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International Digital Organization for Scientific Research ISSN: 2550-7966
IDOSR JOURNAL OF HUMANITIES AND SOCIAL SCIENCES 1(1): 22-33, 2016.

# CAPITAL FLIGHT FROM NIGERIA CONSEQUENCES AND SOLUTIONS

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## ABSTRACT

The broad objective of this study is to see capital flight from Nigeria as a portfolio choice and investigate its causes and prefer solutions. The researcher uses primary and secondary data as sources of instruments. They primary data include the interview, while the secondary data involves through books, journals, and newspapers that gave me insight to the problem of study. Findings include the following: Capital flight is caused by political factors, macro-economic management and policy distortion that serves as incentive for residents to take their assets out of the country. Recommendations were made. They include the following: political stability; well management of fiscal and monetary policy; and improving Nigeria risk rating.

**Keywords:** Capital flight, Nigeria, Consequences and Solution.

## INTRODUCTION

Portfolio theory is concerned with how an investor selects an optimum portfolio of risky assets. In this regards an investor is confronted with decisions that must be made under conditions of uncertainty. An optimum portfolio therefore will be that which maximizes his expected utility. It can also be regarded as theory of dulcification because that individual here is trying to spread his investigation to include various assets. The individual will therefore choose that portfolio that promises the highest level of return with a given risk exposure or with a given level of return the portfolio that has the lowest risk exposure [1].

A portfolio is a contribution of various types of assets. Some of the assets could be risk free, some fairly risky, while others may be considered to be very risky. However, it can be shown that adding an appearance they risk asset to a portfolio as a while. Investing in an asset that reduces the overall risk of a portfolio is called hedging.

Investor maximizes the expected utility of their terminal wealth, not the expected value of this wealth; Risk aversion requires decreasing marginal utility of wealth [2].

The best principle of portfolio selection boil down to a commonsense statement that investors try to increase the expected return on the portfolio and to reduce the standard deviation of that return. A portfolio that gives the highest expected return for a given standard deviation, or the lowest standard deviation for a given expected return, is known as an efficient portfolio [3].

Portfolio theory is concerned with the study of a group of assets. As a result of this, the risk of an individually assets is less significant than the entire risk from the portfolio.

Capital flight meaning is yet to be settled. The word "flight" has been used to connote illegal movement of capital from one country to another. The term capital flight is to some extent subjectively used to include broad definition covering all private out flows, in which "normal" flows of international transactions are excluded. The broad perspective takes into consideration all private capital outflows from developing countries, be they short-term or long-term, portfolio or equity investments could be termed capital flight. Capital has been defined in many ways. Lawanson, (2004: 8), [4], citing Kinleberger (1987), [5], and Walter (1987), [6], broadly define capital flight as all capital that "flees" irrespective of motive.

## STATEMENT OF PROBLEM

The consequences, causes and magnitude of capital outflows from developing countries such as Nigeria is responsible for the slow experience of the highly indebted African countries as well the debt crisis itself.

The sluggish growth and persistent balance of payment (BOP) deficits in most developing countries, despite private transfers and long-term capital inflows have been attributed to capital flight [4 and 7].

The potential for attracting foreign equity into the Nigerian equity market has not been realized because of poor economic fundamentals and policy lapses, which created a level of under development in the equity market. The market size remains small [8].

## OBJECTIVES OF STUDY

The broad objectives of this study are to see capital flights from Nigeria as a portfolio choice, and instigate its causes and portfolio solutions.

The specific objectives are:

- To find the meaning of capital flight
- To identify the causes of capital flight from Nigeria
- To proffer solutions for the capita flight
- Conclusion

## LITERATURE REVIEW

Portfolio theory is concerned with how an investor selects an optimum portfolio of risky assets.

The expected return of a portfolio is defined as the weighted average returns of each individual asset in the portfolios. Investors are not in the habit of holding only one asset. They prefer to hold a combination of assets

at a particular point in time. The investor will therefore choose that portfolio that promises the highest level of return with a given risk exposure or with given level of return, the portfolio that has the lowest risk exposure [1].

Capital flight from Nigeria is quite extensive, in the opinion of Lawanson (2004: 3), [4], as estimated from many methods; he cited [9, 10 and 11]. The incidence and problem of massive capital flight from the country is intentioned with inherent structural defects that characterized the economy and her political path since independence.

Since independence in 1960, Nigeria has had long history of political instability, dominated by military rules. The mid-1960's was the first military coup in 1966, which resulted in Gen. Aguyi Ironsi becoming the head of state. Another coup followed for which Lt Col. Yakubu Gowon assumed the head of state. Since then military rule has become the main feature of Nigerian government. From 1966 to 1979, the country was under the military rule. This military governance certainly adversely affects capital flight from Nigeria.

With the oil boom of the early 1970 and 1979, the Nigerian economic landscape, in terms of production, investment, and consumption pattern substantially altered.

The non-oil traded good sector became relegated to the background. The share of oil in total export rose to more than 90%, contributing almost 80% of federal revenue. Not only did federal government expenditure increased by 100% between 1973 and 1974, the investment – GDP ratio more than doubled between 1971 and 1977.

When the oil price fell persistently the government was forced to erect economic stabilization Act in 1982, in which some stringent conditions relating to foreign exchange rationing, import license control, and import

were imposed. The government financed fiscal and external imbalance through international reserves depletion, and debt accumulation. As the situation persisted, government was forced to contact additional debt at variable interest rate and shorter maturity, while the real interest rate continues to increase as against negative growth rate of the economy. This further compounded the feasibility of meeting the country's debt obligations, and necessitates additional borrowings [4 and 9]. These debt problems motivated the capital flight.

The capital flight literature is built on these early theoretical models, essentially extending them in three directions. First, the risk of expropriation has been generalized to the risk of high taxation and related to large foreign borrowing. In most models, capital flight is subject to herding- as more capital flees the expected per-capital tax liability increases and heightens the incentives for further capital flight. Second, political economy models have endogemized the reasons why governments may levy punitive high and variable taxes on domestic assets. Third, public finance models have focused on the effect of capital income taxation that varies de facto by residence and source, explaining capital flighty and domestic investment financed with foreign borrowing.

## MEANING OF CAPITAL FLIGHT

A portfolio is a combination of various types of assets. Portfolio theory is concerned with how an investor selects an optimum portfolio [1].

The term capital flight is to some extent subjectively used to include broad definition covering all private outflows or narrow definition of capital outflows, in which "normal" flows of international transactions are excluded. The concept of capital flight is divergent. There is no universally accepted definition of capital, flight (Lawanson 2004: 08), [4], cited many contributors on capital flight such as this: On the broad extreme, it has been

defined to include all private capital outflows from developing countries (Kahn and III) Hague, 1987); on the narrow extreme it includes only illegal capital exports [6]; capital is defined as all capital flight that "flees" inspective of the motive [5 and 6].

In contrast, some researchers only take short-term outflows from economic and political uncertainties in the home county as capital flight. Lawanson (2004: 9), [4], while citing Ajayi, 1992, [6], Pastor, 1990, [7], Williamson, (1997), [8], bought out constraint on capital outflows and inflows, while capital outflows from developed countries are termed foreign investment, the same are referred to as capital flight when the capital outflows originate from less developed countries. It is difficult to distinguish between flows that can be considered "normal" and those which into the category of "flight" capital flows.

In the option of Hermens and Lensink (1992), [8], as cited by Lawanson (2004: 9), [4], normal capital outflows are defined as the legal capital outflows, while all capital outflows based on the desire to place assets beyond the control of domestic authorities are labeled capital flight. However, separating flight capital from "normal" portfolio diversification and trade transactions id fraught with difficulties and may involve judgment which explains in part, the variation in definitions of capital flight.

Distinguishing between capital outflows motivated by "normal portfolio decisions" and those based on the desire to place assets beyond the control of domestic authorities. Lawanson (2004:8), [4], citing Dooley (1988), [9], defines capital flight as thee "stock of calms on non-residents that do not generate investment income receipts in the creditor country's balance of payment data" and [9], defines capital as short-term capital outflows that respond to political or financial crises, heavier taxes,a

prospective tightening of capital controls or major devaluations of the domestic currency, or actual or incipient hyperinflation.

## CAUSES OF CAPITAL FLIGHT FROM NIGERIA

Capital flight is caused by political factors, macro-economic mismanagement and policy distortion that serve as incentive for residents to take their assets out of the country [9]. The tendency is for investors to put their money abroad not only to the normal forces of the market but also by political measures, in order to restrict outward movements of capital in the opinion of [10].

Causes of capital flight include overvalued exchange rates, foreign-domestic interest rate differentiate, high fiscal deficit low level of externals reserves, financial repression, flow of foreign direct investment, as low GDP growth. If foreign interest rates exceed domestic interest rate, especially during eras of financial repression, residents will be motivated to hold their wealth in foreign bank account. Investors normally seek high return and low risk, and so the increases in interest rates paid on foreign bonds tend to deviate the money to international financial markets. Capital flight will always be favoured by wide spread between domestic and foreign interest rates. Current high inflation may lead to an expected feature depreciation of the exchange rate. The overvaluation of exchange rate can also cause capital flight. A country with a persistent deficit will experience a depreciating currency. Since the real value of domestic savings, is trimmed down by devaluation, wealth holders are stimulated to hold their assets abroad. Certainty expectation about possible feature devaluation in situation of overvalued exchanged rate can also reduce domestic saving in favours of reallocating wealth towards foreign holdings.

Capital flights could be influenced by the profitability of differential on investment in real productive sector between domestic economy and abroad. If the expected return on investment in major developed countries is higher than returns from domestic investments, rational economic decision suggest that agents will prefer to place more their capital abroad to maximize returns on investment.

Risk rating of investment in the domestic economy is another good point. When investors perceive domestic economy as instable macro economic and political environment they may include capital outflows even when the foreign rate of return on investment is lower than rate of returns obtained domestically.

Government fiscal policy is another factor influencing capital flight. Residents expect higher future taxes or increased current price stability if government deficits rise, thus stimulating capital flight. Inflation pressures ensure when money creation is used to finance budget deficits. When budget deficit is financed by bond sales, domestic residents build expectation about increase in future tax liabilities to service the debt, and therefore want their capital abroad to escape such tax burden.

High indebtedness: Disbursement of foreign loan is a strong determinant of capital flight. Disbursement of foreign loan, especially public sector borrowing, provides the needed foreign exchange required to facilitate capital flight.

Resident are motivated to put their wealth abroad, in anticipation of capital los arising from tax inflation.

Political instability and corrupt practices constitute the non-economic causes of capital flight in developing countries, including Nigeria: coups, political demonstration and violence, riots, strikes, corruption in government, non-democratic rules. In this situation, constitution is usually

suspected and replaced by decree which is undemocratic and full of violation of human rights, lack of account ability and many other unwelcome practices that motivate capital flight.

Generally capital moves from one country to another looking for profit and the possible minimum financial and political risk.

## SOLUTIONS TO COMPACT CAPITAL FLIGHT

Political stability is a key issue on the solution to capital flight. Instability that comes from coups, violence, strikes etc are discussed brings a lot of problems that induce capital flight no securities market will be successful in the absence of political stability [10].

The government should manage her fiscal very well. The government should avoid as much as possible financing budget deficit by selling of bonds in order to avoid domestic residents expecting increase in future tax liabilities to service the debt, and as such would want their capital abroad.

Nigeria should try not to allow the expected return on investment on major developing countries to be higher then return from domestic investment as investors will prefer to place more at their capital abroad to minimize return on investment.

Nigeria should work to make sure that our risk rating is very low, as this may induce capital inflow to the nation instead of inducing capital flight if the reverse is the case.

The country should as much as possible not allow foreign interest rates exceed domestic interest rate, especially during eras of financial repression because residents will be motivated to hold their wealth in foreign bank accounts.

The government should manage tax inflation very well in order not to motivate capital flight. The tax system has not been fovourable to

investment in the equity market in Nigeria. Equity investors suffer tax burden at the corporate tax point (30-40%), capital gain tax point (20% until recently, now nil) and withholding tax on dividend payment (10% - 15%) [11].

Over valuation of exchange rates should be avoided as much as possible. We should avoid persistent deficit and its depreciation. Such as depreciation that will raise the price of import and at the same time, increase demand for the country's exports and import substitute. It may therefore, exert both cost push and demand for the country's export and substitute. It may therefore, exert both cost push and demand pull inflationary pressure on the domestic economy. This will encourage capital flight and should be avoided.

Developing countries that avoid extreme exchange rate arrangements – currency boards and floating rates with purely domestic objectives for monetary policy – need to manage the nominal exchange rate. In doing so, they have long been enjoined to avoid misalignment – that is, the emergence of large gaps between the actual exchange rate and some motion of a sustainable "equilibrium" real exchange rate [11].

## CONCLUSION

Exchange rate overvaluation, foreign in indebtedness, and investors risk all increase the proportion of the portfolio held abroad. The government fiscal policies an political measures should be such that will bring down exchange rate overvaluation, foreign indebtedness and investors risk in order to induce portfolio held on the country and discourage the portfolio held abroad.

Policy measures to ensure inflows will be proposed along the general framework or reduction in the country risk, and appreciate policy measures to be put in place for further development in the market in Nigeria.

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