pp. 283-318.
- Felix, D., "How to resolve Latin America's debt crisis," *Challenge*, Vol. 28, No. 5 (1985), pp. 44-51.
- Frankenberg, G., and R. Knieper, "Legal problems of the overindebtedness of developing countries: The current relevance of the doctrine of odious debts," *International Journal of the Sociology of Law*, Vol. 12 (1984), pp. 415-438.
- Gulati, S., "Capital flight: Causes, consequences and cures," *Journal of International Affairs*, Vol. 42, No. 1 (1988), pp. 165-185.
- Henry, J., "The new Philippines: Revolution, recovery and reality," *International Development Review* (New York), Vol. 2, No. 1 (1989), pp. 64-85.
- Henry, J., "Where the money went: Third World debt hoax," *The New Republic* (April 14, 1986), pp. 20-23.
- Hoeflich, M. E., "Through a glass darkly: Reflections upon the history of the international law of public debt in connection with state succession," *University of Illinois Law Review*, Vol. 1982, No. 1 (1982), pp. 39-70.
- International Monetary Fund (IMF), *International Financial Statistics Yearbook 1987* (Washington, DC: IMF, 1987).
- Khan, M. S., and N. Ul Haque, "Capital flight from developing countries," *Finance and Development*, Vol. 24 (March 1987), pp. 2-5.
- Khan, M. S. and N. Ul Haque, "Foreign borrowing and capital flight: A formal analysis," *IMF Staff Papers*, Vol. 32, No. 4 (1985), pp. 606-628.
- Lessard, D. R., "Comment" [on Cuddington's 'Macroeconomic Determinants of Capital Flight'], in D. R. Lessard and J. Williamson (Eds.), *Capital Flight and Third World Debt* (Washington, DC: Institute for International Economics, 1987), pp. 97-100.
- Lessard, D. R., "Country risk and the structure of international financial intermediation," Paper presented at the Federal Reserve Bank Conference on Financial Risk (St. Louis, MO: November 14-15, 1986).
- Lessard, D. R., and J. Williamson (Eds.), *Capital Flight and Third World Debt* (Washington, DC: Institute for International Economics, 1987a).
- Lessard, D. R., and J. Williamson, "The problem and policy responses," in D. R. Lessard and J. Williamson (Eds.), *Capital Flight and Third World Debt*

- (Washington, DC: Institute for International Economics, 1987b), pp. 201-254.
- Morgan Guaranty Trust Company of New York, "LDC Capital Flight," *World Financial Markets* (March 1986), pp. 13-15.
- Naylor, R. T., *Hot Money and the Politics of Debt* (New York: Simon and Schuster, 1987).
- O'Connell, D. P., *State Succession in Municipal Law and International Law. Vol. I: Internal Relations* (Cambridge: Cambridge University Press, 1967).
- Pastor, M., "Capital flight from Latin America," *World Development*, Vol. 18, No. 1 (1990), pp. 1-13.
- Pesaran, M. H., and B. Pesaran, *Data-FIT: An Interactive Econometric Software Package* (Oxford: Oxford University Press, 1987).
- Sachs, J. D., "Comments" [on Diaz-Alejandro's "Latin American Debt"], *Brookings Papers on Economic Activity*, No. 2 (1984), pp. 393-401.
- Shaplen, R., "The Philippines — Part II," *The New Yorker* (September 1, 1986).
- Walter, I., "The mechanisms of capital flight," in D. R. Lessard and J. Williamson (Eds.), *Capital Flight and Third World Debt* (Washington, DC: Institute for International Economics, 1987), pp. 103-128.
- Wideman, B., "The dizzying pace of expansion," *Far Eastern Economic Review* (November 26, 1976), pp. 54-55.
- World Bank, *World Development Report 1985* (New York: Oxford University Press, 1985).
- Zedillo, E., "Mexico," in D. R. Lessard and J. Williamson (Eds.), *Capital Flight and Third World Debt* (Washington, DC: Institute for International Economics, 1987), pp. 174-185.

## I. INTRODUCTION

Professor Carl Shoup led a distinguished group of experts to examine the tax system of Venezuela and make recommendations for reform.<sup>1</sup> During the early 1980s a Fiscal Reform Commission, composed of Venezuelans, drawing on technical expertise of foreign advisers from the International Monetary Fund, again examined the nation's tax system and recommended reforms.<sup>2</sup> Colombia has a history of tax reform studies during the same period that is superficially similar. Professors Robert Taylor and Richard Musgrave led teams of foreign advisors to Colombia in the early 1960s (1968-69, respectively), and this author completed a study of the taxation of income from interest and capital in 1987-88.<sup>3</sup> The reports of these the Shoup and Musgrave Missions have become classics in the field of taxation in developing countries.

The similarity of tax reform experience in these neighboring countries essentially ends with the existence of several studies in each. In Venezuela the reforms enacted as a result of the Shoup Mission extend little beyond elimination of a low-rate turnover tax, the taxation of dividends, and the replacement of the complicated system of schedular income taxes with a semi-global income tax. Virtually all the other proposals of the Shoup Mission were ignored — or adopted in distorted form. Thus in the early 1980s the Fiscal Reform Commission found many of the same defects identified by the Shoup Mission — and some new ones. These defects have remained largely uncorrected. In September

1989 the Ministry of Finance announced that the nation would be introducing a new tax system.

By design, much of the country's economic growth since the mid-1970s has been due to the expansion of the oil and gas export industry. There is a high unemployment rate of about 10 percent, and a high rate of inflation. The foreign debt is growing rapidly, and the foreign currency is overvalued. There have been significant increases in social capital expenditures. Finally, in the last 10 years Colombia adopted a comprehensive system of inflation adjustment in the administration of income based on the 1987 study. Administrative improvements were an extremely important aspect of the reform enacted during 1989-90.<sup>4</sup> Colombia now has one of the best income tax systems of any developing country.<sup>5</sup> In short, Colombia has greatly improved its tax system over the past 20 years, while Venezuela has made relatively little progress in this area.

This paper compares these two countries' experience with income tax reform since the late 1950s. Sections 2 and 3 highlight the history of income tax reforms. Colombia's system is developed first, to provide a benchmark against which to appraise Venezuela's. Section 4 brings together some of the major differences revealed by the individual histories, and Section 5 comments on differences in experience.

<sup>1</sup>The report acknowledges the helpful comments of Robert Doherty and Carl Shoup, as well as an earlier draft.