Review

On The Tax Implications of Capital Flight: Evidence from Nigeria

Uguru Leonard C., PhD

Department of Accountancy, Ebonyi State University, Abakaliki

Author e-mail address: uguruleonard@yahoo.co.uk

ABSTRACT

The study offers further documentation of the effect of capital flight on tax revenue in Nigeria. After a theoretical and empirical literature review of the subject, an Ordinary Least Square model is employed based on time series data quantifying capital flight under the hot money or balance of payment approach. It is found that a unit increase in capital flight will lead to a 0.02 or 2% decrease in tax revenue. Consequently, policy measures discouraging capital flight, like placing a limit on the repatriating percentage of local profit, would improve tax revenue in Nigeria.

Keywords: Capital flight, Tax revenue, Hot money measure, Nigeria

INTRODUCTION

Capital flight is the international capital movements which respond to heightened domestic economic and political uncertainty. Capital flight responds to the degree of domestic macroeconomic mismanagement postulated to generate a domestically undiversifiable risk that can significantly reduce the returns to local investment (Schineller, 1997). The International Monetary Fund (IMF) in 1995 estimated that capital flight amounted to roughly half of the outstanding foreign debt of the most heavily indebted countries of the world. Capital flight is sometimes used to refer to the removal of wealth and assets from a city or region within a country. Capital flight in effect reduces the resources available to the domestic economy and represents a loss of growth potentials (Odoh, 2001). The inability to reverse the outflow may become an obstacle to having access to new finance to the countries that need external finance to support their adjustment factors. Some foreign creditors are becoming worried that a substantial part of the loans they provide to the less developed countries is used ultimately to finance future capital flight.

Pastor (1990) and Ajayi (1997) as cited in Akani (2013) maintain that capital flight has adverse consequences for developing countries. For instance, the loss of capital through capital flight reduces the domestic tax base hence income distribution is affected. Also, they observed that, capital flight deplete the bank's ability to raise capital for financing investment projects. In other words, capital flight is a cog in the wheel of financing domestic real investment as it diverts domestic savings to the benefit of foreign financial investment.

Capital flight is against the theory of capital arbitrage, which suggests that capital should flow from resource surplus (the haves) to the resource deficit (the have not) countries. According to Ajayi (1997), globalization and large balance of payment deficits lead to massive waves of currency speculation. He averred that globalization has the economic consequence of unprecedented outflows of foreign private capital from developing countries. Olugbenga and Alamu (2013) state that outflow of funds from debt ridden economies would further increase their external reserves and balance of payment (BOP) position, reduce domestic savings and future growth potentials.

In recent times, multinational enterprises have risen in power and visibility, but have come to be viewed more ambivalently by both governments and consumers worldwide. Indeed, multinationals today are viewed with increased suspicion given their perceived lack of concern for economic well-being of their host countries and more importantly, the public impression that multinationals indulge in capital flight by moving their profits across

borders at will. It has been observed that the largest means of shifting capital out of Nigeria is reckoned to be transfer mispricing (Tax Justice Network, 2005). Multinational corporations avoid taxes by mispricing trade transactions between different jurisdictions and subsidiaries, allowing their profits to be moved offshore without being taxed. Tax administrations of many African countries lack sufficient staff to be able to devote time to tackle the complex transfer pricing strategies of multinationals. The result is that no African country has raised a successful challenge to a transfer pricing arrangement, yet the practice is on the increase. Baker (2008) averred that capital flight due to transfer mispricing exceeds US$10 billion a year. With a few exceptions (Chang and Cumby, 1991; Ajayi, 1997; Ndikumana and Boyce, 1998), most past estimates pay no attention to the falsification of trade transactions. Instead they take the trade statistics (unlike the capital account statistics) in the official balance of payments tables at the face value. In practice, the official balance of payment data on exports and imports are often of poor quality due to trade mis-invoicing.

Multinational's increased profit arise from money which is in effect collected by the government by taxation from its taxpayers (Davidmann, 2006). Multinational corporations have bribed the officials of the Federal Inland Revenue Service to reduce the amount of taxes payable to the Nigeria government (Halliburton, 2004; Bristow Helicopters, 2007), and sometimes collaborate with some public officials to avoid paying democratically assessed and agreed taxes on their operations in Nigeria (Shell and Daukoru, 2006).

However, Murphy (2007) observes that capital flight occurs because the owner of the money involved believes that the cash or assets they hold will be loss to them if they are kept in the country in which they are originated. The reasons for holding such asset abroad may be as a result of political and economic instability. Notwithstanding the reasons for capital flight, the country in which it originated may not charge tax on the money or the investment income it may generate, thereby reducing the revenue base of the originating country through tax evasion. However, the relevant question which is the fulcrum of this study is: what implication has capital flight on the tax revenue of Nigeria? Therefore, the study seeks to ascertain the effect of capital flight on tax revenue in Nigeria.

LITERATURE REVIEW

The studies which have considered the issues of capital flight have found that trade mis-invoicing is a significant net addition to total capital flight in some countries in some years (Ajayi, 1997; Ndikumana and Boyce, 1998). Capital flight from Sub-Saharan Africa, estimated at $274 billion (including interest earnings), was equivalent to 145 percent of the total debt owed by these countries in mid-1990s. The largest means of shifting capital out of Africa is reckoned to be transfer mispricing. Capital flight due to transfer mispricing exceeds $10 billion a year (Baker, 2005). Fake transactions are estimated to account for an additional $150 – 200 billion a year and 60 percent of trade transactions into or out of Africa are estimated to be mispriced, by an average of 11 percent (Tax Justice Network, 2005).

Dooley and Kletzer (1994) maintain that the longer capital flight remains, the worse are the consequences for economic activity. Especially in a country that is heavily dependent on external financing. One can agree that a country like Nigeria perfectly fits into this description and that the level of domestic macroeconomic mismanagement generates domestically undiversifiable risk that can significantly reduce the returns to local investment. Capital flight in effect reduces the resources available to the domestic economy and represents a loss of growth potentials (Odoh, 2001). The inability to reverse the outflow may become an obstacle to having access to new finance to the countries that need external finance to support their adjustment factors. Some foreign creditors are becoming worried that a substantial part of the loans they provide to the less developed countries is used ultimately to finance future capital flight.

Speaking on the implications of capital flight on development, Emeagwali (2000) subsumed the implications in three points. First, money outside Africa cannot be used to develop Africa. Second, money outside Africa cannot be taxed. Third, it is the poor people in Africa that indirectly pay for the external debts. He further asserted that capital flight increases the level of corruption. The flight of capital means that police officers cannot be adequately paid and are forced to extort bribes. Medical doctors, teachers and government clerks extort bribes from citizens.

The government of Nigeria at different point in time has initiated different policies and programmes focused at increasing capital inflow into the country from abroad and harness its proper contribution to the development of the overall economy. In Akani (2013), some of these policies and programmes include Nigeria Investment Promotion Commission (NIPC), the Bureau of Public Enterprises (BPE), the National Council of Privatization (NCP), Economic and Financial Crime Commission (EFCC), and other anti-regulatory agencies and economic/budgetary reforms geared towards boosting the foreign capital inflows and proper utilization for economic development. Unfortunately, Nigeria despite being the sixth largest oil producer in the world and with the abundant human and natural resources is currently wallowing in public debt of about $60 billion. Also, Nigeria is one of the most corrupt and poorest nations in the world according to Transparency International (2010). To be specific, a survey by Transparency International in July 2012 revealed that Nigeria occupies 128 positions in

corrupt list out of a total of 186 countries surveyed. As if that was not enough, in 2015, the latest release ranked the country as the 27th most corrupt, having been placed at 136 out of 175 countries (Akani, 2015).

Multinational companies indulge in capital flight through some profit eroding mechanisms like tax havens and transfer mispricing. Tax havens are places where you can set up a non-functioning entity and then you can sell to this entity and it can sell to other entities, and you can structure the pricing in such a way that all or most of the profits are earned in the tax haven entity and it does not have to pay or pays only minimal taxes on such profits. Baker (2007) observes that there are 72 tax havens around the world.

In Nigeria, multinational corporations have bribed the officials of the Federal Inland Revenue Service to reduce the amount of taxes payable to the Nigeria government (Associated Press, 2004; Bristow Helicopters, 2007), and sometimes collaborate with some public officials to avoid paying democratically assessed and agreed taxes on their operations in Nigeria (Shell and Daukoru, 2006). For instance, under investigation by the Economic and Financial Crime Commission (EFCC), the United States oil services company, Halliburton, admitted that its officials had paid bribes amounting to US $2.4 million to tax officials in return for favourable tax treatment worth more than $14 million. Halliburton is also under investigation for making illegal payments amounting to around $180 million to offshore accounts belonging to Sani Abacha in return for contracts to build a natural gas plant in Nigeria (Bakre, 2006).

Also, in 2006, Shell Petroleum Development Corporation, after extensive denial and litigation, including a failed appeal to the Federal Inland Revenue Commissioner and the Court of Appeal, was forced to settle a disputed tax liability amounting to US$17.8 million owed to the Federal Inland Revenue Service of Nigeria (Bakre, 2006).

Chevron has also been investigated for tax evasion in Nigeria. In August 2006, the Nigerian House of Representatives' Committee on Petroleum Resources ordered Chevron Nigeria Ltd to pay $492 million in settlement for additional taxes arising from tax evasion. Chevron and its associates are under investigation for corruption fraud and tax evasion amounting to $10.8 billion (Tax Justice Network, 2007).

EMPIRICAL REVIEW

In Dooley (1978), a significant relationship between capital flight and inflation repression and risk premium was discovered in a study of seven developing countries which include Argentina, Brazil, Chile, Venezuela, Philippine, Peru and Mexico. He concludes that the perceived inflation risk on returns on domestic assets by resident encourage capital flight. In a similar study,

Cuddington (1986) with the use of portfolio adjustment model found that residents would consider foreign financial assets as an edge against domestic inflation. Cuddington discovered that the motivators of capital outflow include exchange rate overvaluation, disbursement of public debt and lagged capital flight. He studied four developing countries – Argentina, Mexico, Uruguay and Venezuela.

Isu (2002) analyzed the implication of capital flight on the development of Nigeria and concludes that Nigeria had greatly suffered as a result of capital flight. Thus, within the period of study (1970 – 1991), Nigeria is assumed to have lost resources in excess of $45 billion to capital flight. He recommends that the element of uncertainty in Nigeria's macro economy occasioned by an unpredictable political transition, unpredictable economic environment, unpredictable living standards and unpredictable productivity levels should be forcibly removed from the Nigerian environment to make for a reversal of the capital outflows syndrome.

Saheed and Ayodeji (2010) examined the impact of capital flight on exchange rate and economic growth in Nigeria, using ordinary least squares (OLS) method to analyze the secondary data. It was found that capital flight has a positive and significant impact on the exchange rate in Nigeria, and unlike most of the existing studies, capital flight has a positive effect on economic growth in Nigeria. Similar to this finding, Adesoye, Maku and Atanda (2012) found that capital flight has positive impact on economic growth. Saheed and Ayodeji (2012) recommend that since most illicit capital outflow results from mis-invoices like under invoicing of exports and over invoicing of import, the effectiveness and efficiency of the custom officials need to be improved upon through further training and workshops, especially on how to detect and handle mis-invoicing in import and export activities.

Ugwuanyi and Uguru (2010) analyzed the influence of capital flight as a multidisciplinary phenomenon on foreign direct investment in Nigeria. They employed the ordinary least squares (OLS) regression model in the study and found that capital flight has a negative and significant influence on foreign direct investment in Nigeria for the period under study (1997 – 2004). It is, however, recommended that government should minimize policy reversals, since an erratic stance and frequent policy reversals create uncertainty that reduce private domestic investment thereby creating room for capital flight and its attendant undesirable effect.

Busari (2010) examines the impact of capital flight on some economic recession indicators in Nigeria, whereby capital flight was regressed against GDP, inflation, interest rate, unemployment and exchange rate, with the use of ordinary least squares (OLS) model. The findings show that capital flight has a negative effect on GDP, inflation, interest rate and unemployment. The variables used in the study were statistically insignificant except for

GDP and unemployment.

In Uguru (2011), the impact of capital flight on the corporate performance indices of profit, cost of production and tax paid by some selected multinational corporations in Nigeria was evaluated. With the employment of the OLS regression model, the findings show that corporate profits which are supposed to be ploughed back into the economy are shifted abroad; transfer mispricing and over invoicing of import increase the high cost of production of firms, which lead to high cost of consumer goods in Nigeria, and capital flight reduces government revenue through tax evasion.

Oke and Kolapo (2012) investigate the relationship between capital flight determinants and Nigeria economic growth for the period of 1985 to 2010. Using the co-integration approach, it was concluded that exchange rate and inflation are the main determinants of capital flight from Nigeria. However, the study of Saheed and Ayodeji (2012) investigated the impact of capital flight on exchange rate and economic growth. Their findings were at variance with most existing studies on capital flight in Nigeria. They concluded that capital flight has positive relationship between capital flight and investment in Nigeria. Adesoye, Maku and Atanda (2012) corroborated the findings of Saheed and Ayodeji (2012).

Umoru (2013) in his study explores empirically the relative effect of capital outflows on the growth rate of GDP in Nigeria. The paper estimates a simultaneous equation model and the numerical coefficients of the model were estimated with the Generalized Method of Moment (GMM). Using the secondary data from 1980 – 2000, the Augment Dickey Fuller (ADF) regression was adopted in the test of hypothesis formulated. The findings show that capital flight has adverse effects on the growth rate of GDP. The study recommends that there is an acute need to implement economic policies that can invigorate domestic investment and discourage capital flight in order to enhance economic growth in Nigeria.

Akani (2013) investigates into the determinant, measurement and impact of capital flight on the economic growth in Nigeria using ordinary least square (OLS), multiple regression and descriptive Folorunso (2008), Nigeria was used as an example to analyze capital flight in a developing economy. The arbitrage approach was employed in explaining the burden of capital flight and his rate and inflation shows no evidence of debt fuelled capital flight. This finding was contrary to the result of the study of Ajayi (1992).

Olugbenga and Alamu (2013) examined the impacts of capital flight on Nigeria economic growth over a period of 30 years (1981 – 2010). The Johansen Co-integration test was utilized to investigate the dynamic relationship between capital flight and economic growth. The result shows that capital flight has negative impact on economic growth in the short-run but the reverse is the case in the long-run. The study therefore recommends that since unproductive use of borrowed fund is reflected in

embezzlement by political office holders and subsequent transfer to foreign private accounts, effort should then be made to ensure strict monitoring of execution of public projects, accountability and transparency. Also, enabling business environment to encourage foreign investors into Nigeria should be created; and capital outflows that finance importation of capital goods that are necessary of development purposes should be encouraged due to its long-run positive effects.

Enyi (2014) examined the impact of inflation and tax rate on capital flight in Nigeria. The study adopted ordinary least square analytical technique in data analysis and the result revealed that inflation and tax have significant influence on capital flight in both short run and long run. It recommended that special incentive should be given for domestic investment so as to minimize the outflow of domestic capital.

METHODS

The study adopted an ex-post facto research design. Kerlinger (1977) cited in Obasi (1999) states that ex-post facto research is a form of descriptive research in which an independent variable has already occurred and in which an investigator starts with the observation of dependent variable then studies the independent variable in retrospect for possible relationship to and effects on the dependent variable.

The source of data was purely secondary sources from Central Bank of Nigeria Statistical Bulletin, National Bureau of Statistics Annual Abstract of Statistics and Journal articles. The data used was mainly time series data which are quantitative in nature. Based on the theoretical background that underlies this relationship, this study employed a regression model that aptly captures the relationship between the variables to capture the influence of capital flight on tax revenue in Nigeria, the empirical model that accommodates the capital flight and tax revenue nexus was specified. The hot money measure of capital flight, otherwise known as the balance of payment approach, is adopted in the computation of capital flight in this study. This measure focuses on recorded short-term capital outflows and unrecorded net errors and omissions in the balances of payments. The errors and omissions line is added because capital outflows are conducted surreptitiously, and as such, they will only be captured in errors and omissions especially in the country with capital control.

Using equation, the hot money measure expressed capital flight as;

$$CF = f(FB, FDI, CAD, \ \Delta FR, EO, \Delta WBIMF). \ldots \ldots \ldots (1)$$

This function can be better expressed as follows

$$CF = FB + FDI - CAD - \ \Delta FR - EO - \ \Delta WBIMF \ldots (2)$$

Where, TKO is the total capital outflows

Table1. Effect of Capital Flight on Tax Revenue in Nigeria

Variables	Coefficients	Std. Error	t-value	Sig.
Constant	19.168	6.725	2.850	*
Capital flight (₦)	-0.020	0.000	6.087	*
R	0.703			
R^2	0.494			
Adj R	0.480			
Std Error Estimate	1.982			
F-ratio	37.047			

Source: SPSS Analyzed Data, 2015
*indicates significance at 1% level.

FB is foreign borrowing as reported is the BOP statistics.
FDI is the net foreign direct investment
CAD is the current account deficit/surplus
ΔFR is the change in the stock of official foreign reserves
EO is net errors and omissions
ΔWBIMF is the difference between the changes in the stock of external debt reported by the World Bank and foreign borrowing reported in the BOP statistics published by the IMF.
On the other side of the equation, the notation relating to tax revenue is expressed as follows:

TRev = f(CIT, VAT, PPT, C&ED) . . . . (3)
This function can also be better expressed as
TRev = CIT + VAT + PPT + C&ED . . . . (4)

Where, TRev is tax revenue in Nigeria
CIT is company income tax
VAT is value added tax
C&ED is custom and excise duty.

However, the simple regression analysis model specified for this study is given as:
TRev (tax revenue) = f(capital flight)
That is, TRev = β_0 - β_1CF + ε . . . . (5)

Substituting the hot money expression for capital flight in our model, we have the following:
TRev = β_0 + β_1FB + β_2FDI + β_3CAD + β_4ΔFR + β_5EO + β_6ΔWBIMF + ε . . . (6)

Where, β_0 - β_6 are coefficients, and ε is the stochastic error term.

RESULTS

The result in Table1 shows the simple regression analysis on the effect of capital flight on tax revenue in Nigeria. The multiple regressions co-efficient (R) was 0.703 or 70.3%, implying that capital flight was highly correlated with tax revenue in Nigeria. The coefficient of determination (R^2) was 0.494 or 49.4%, indicating that about 49.4% of the total observed variation in the in tax revenue in Nigeria was explained by the changes in capital flight. The goodness of fit of the model was indicated by the high value of F-statistic (37.047). The overall model was significantly different (P < 0.05), suggesting that capital flight exert influence on tax revenue in Nigeria.

The coefficient of capital flight was negatively signed as well as statistically significant at 1%. This means that a unit increase in capital flight will lead to 0.02 or 2% decrease in tax revenue in Nigeria.

Test of Hypothesis

The null hypothesis which states that there is no significant effect of capital flight on tax revenue in Nigeria was tested using the F-statistics.

Mathematically, it is stated as:

$$\text{F-cal} = \frac{R^2 (N - K)}{1 - R^2 (K - 1)}$$

Where:
R^2 = 0.494
N = 40
K = 2

$$\text{F-cal} = \frac{0.494 (40 - 2)}{1 - 0.494 (2 - 1)}$$

$$\text{F-cal} = \frac{18.772}{0.506} = 37.10$$

F-cal = 37.10
F-tab = 4.08

Decision rule: If F- cal > F– tab, reject the null hypothesis otherwise accept. The F-cal value (37.10) is greater than F-tab value (4.08), the null hypothesis is rejected and the alternative hypothesis is accepted that the capital flight has significant effect on tax revenue in Nigeria.

CONCLUSION AND RECOMMENDATIONS

The objective of the study is to ascertain the effect of capital flight on the tax revenue in Nigeria. Our findings revealed that capital flight has significant effect on tax revenue in Nigeria. Results of the study equally show that a unit increase in capital flight will lead to a 2 per cent decrease in tax revenue in Nigeria. This finding is in agreement with the outcome of the studies of Taiwo (2007), Akani (2013), Umoru (2013), and Olugbenga and Alamu (2013). However, their studies were mainly on capital flight and economic growth and development in Nigeria and not necessarily on tax revenue. On the other hand, we thought it wise to relate tax revenue and economic growth and development knowing very well that tax revenue is one of the major drivers of economic growth and development in any country.

However, the result of Enyi (2014) concludes that inflation and tax rates have positive impact on capital flight. In other words, increase in tax rates have positive impact on capital flight but our finding revealed that increase in capital flight reduces tax revenue in Nigeria. To corroborate our finding, Emeagwali (2000) observes that money illegally moved out of the country cannot be taxed; hence capital flight negatively affects tax revenue.

Therefore, the study recommends that investment and re-investment of profit by foreign investors in Nigeria will be possible if enabling and business-friendly environment is provided. This will be achieved through the provision of the infrastructural facilities such as good road, water and electricity. Also, multifarious taxation should be eradicated to avoid depletion of profits that sometimes lead multinational companies to seek for tax havens abroad.

Double taxation relief agreement should be judiciously applied to ensure that foreign capitals are not unduly taxed to minimize capital outflow from Nigeria. Nigerian government should equally establish monetary and fiscal policies that will be able to stabilize the economy. This is in view of the fact that unstable economy is one of the causes of capital flight.

Finally, Nigerian government should enforce economic policies that can encourage domestic investment and discourage capital flight so as to step up the revenue level from taxation in Nigeria. For instance, placing a limitation as to the amount or percentage of local profit that could be repatriated to parent company from the subsidiary will help to reduce capital flight from Nigeria.

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