

# The Paradox of Capital Flight from a Capital-Starved Continent

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## Introduction

There is general consensus in the growth literature that investment is an important determinant of economic growth. The effect of investment on growth is robust (Levine and Renelt 1992; Sali-i-Martin 1997)—and the results hold for sub-Saharan African (SSA) countries (Hoefler 2002; Cinyabuguma and Putterman 2010).<sup>1</sup> Thus one of the explanations often cited for Africa's underdevelopment is that the region lacks the capital needed for investment. The argument is as follows: (i) Africa has a resource gap—i.e., the capital available for investment is less than the capital required to invest in order to ensure sustainable growth; (ii) Africa has to fill the

<sup>1</sup> There is an extensive literature on the “African dummy variable” which investigates whether the factors that determine growth for SSA countries may be different from the determinants of growth in other regions. See Cinyabuguma and Putterman (2010) for a review of the literature.

resource gap in order to achieve long-term development; and (iii) Africa will have to depend on external capital to fill the resource gap. Consequently, many African policymakers have called for an increase in foreign aid. In addition, several African countries have increased their efforts to attract foreign direct investment (FDI), albeit unsuccessfully (Asiedu 2004).<sup>2</sup>

The importance of external capital as a solution to Africa's development problems is also stressed in the Millennium Declaration Goal (MDGs) document and the NEPAD framework papers of the New Partnership for Africa's Development (NEPAD).<sup>3</sup> Specifically, page 37 of the NEPAD framework document states that:

To achieve the estimated 7 per cent annual growth rate needed to meet the International Development Goals (IDG), particularly, the goal of reducing by half the proportion of Africans living in poverty by the year 2015, Africa needs to fill an annual resource gap of 12 per cent of its GDP, or US \$64 billion. This will require increased domestic savings, as well as improvements in the public revenue collection systems. However, the bulk of the needed resources will have to be obtained from outside the continent. [emphasis by authors]

Indeed, one of the key pillars of the NEPAD strategic plan is the Capital Flows Initiative (CFI). The CFI emphasizes the importance of increasing foreign aid and international private investments, in particular, foreign direct investment (FDI) as a strategy to fill the resource gap and also reduce

<sup>2</sup> We note that FDI to SSA has increased substantially since 2005 (see Figure 1 on page 27). However the investments are concentrated in a few countries. For example, from 2005-2010, about 63% of FDI to the region went to 5 countries: Nigeria, South Africa, Republic of Congo, Ghana and Sudan (WDI 2011).

<sup>3</sup> NEPAD is a development plan put together by African leaders to eradicate poverty and promote growth in the region. For more on this issue, see Owusu (2003).

poverty in the region.<sup>4</sup> For example, the CFI notes “NEPAD seeks to increase private capital flows to Africa, as an essential component of a sustainable long-term approach to filling the resource gap” (NEPAD 2001, 39) and “Additional Official Development Assistance is required to enable least developed countries to achieve the international development goals (IDGs)” (NEPAD 2001, 40).

The CFI also notes that capital flight exacerbates the resource gap problem—and that “this situation can only be reversed if African economies become attractive locations for residents to hold their wealth.” It is important to note that there are two types of capital flight: *illicit* and *licit* capital flights. The capital flight referenced in the NEPAD document pertains to licit financial transactions. This paper asserts that in addressing Africa’s resource gap problem, more attention should be paid to illicit capital flight. As shown in Ndikumana and Boyce (2011), illicit financial outflows are common in African countries. Furthermore, the magnitude of illicit capital flight is quite substantial, both in absolute monetary terms and relative to GDP. Illicit capital outflows widen the resource gap and therefore increase the need for foreign capital.

This paper analyzes the links between illicit capital flight, foreign aid, and FDI to Africa. We argue that Africa’s resource gap could be narrowed and even completely filled if *illicit* capital flows from the continent were curtailed. Specifically, we show that over the period 1970-2008, illicit capital flight was much larger than foreign aid as well as FDI, and comparable to the sum of FDI and aid. Thus our analysis reveals a paradox: Africa is *supposed* to be a capital-starved region—yet it is a capital exporter. We also advance reasons why relying on external resources to finance Africa’s development may be problematic.

<sup>4</sup> We note that foreign direct investment has other benefits, such as technology transfer and employment creation. This paper focuses on using FDI to finance the resource gap.

## Illicit capital flight, FDI, and foreign aid to sub-Saharan Africa

Table 1 (p. 26) and Figure 1 (p. 27) show trends in illicit capital outflows (ICF), FDI and foreign aid to 33 countries in SSA for which data on capital flight are available.<sup>5</sup> The data are in constant 2008 dollars and cover the years 1970-2008. To facilitate the discussion, we report the average annual financial flows per country from 1980-2008 as well as the average annual flows per country for 4 sub-periods: 1970-1979; 1980-1989; 1990-1999 and 2000-2008.<sup>6</sup> In order to facilitate comparison between ICF and external flows, we also report the ratio of ICF to FDI, aid and the sum of FDI and aid.

There are several notable points. First, ICF have increased substantially over time. On the average, ICF in 2000-08 were about three times ICF in 1970-1979, and increased by about 90 percent over the periods 1990-1999 to 2000-2008. This clearly suggests that illicit capital flight still remains a problem and that the situation has gotten worse over time.

The second noticeable point is that ICF outpaced FDI and foreign aid. This is clearly evident from Figure 1, where the ICF graph lies above the graphs of FDI and aid. Table 1 also shows that the ratio of ICF to FDI exceeds one in all the periods (ranges from 2.5 to 22.9), suggesting that ICF dwarfs FDI flows. The ICF-aid ratios are much lower than the ICF-FDI and they range from 0.94 to 1.6. For example from 1970-2008, ICF was about 3 times FDI flows but only 1.3 times aid flows. This result

<sup>5</sup> Data series prepared for Ndikumana and Boyce 2011, available at [http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital\\_flight\\_series\\_1970-2008.pdf](http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital_flight_series_1970-2008.pdf).

<sup>6</sup> We report average flows instead of cumulative flows because the data on illicit capital flows are not available for some countries in the 1970s. As a consequence, a comparison based on cumulative flows will underestimate the magnitude of illicit capital flows. The country and per-country averages are calculated excluding missing years in some country series.

is interesting because it implies that overall countries relied on foreign aid to fill the resource gap.

Our discussion so far is based on aggregated data for the 33 countries. Such an analysis is useful in that it provides a good overview of ICF in comparison to other external flows for the countries. The disadvantage is that it obscures the variation in financial flows between countries. In addition, the data on financial flows may reflect the situation in only a few countries. For example, two countries, South Africa and Nigeria accounted for about 46 percent of FDI flows from 1970-2008. Accordingly, the conclusions based on the aggregate data for the countries may be misleading. We therefore also report the annual flows for ICF, FDI, and aid as well as the ICF-FDI and ICF-aid ratios for each of the 33 countries.

As shown in Table 2 (p. 29), there is a wide variation among countries in the magnitudes of ICF, FDI, and the ICF-external flow ratios. We group the countries into two sets based on how the countries finance their resource gap. Aid-dependent countries are those countries for which the ICF-aid ratio is greater than the ICF-FDI ratio, and FDI-dependent countries refer to countries for which the ICF-aid ratio is less than the ICF-FDI ratio. Thus, aid-dependent countries rely on foreign aid to fill the resource gap and FDI-dependent countries rely on FDI to fill the gap. The data for the aid-dependent countries and FDI-dependent countries are shown in Panel A and Panel B, respectively.

One noteworthy point is that 27 out of the 33 countries (about 80 percent) are aid-dependent. Also note that for several countries the ICF-FDI ratio is quite high, suggesting that ICF dwarfs FDI. This is interesting because as pointed out earlier, several countries in the region have been aggressive in their efforts to attract private foreign capital, in particular, FDI, albeit unsuccessfully.<sup>7</sup> For many of

these countries, there will be less need for FDI to fill the resource gap if ICF are curtailed.

## Conclusion

Relying on external capital to fill Africa's resource gap and also to address poverty in the region may be problematic for three reasons.

First, both FDI and aid are volatile, and volatility has an adverse effect on the economy (Desai and Kharas 2010).<sup>8</sup> For example, FDI to SSA increased in real terms from \$15 billion in 2006 to about \$38 billion in 2008, which is an increase of about 146 percent, but decreased to \$26 billion in 2010, a decline of about 30 percent from 2008 to 2010 (WDI 2012). With regards to foreign aid, net aid increased substantially after the adoption of the MDG goals in 2001, and declined after the 2007 world financial crisis. Net aid to SSA tripled in real terms from about \$10 billion 2001 to about \$36 billion in 2006, but it declined to \$30 billion at the end of 2007, a decrease of about 14 percent.

Second, the extensive aid-growth literature suggests that the effect of foreign aid on economic growth is ambiguous (Charnning, Jones, and Tarp 2010).

Third, the region has generally been unsuccessful in attracting FDI, and this trend is unlikely to change. As a consequence, relying on FDI to fill the finance gap is unrealistic, both in the short and medium term.

We therefore recommend that sub-Saharan African countries need to establish effective strategies to curtail illicit capital flight as part of the broader agenda of mobilizing resources for economic development.

<sup>7</sup> We note that FDI has other advantages, such as technology transfer and employment creation.

<sup>8</sup> See Desai and Kharas (2010) for a review of the literature on the effects of aid volatility.

## References

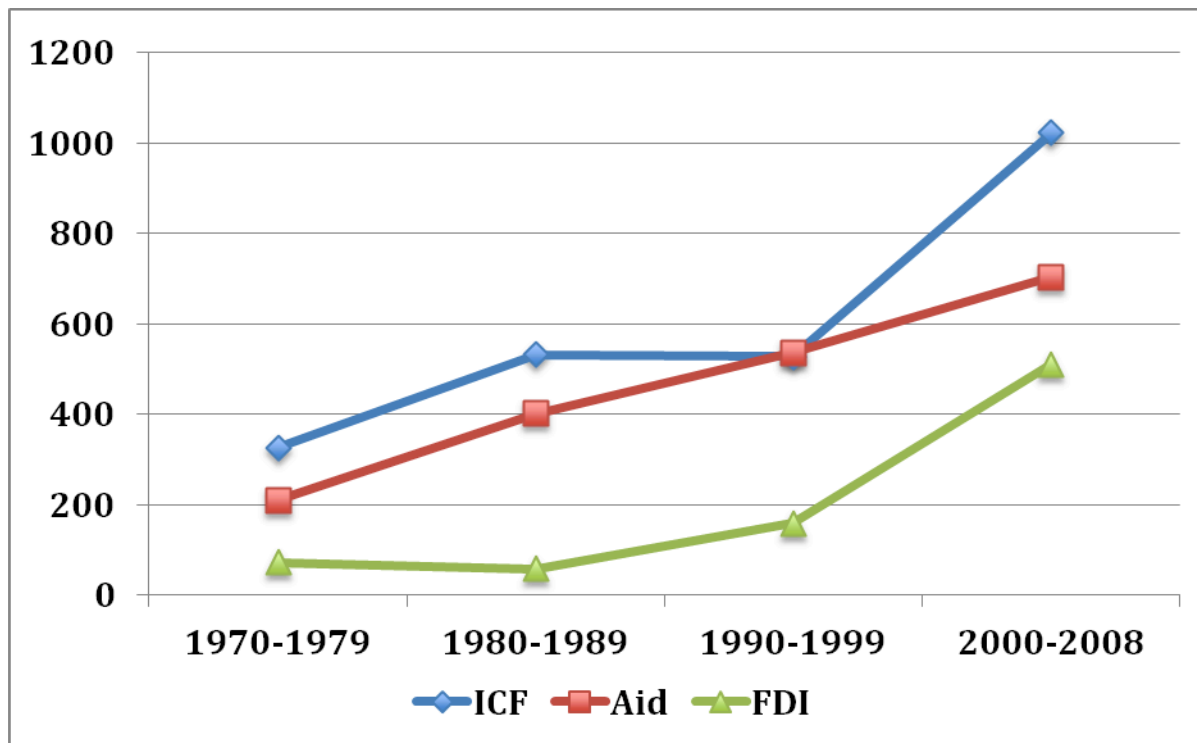
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**Table 1: Illicit Capital Flight, Foreign Aid, and FDI: Annual Flows per Country, 1970-2008 (million, constant 2008 dollars)**

<b>Description</b>	<b>1970-79</b>	<b>1980-89</b>	<b>1990-99</b>	<b>2000-08</b>	<b>1970-2008</b>
Illicit Capital Flight (ICF)	326.58	531.80	527.67	1023.04	604.19
Foreign Aid (Aid)	209.44	402.12	536.68	704.07	200.82
Foreign Direct Investment (FDI)	71.86	57.56	159.05	510.64	461.19
(Aid+FDI)	281.30	459.68	695.73	1214.71	662.01
ICF/FDI	5.61	22.91	6.95	2.51	3.01
ICF/Aid	1.55	1.33	0.94	1.48	1.31
ICF/(Aid+FDI)	1.14	1.17	0.77	0.84	0.91

Notes for Tables 1 and 2: The data on capital flight, aid and FDI are flows per year in constant 2008 million dollars. The data are for 33 countries in Sub-Saharan Africa: Angola, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Congo, Dem. Rep., Congo, Rep., Cote d'Ivoire, Ethiopia, Gabon, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mozambique, Nigeria, Rwanda, Sao Tome and Principe, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe. The data on capital flight are from [http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital\\_flight\\_series\\_1970-2008.pdf](http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital_flight_series_1970-2008.pdf), a data series used for Ndikumana and Boyce (2011) and the data on FDI and foreign aid are calculated by the authors based on data from the World Development Indicators. Note that there are missing years in the data series for a number of countries. The country and per-country averages are calculated excluding missing years.

**Figure 1: Illicit Capital Flight (ICF), Foreign Aid, and Foreign Direct Investment (FDI): Average Annual per Country Flows, 1970-2008 (million, constant 2008 \$)**



Notes: The data are for 33 countries in Sub-Saharan Africa: Angola, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Congo, Dem. Rep., Congo, Rep., Cote d'Ivoire, Ethiopia, Gabon, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mozambique, Nigeria, Rwanda, Sao Tome and Principe, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe. The data on capital flight are from [http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital\\_flight\\_series\\_1970-2008.pdf](http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital_flight_series_1970-2008.pdf), a data series used for Ndikumana and Boyce (2011) and the data on FDI and foreign aid are calculated by the authors based on data from the World Development Indicators. Note that there are missing years in the data series for a number of countries.. The country and per-country averages are calculated excluding the missing years.

**Table 2: Illicit Capital Flight (ICF), Foreign Aid and Foreign Direct Investment (FDI), 1970-2008**

<b>Panel A: Aid Dependent Countries</b>							
<b>Average annual flows 1970-2008 constant \$ (million)</b>					<b>Ratios</b>		
<b>Country</b>	<b>ICF</b>	<b>FDI</b>	<b>Aid</b>	<b>Aid+FDI</b>	<b>ICF/FDI</b>	<b>ICF/Aid</b>	<b>ICF/(Aid+FDI)</b>
Burkina Faso	29.08	23.91	478.74	502.65	1.22	0.06	0.06
Burundi	186.02	0.98	253.96	254.94	189.75	0.73	0.73
Cameroon	616.46	112.47	596.96	709.43	5.48	1.03	0.87
Cape Verde	128.00	25.79	116.36	142.15	4.96	1.10	0.90
Central African Rep.	61.55	12.47	177.88	190.35	4.94	0.35	0.32
Chad	63.60	90.49	268.92	359.41	0.70	0.24	0.18
Congo, Dem. Rep.	787.82	177.19	933.11	1110.30	4.45	0.84	0.71
Cote d'Ivoire	1165.49	171.95	553.63	725.58	6.78	2.11	1.61
Ethiopia	515.96	105.31	1079.80	1185.11	4.90	0.48	0.44
Gabon	585.79	35.85	108.96	144.82	16.34	5.38	4.05
Ghana	272.02	193.67	681.13	874.80	1.40	0.40	0.31
Guinea	39.88	41.63	276.26	317.89	0.96	0.14	0.13
Kenya	182.59	88.34	807.88	896.22	2.07	0.23	0.20
Lesotho	20.76	61.44	128.75	190.19	0.34	0.16	0.11
Madagascar	240.38	81.12	495.68	576.80	2.96	0.48	0.42
Malawi	58.80	34.18	455.25	489.43	1.72	0.13	0.12
Mauritania	100.21	60.36	328.15	388.51	1.66	0.31	0.26
Mozambique	537.78	104.97	950.84	1055.81	5.12	0.57	0.51
Rwanda	113.28	17.93	415.20	433.12	6.32	0.27	0.26
Sao Tome	34.62	5.21	34.41	39.62	6.64	1.01	0.87
Sierra Leone	156.21	15.04	194.86	209.90	10.39	0.80	0.74
Sudan	480.50	459.04	998.74	1457.78	1.05	0.48	0.33
Swaziland	59.65	55.23	55.90	111.13	1.08	1.07	0.54
Tanzania	203.45	163.71	1305.28	1468.99	1.24	0.16	0.14
Uganda	356.06	128.00	673.70	801.71	2.78	0.53	0.44
Zambia	625.95	220.99	755.41	976.40	2.83	0.83	0.64
Zimbabwe	706.97	54.54	334.05	388.59	12.96	2.12	1.82
<b>Panel B: FDI Dependent Countries</b>							
<b>Average annual flows 1970-2008 constant \$ (million)</b>					<b>Ratios</b>		
<b>Country</b>	<b>ICF</b>	<b>FDI</b>	<b>Aid</b>	<b>Aid+FDI</b>	<b>ICF/FDI</b>	<b>ICF/Aid</b>	<b>ICF/(Aid+FDI)</b>
Angola	3109.26	524.11	291.01	815.12	5.93	10.68	3.81
Botswana	53.78	184.65	156.98	341.63	0.29	0.34	0.16
Congo, Rep.	628.94	269.03	223.09	492.12	2.34	2.82	1.28
Nigeria	7595.41	1745.23	793.56	2538.78	4.35	9.57	2.99
Seychelles	146.60	41.29	29.71	71.01	3.55	4.93	2.06
South Africa	951.61	1320.97	265.12	1586.09	0.72	3.59	0.60