Capital Flight from Africa and Development Inequality: Domestic and Global Dimensions[1][2]

Léonce Ndikumana

Department of Economics and Political Economy Research Institute

University of Massachusetts at Amherst

**March 29, 2015**

## Abstract

Over the past decades African economies have exhibited two stunning paradoxes: growth acceleration coexisting with stubbornly high poverty rates; increasing capital flight along with widening development financing gaps. There has been no attempt to link the two in the literature. This paper attempts to fill the gap; it suggests that the implications of capital flight for the inequality-growth-poverty nexus may be the key. Specifically, the paper proposes to shift attention to conceptual and empirical analysis of the implications of capital flight for inequality along income lines and inequality in development both within African countries and between Africa and advanced economies. The evidence presented in the paper indicates that Africa may be more unequal along human development dimensions than along income, and points to the possibility that capital flight may be one of the factors behind the observed limited poverty reduction gains from growth and persistent development gap between African countries and advanced economies.

[1] Paper presented at the 2015 Conference of The Institute for New Economic Thinking (INET), Paris, 10 April 2015.

[2] This paper benefited substantially from excellent research assistance from Sam Tanyos, Medical School student at the University of Pennsylvania.

## Table of Contents

## 1. Introduction

Developments over the past decades in Africa reveal two stunning paradoxes. First, while the continent has recorded impressive economic growth,[3] becoming the second fastest growing region, the continent – especially sub-Saharan Africa – continues to lag behind in most development targets and is the only region where the number of poor people keeps rising.[4] Along with GDP, inequality is also growing. Second, while the continent faces large and deepening financing gaps, it also continues to experience large and growing volumes of capital flight (Ndikumana et al., 2015). While these paradoxes are gathering increasing attention in the literature, there has been little attempt to link them conceptually and empirically. Research on capital flight has primarily focused on documenting its magnitude and exploring its determinants. Research on the implications of capital flight for economic development is at its early stages, but it is already showing strong evidence on negative effects on poverty (Nkurunziza, 2012, 2015). Thus far, there is no attention on the distributional implications of capital flight at national and global levels.

Capital flight is not an African problem or generally a development country problem only. In fact, recent studies show that developing countries account for a small share of global unrecorded financial flows or 'missing private wealth' (Zucman, 2013). However, while the volume of capital flight from Africa may be relatively small from a global perspective, it carries substantially heavier costs for the source economies in terms of forgone economic development opportunities. This paper seeks to initiate a discussion of the implications of capital flight for inequality not only along income lines but also, and most importantly, in terms of access to social services and human development outcomes both at national and global levels; that is, inequality in development. The paper therefore contributes to the broader debate on the role of inequality in economic development, and more specifically on the importance of inequality for the capital fight-economic development nexus.

[3] See, among others, AfDB et al. (2014) and UNECA (2013).
[4] The number of poor people in SSA increased from 205 million in 1981 to 415 million in 2011. The data are from POVCALNET, at http://iresearch.worldbank.org/PovcalNet/index.htm?1.

The paper has important relevance for the expanding literature on growth and inequality at national and global levels. At the global level, the recent influential work by Thomas Picketty and his collaborators has galvanized attention to the widening inequality between the ultra-rich and the middle class in developed countries, calling for urgent policy responses including a global income tax (Piketty and Goldhammer, 2014). This study contributes to this literature by extending the attention to development inequality within developing countries and between developing countries – Africa in particular – and developed countries. Specifically, the paper discusses how capital flight contributes to increasing inequality within African countries and to deepening the development gap between Africa and the advanced world. The paper also contributes to the literature on the inequality-growth-poverty nexus, especially strengthening the argument that because inequality reduces the gains from growth in terms of poverty reduction and human development, it is possible for growth acceleration to coexist with stagnating and even deepening poverty (Fosu, 2009, 2010, 2015; Kalwij and Verschoor, 2007; Ravallion, 1997; Thorbecke, 2013). Specifically, this study suggests that by widening development inequality within Africa, capital flight may be one of the factors that explains the observed weak link between growth and poverty reduction in the continent.

The next section of the paper presents the global context of the problem of capital flight, highlighting the role of the flaws in the global financial system, especially the role of tax havens in facilitating unrecorded outflows of private wealth. Section 3 presents the state of knowledge on capital flight from African countries. Section 4 provides a conceptual framework for the analysis of the implications of capital flight for economic development with empirical illustrations with the case of health outcomes. It highlights distributional implications of capital flight for access to social services and health outcomes along vertical and horizontal dimensions. Section 5 concludes with a summary of the findings and suggestions for further research.

## 2. The 'dark matter' in the Balance of Payments

The past few decades have witnessed rapid acceleration of cross-border capital flows, which have outpaced trade and production. At the same time, these trends have exhibited substantial irregularities in international financial and trade statistics. In OECD countries, concerns have been raised about the large discrepancies between current account balances and trade balances,

and between assets and liabilities. Analysis of global financial statistics reveals two important puzzles (Zucman, 2013). The first consists of large and systematic discrepancies between global liabilities and assets, and between global investment income receipts and payments. Total liabilities exceed total assets, ironically suggesting that the world as a whole is a 'net creditor'; the question is, net creditor to whom?. Moreover, interest income paid seems to exceed interest income received globally. These discrepancies cannot be attributed to normal statistical noise as reported in the errors and omissions line of the Balance of Payments (BoP). In other words, what the Deutsche Bank once referred to as 'dark matter' in the BoP is in fact a substantial, persistent and growing phenomenon. These discrepancies represent 'missing wealth', corresponding to large flows of assets and interest earnings that are not declared by the beneficiary owners. This missing private wealth therefore represents capital flight.

Determining the exact size of the 'missing money' or the 'blind spot' in global financial statistics (Zucman, 2013, p. 1327) is naturally impossible because of the inherent illicit nature of the underlying transaction for the bulk of these flows, in addition to deficiencies in national statistical systems. These problems are compounded by the lack of coordination and cooperation across countries in reporting banking and corporate transactions and incomes. However, existing estimates provide a reasonable order of magnitude that clearly demonstrates the substantial importance of the problem. Using a new data base from the Swiss National Bank on private holdings in Swiss bank accounts, Zucman (2013) estimates that by the end of 2008, global liabilities exceeded recorded assets by $5.9 trillion ($4.5 trillion in securities and $1.4 trillion in deposits). These funds which are not recorded in national statistics are held in offshore financial centers. Indeed, other sources have published even higher figures of private wealth held in secrecy jurisdictions (Zucman, 2013): $6.7 trillion in 2008 by the Boston Consulting Group; $8.7 trillion in 2002 by Gemini & Merrill Lynch; $11.5 trillion in 2005 by Tax Justice Network.[5]

There is a close correlation between the explosion of unrecorded investment and income cross-border flows and the expansion of the offshore industry, specifically tax havens. While there is no consensus on the definition of tax havens, the one offered by Palan et al. (2010, p. 8) serves our practical purposes well: "tax havens are places or countries (not all of them are sovereign states) that have sufficient autonomy to write their own tax, finance, and other laws and

[5] See also Henry (2012) for further estimates of offshore private wealth holdings from various sources.

regulations. They all take advantage of this autonomy to create legislation designed to assist nonresident persons or corporations to avoid the regulatory obligations imposed on them in the places where those nonresident people undertake the substance of their economic transactions." Tax havens are not a new phenomenon; what is striking, however, is the rapid growth of transactions conducted in or transiting through these territories. Their explosion can be associated with two forces that Palan (2002, p. 154) refers to as the "increasing integration within the context of political fragmentation." Specifically, the modern global economy is characterized by consolidation of state sovereignty over economic laws on the one hand, and increasing dominance of multinational enterprises as well as rapid cross-border movement of capital on the other hand. These developments make it increasingly difficult to regulate private capital flows, and thus facilitate unrecorded cross-border movement of capital.

The role of tax havens in facilitating unrecorded movement of wealth or capital flight is a result of the special features and services that make them particularly attractive to capital owners. The first and probably most important feature is institutionalized banking secrecy, a practice that has evolved and has been consolidated over time dating from the 18$^{th}$ century when Swiss banks offered 'numbered accounts' or *comptes anonymes* to aristocrats during the French revolution (Palan, 2002). Banking secrecy is a key feature of the legal framework in tax havens and a major factor that attracts private wealth holders seeking to evade legal scrutiny, especially prosecution of tax evasion and illicit acquisition of wealth.

The second feature of tax havens is the permissive corporate laws, especially the ease of incorporation that enables companies and high-networth individuals to establish special-purpose vehicles with a face of a corporation that only serve as transit spots for unrecorded financial transactions (Ndikumana, 2014b). Tax havens specialize in disguising the identity of corporations and individuals behind sham corporations, behaving like mere parking lot operators, who "could not care less about the business of their customers only that they pay for parking their vehicles there" (Palan, 2002, p. 152). Countries or territories that behave like such parking lots indeed account for a large share of global unrecorded wealth. It is estimated that Luxemburg, Ireland, and the Cayman Islands account for about 48 percent of global 'missing private wealth' (Zucman, 2013, p. 1347). Thus, the flows behind what appears to be 'dark matter' in the Balance of Payments or 'blind spot' in global financial statistics can actually be linked to real geographic

destinations. In other words, as Zucman (2013, p. 1345) puts it, “the wealth does not randomly vanish.” The ‘missing wealth’ is carefully concealed in tax havens.

The proliferation of tax havens and their role in facilitating capital flight poses serious concerns not only because of the massive amount of tax revenue losses that capital flight implies for source countries, but also for the threat that they pose for the stability of the global financial system. Profit shifting through tax havens results in substantial reduction in the actual tax paid by corporation relative to their profits. For example, it is estimated that the effective corporate tax rate in the United States has declined from 30% to 20% over the past 15 years, and that two-thirds of the decline is attributable to the shifting of corporate profits towards tax havens (Zucman, 2014). The global financial crisis helped to raise awareness on these issues and provided an impetus for efforts to curb illicit financial flows and tax evasion. But progress is limited. The lack of international coordination of efforts to fight tax evasion provides opportunities for multinational corporations and high-networth individuals to shift wealth across jurisdictions when pressed by individual country measures to enforce disclosure and asset repatriation. Indeed, Johannesen and Zucman (2014) point out that attempts to crack down on banking secrecy has mainly benefited the least compliant tax havens.

The exploding volume of unrecorded flow of private wealth has important implications for growth and inequality both within and across countries. It may be one of the factors behind the growing income gaps between the super-rich and the middle class as documented in the recent influential work by Picketty and his collaborators (Piketty and Goldhammer, 2014).

While capital flight and tax evasion represent an important problem for the global economy as a whole, they constitute a more crippling problem for developing countries in general and African countries in particular. Having provided this global context, the paper henceforth focuses on the case of capital flight from African countries and its implications for development inequality with an illustration with inequality in access to social services such as water and sanitation and disparities in health outcomes both within African countries and between Africa and the rest of the world.

## 3. Africa's 'missing money'

### *Significance of the problem of capital flight*

While the phenomenon of 'missing wealth' in developed countries is getting increasing attention in academia, the media and policy circles, the problems of capital flight and illicit financial flows which are at the origin of this phenomenon have been endemic in developing countries in general and in Africa in particular for several decades. In the case of African countries, the problem of capital flight was first brought to light in the economics literature at the end of the 1980s and early 1990s, at a time where the continent was struggling with the debt crisis. Research revealed substantial discrepancies between recorded capital inflows and the use of foreign exchange, which could not be attributed to random statistical errors (Ajayi, 1997; Chang and Cumby, 1991; Hermes and Lensink, 1992; Kahn, 1991). Subsequent studies confirmed that the problem of capital flight was chronic and widespread and not limited to any particular group of countries (Boyce and Ndikumana, 2001; Ndikumana and Boyce, 2011).[6]

Substantial progress has been made in the literature in documenting the magnitude of capital flight and its drivers, although more work is still needed to uncover country specificities with regard to the channels and determinants of capital flight. Nonetheless, we can draw a set of important conclusions from the existing literature on capital flight from Africa (Ndikumana et al., 2015). First, capital flight is not a new phenomenon; it has persisted throughout the past several decades from as far back as data availability can allow to estimate it. Over the four decades from 1970 to 2010, a representative sample of 39 African countries is estimated to have lost a total of $1.3 trillion in constant 2010 dollar terms, representing 82 percent of the group's GDP in 2010. Including accumulated interest earnings, the stock of capital flight reached $1.7 trillion in 2010. During the decade of the 1970s alone, the 39 countries as a group lost as much as $225 billion (in constant 2010 dollars) due to capital flight (Table 1).[7].

[6] See Ajayi and Ndikumana (2015) for in-depth exploration of various themes related to capital flight from Africa as well as updated data.

[7] This figure underestimates the true extent of capital flight in the 1970s because a number of countries in the sample do not have data for many years in that decade; some have data starting only in the 1980s. This is the case for Angola (1986), Burundi (1985), Cape Verde (1982), Guinea Bissau (1982), Guinea (1986), Mozambique (1985),

The second finding is that capital flight from Africa has accelerated since the turn of the century. Total capital flight from the sample of 39 African countries jumped to over half a trillion dollars ($511 billion) during 2000-10 from $230 billion in the previous decade (Ndikumana et al., 2015). This finding deserves attention, in particular because this acceleration of capital flight has occurred even as the continent was experiencing substantial improvement in economic performance and consolidation of political stability. This suggests that capital flight cannot be justified on the basis of investors seeking protection from economic and political uncertainty. Thus there is a need for explicit measures to stem the financial haemorrhage as market forces alone are not likely to resolve the problem.

Third, the bulk of the surge in capital flight from Africa is concentrated in oil-rich countries. Over the 2000-10 period, capital flight from oil-rich countries totaled $423.3 billion compared to $87.6 billion from non-oil countries. During 1990-99, however, the two groups had experienced a similar (smaller) amount of capital flight: $117.6 and $112.7, respectively. It is noteworthy that the acceleration of capital flight since 2000 coincides with the resource boom experienced prior to the global economic and financial crisis. The evidence suggests that a substantial fraction of the gains from the oil boom has financed the accumulation of private assets through capital flight.

Fourth, capital flight from Africa is large relative to the size of source economies. Total capital flight (in constant terms) as of 2010 exceeds GDP for 18 out of the 39 countries in the sample referred to above. Capital flight is also large relative to other international flows (Table 1). The stock of capital flight exceeds the stock of external debts owed by this group of countries, making the group a 'net creditor' to the rest of the world. The accumulated capital flight over the past four decades also exceeds total official development aid as well as foreign direct investment.

The evidence suggests that contrary to the popular view that Africa is heavily dependent on external financing, the continent is in fact a 'net creditor' to the rest of the world. Indeed, Africa could expunge its debts if it were able to recuperate a fraction of its wealth that is illicitly stashed abroad. The evidence also implies that Africa would not need aid – at least not as much as it does

---

and Seychelles (1981). See Ndikumana et al. (2015) for detailed information on data availability for the 39 countries covered by the PERI capital flight database (www.peri.umass.edu/300).

now – if it were able to keep its capital onshore. Therefore, discussions about mobilization of financing to meet Africa's development needs should consider strategies to stem illicit capital outflows and measures to repatriate the continent's stolen assets.

### *Capital flight, illicit financial flows, and missing wealth*

The estimates of capital flight available in the literature constitute only a subset of Africa's 'missing wealth,' which encompasses the broader phenomenon of illicit financial flows from the continent. Attempts to estimate illicit financial flows are constrained by lack of a consistent methodology and appropriate data.[8] While the concepts of capital flight and illicit financial flows are often used interchangeably, the two are not identical. Capital flows are illicit if they involve illicitly acquired funds, or are transferred abroad and held there without full disclosure to the national authorities, or both.

While most if not all capital flight consists of illicit financial flows, not all illicit financial flows are captured under capital flight according to the definition and algorithm adopted in the literature. Two examples of illicit financial flows that are not captured as capital flight which are often referred to in discussions of both capital flight and illicit financial flows are import smuggling and transfer pricing. Import smuggling may take the form of technical smuggling where the value of imports is under-estimated to evade customs duties, or pure smuggling where the imports are simply not reported. Import smuggling is illicit because it breaks cross-border trade regulations. But the associated flows do not constitute capital flight, because the imports are paid for, implying that there is a counterpart to the foreign exchange that financed the smuggled imports.

Transfer pricing is a profit shifting scheme used by multinational corporations consisting of setting the prices assigned to intra-firm trade in goods and services with the purpose of inflating their costs and reducing profits in high-tax jurisdictions.[9] It is important to note that transfer pricing is different from trade misinvoicing, which consists of deliberately orchestrated discrepancies between reported values of exports and imports between trading partners. In the

[8] See Kar and Cartwright-Smith (2010) and AfDB and GFI (2013)for estimates of illicit financial flows from Africa.
[9] See examples of transfer pricing by SAB Miller in Action Aid (2010) and Mopani, the Zambian branch of Glencore operating in copper mining in Zambia (Ndikumana, 2013; Sharife, 2011).

case of transfer pricing, there are no discrepancies in the reported values of trade transactions, except that the inputted prices are at variance with the normal prices that would have been paid in an arms-length transaction between different firms. Thus, transfer pricing does not represent capital flight even though it causes losses in tax revenue. It is clear, therefore, that the existing estimates of capital flight represent only a subset of the overall illicit financial flows from the continent.

### *How does capital flight from Africa fit in the story of global 'missing wealth'?*

The consistent increase in capital flight from Africa is part of the global phenomenon of explosion of unrecorded financial flows resulting from the combination of regulatory failures at national level and structural deficiencies in the global financial system. In particular, the weak regulation of the financial system and the corporate sector, and the proliferation of tax havens are at the heart of the increasing opacity of global financial flows. From a closer look, however, a number of features set apart the case of capital flight from Africa from the phenomenon of 'missing wealth' in developed countries. The first difference is the timing of the acceleration of unrecorded financial flows. In the case of developed countries, unrecorded outflows of private wealth have accelerated during the global financial crisis and especially during the Eurozone crisis (Zucman 2013). This would be consistent with standard portfolio choice theory that suggests that private asset holders would transfer their wealth abroad to minimize losses in the face of heightened uncertainty. In the case of Africa, however, capital flight accelerated since the turn of the century, a period marked by a growth surge and substantial improvement in macroeconomic stability. Such developments imply reduced investment uncertainty and increased expected returns to capital in Africa. Under such circumstances, we would expect capital flight from Africa to decline and investment in domestic assets to rise. Therefore, the acceleration of capital flight from Africa needs a different explanation; in other words, capital flight from Africa is driven by other motives than portfolio choice. The most likely factors are tax evasion and the fear of prosecution for illicit acquisition of the underlying assets (stolen or embezzled funds, proceeds of trade in illegal goods and services, etc.) that their owners seek to hide from national authorities. The aggregate data, however, does not permit to distinguish between capital flight fueled by illicit wealth from that originating from illicit transfer of legally acquired wealth.

In the case of developed countries, especially in Europe, one would expect that the end of the Eurozone crisis would lead to a deceleration of illicit export of capital. For Africa, however, the evidence suggests that capital flight is not linked to business cycles, implying that it is likely to continue accelerating for the foreseeable future.

A second important distinguishing feature of 'missing wealth' in Africa relative to advanced economies is with regard to solutions to the problem. In the case of developed countries, there has been substantial success in the discovery of missing wealth and in deploying legal provisions to crack down on banking secrecy, to track down hidden wealth and curb further illicit financial outflows. The United States has been successful in forcing Swiss banks to disclose bank accounts held by American tax payers. This has set the trend towards more disclosure of banking transactions in Europe, which may help curb illicit financial flows from European countries. In contrast, African countries have seen little progress in tracking and repatriating illicit wealth, the bulk of which consists of stolen assets. The setting up of legal and administrative mechanisms such as the World Bank and United Nations' Stolen Asset Recovery initiative has not yielded meaningful results. The success in developed countries is primarily a result of bilateral negotiations between governments of source countries and those of destination countries or tax havens. Unfortunately, African countries individually have neither the economic and political power nor the technical capacity (e.g., legal expertise) to engage in negotiation with tax havens. Moreover, at the moment there is no effective global institutional framework for assisting source countries in the discovery and recovery of hidden wealth. This makes it difficult for African countries to combat illicit financial flows.

A third important difference between African countries and developed countries is that for Africa capital flight constitutes a net loss to the source economies. In the case of developed countries, the 'missing wealth' is hidden in territories that have intricate linkages with the financial systems of source countries. For example, the bulk of the 'missing wealth' is in fact held in offshore financial centers which are in major cities of developed countries. These resources are contributing to lubricating economic activity in the source countries. Moreover, the corporations that own the missing wealth in tax havens actually conduct the bulk of their businesses in the source countries, including physical capital investment, employment and manufacturing. In contrast, for African countries, the missing wealth is not associated with economic activity in the

financial and real sectors of source countries. Instead, capital flight serves to enrich developed countries where the wealth is stashed. To quote former German president Horst Köhler, "we cannot ignore the global kleptocratic model of capitalism that is sucking obscene amounts of capital out of Africa… Chief among the beneficiaries of this flight of capital are the European banks where African despots and tax-evading corporations stash their billions. If we finally brought order to the international financial system and allowed the tax havens to wither away, that would be credible!" (German Ministry of Education and Research, 2014, p. 30)

The existing evidence suggests that from a global perspective, Africa's missing wealth is small. Even considering all developing countries, they represent a relatively small share of global missing wealth (Zucman 2013). However, Africa's missing wealth is large relative to the size of the source economies. Cumulative capital flight from 39 African countries from 1970 to 2010 represented 82 percent of their combined GDP in 2010 (Ndikumana et al, 2015). For 18 out of the 39 countries, the capital flight to GDP ratio exceedes 100%. Furthermore, relative to developed countries, the consequences of capital flight are more damaging for Africa in terms of forgone development opportunities, in a continent that is both the most capital starved region and that is lagging behind in most social development goals. Capital flight not only robs the continent of much needed investment resources, but it also has important distributional effects that worsen social welfare. The next section elaborates on these heretofore under-researched effects of capital flight on African economies.

## 4. Development inequality implications of capital flight from Africa

The literature on capital flight from Africa has thus far focused on estimating its magnitude and exploring its determinants. Two areas that are still crying for conceptualization and empirical investigation are the development impact of capital flight and its distributional implications. This section aims to initiate a shift of the discussion in those directions.

### *Development impact of capital flight*

An entry point into the analysis of the development impact of capital flight is its effects on domestic resources and the implications for capital accumulation, growth and public service delivery. By depleting domestic savings, capital flight keeps a country below its domestic

investment potential and therefore retards economic growth. Indeed, econometric evidence shows significant negative effects of capital flight on domestic investment in African countries (Fofack and Ndikumana, 2010; Ndikumana, 2014a). Evidence from simulations based on the two-gap model indicates that GDP growth rates in Africa could have been substantially higher if African countries had been able to retain and invest at home the funds that fled from the continent over the past decades (Nkurunziza, 2015). Through its negative effects on investment and growth, capital flight ultimately slows down poverty reduction. Empirical evidence shows that if the capital that fled the continent had been invested domestically, many countries would have been able to reach the millennium development goal of halving extreme poverty by 2015. Even for those countries that would not achieve the goal, they would move substantially closer to the target (Nkurunziza, 2015). For example, if Nigeria had been able to invest at home the capital that fled to safe havens, the poverty headcount would be 20 percentage points lower than the status quo in 2015. The same relative magnitude of extra progress would be recorded in Sierra Leone (30% headcount ratio with capital flight invested domestically compared to 50% under the status quo) (Nkurunziza, 2015).

Another channel of the development impact of capital flight is through the depletion of government revenue due to embezzlement of public funds and reduction of the tax base as private wealth is illicitly transferred out of the country. A reduction in government revenue and the subsequent decline in spending on public services worsen social development outcomes such as education and health. For example, Ndikumana and Boyce (2011) find that a reduction in public expenditure on health due to servicing debts that financed capital flight result in an increase in child mortality. The fiscal effects of capital flight are therefore an important channel of the development impact of capital flight in African countries.

### *Distributional effects of capital flight*

Capital flight has distributional effects at national level by increasing inequality in income and human development. It also worsens inequality between Africa and the rest of the world. On the one hand, the benefits arising from capital flight – accumulation of private wealth in safe havens – accrue to the political and economic elites of African countries. These are the individuals who have sufficient private wealth to smuggle abroad; they include public officials who have access

to state resources that they can embezzle and transfer abroad for safekeeping. They include the 'despots' that former German president Horst Köhler referred to as "the *terminally greedy*[10] who have no interest in putting an end to poverty and every interest in the state of their offshore bank accounts" (German Ministry of Education and Research, 2014, p. 28).[11] Capital flight therefore enables the African rich people to accumulate tax-free wealth, which deepens income inequality. On the other hand, by depleting public resources and stifling public service delivery, capital flight forces the middle class and the poor to incur higher direct costs for social services such as education and health care. Households are forced to pay more for public services or to resort to more expensive privately provided services. This phenomenon is self-perpetuating due to the perverse incentives that capital flight creates. On the one hand, the political elites who enact policies and manage public services do not suffer the costs of poor quality and shortages in these services. Indeed, few African government ministers send their sons and daughters to public schools in their countries. On the other hand, the poor and middle class who depend on public services have little power to influence policies. Thus, the misalignment of incentives, costs and benefits perpetuates the under-provision of public services resulting from capital flight.

Capital flight also has distributional effects through asymmetric impact of exchange rate depreciation on the poor and the rich. The wealth of rich Africans held in safe havens is shielded from negative effects of depreciation of the national currency, while the poor whose wealth is held in domestic assets bears the full costs of currency depreciation. This further deepens income inequality within African countries. Capital flight also deepens the income gaps between Africa and the rest of the world and therefore delays the catch up or convergence process.

In analyzing the distributional impact of capital flight, it is important to go beyond the income inequality yardstick that is commonly most used in the literature. At the national level, disparities with regard to access to social services and differences in terms of development outcome along vertical (by income) and horizontal (e.g., rural-urban) dimensions are pronounced and exacerbate social and political implications of inequalities along income lines. In fact, the data shows little correlation between measured income inequality and inequality in access to social services. Figure 1 depicts the rural to urban ratio of the percentage of the population with access to

[10] Emphasis added here.
[11] Also see Ndikumana and Boyce (2012).

improved sanitation facilities against the ratio of the income share of the tenth decile to the share of the first decile. The sample contains all developing countries with adequate data on these indicators. The figure shows no correlation between the two indicators. Instead, it shows that there is more inequality along access to sanitation (along the vertical axis) than along income (along the horizontal axis). The evidence implies that income inequality is an inadequate measure of inequities in social development. Moreover, at the global level, Africa does not seem to have more pronounced income inequality than other regions. The discussion in this section will therefore focus on disparities along social development indicators, illustrating with data on access to water and sanitation and health outcomes at national and global level (Africa vs. other regions). Horizontal inequalities are illustrated by comparing rural to urban areas.

The data systematically shows that African countries perform poorly along key indicators of access to social services (water and sanitation) and health outcomes. Table 2 presents the number of countries that feature among the 20 and 40 worst performers in the world along these development indicators. To provide some insights into the relationship between development outcomes and inequalities on the one hand and capital flight on the other, the table also provides the number of SSA worst performers in human development that are also among the top 15 countries in Africa in terms of capital flight using the ratio of cumulative capital flight to GDP in 2010. With regard to access to water and sanitation, SSA hosts 31 of the 40 worst performers in the world. Moreover, the sub-region counts the majority of the countries with the highest disparities between rural and urban areas in terms of access to water and sanitation. Using the rural to urban ratio of the percentage of the population with access to water and sanitation, 27 countries (water) and 25 countries (sanitation) out of the 40 countries with the highest inequality in the world are in SSA. Moreover, the majority of SSA countries listed among the worst performers in access to water and sanitation are also among the top 15 countries in Africa with the highest capital flight to GDP ratios.

The data on health outcomes shows similar patterns. SSA countries make up the majority of the worst performers in terms of life expectation, child mortality and maternal mortality. Furthermore, a majority of SSA countries at the bottom in terms of these human development dimensions also have high capital flight to GDP ratios. SSA countries also make up the majority of worst performers in public spending on health and coverage of health providers (physicians

per 1000 people). Once again, the worst performers in terms of spending on health care also feature prominently on the top of the list of countries with the highest capital flight to GDP ratios in Africa.

Table 3 provides further evidence on the inequalities in health outcomes from a comparative perspective. The table illustrates both vertical inequalities (by income) and horizontal inequalities (urban vs. rural). The data shows substantial variations across regions. SSA is the most unequal region on the horizontal dimension with regard to provision of health care as measured by the percentage of births attended by skilled health care practitioners. The percentage is nearly twice as high in urban areas (78.2%) than in rural areas (40%). SSA comes second after East Asian and Pacific for child malnutrition as measured by underweight prevalence among under-five children: 23.9% in rural areas compared to 14.8% in urban areas, a ratio of 1.6 compared to a ratio of 2 for East Asia and Pacific.

Vertical inequalities in health outcomes are also more pronounced than regional inequalities in SSA as in other regions. For the top 20 percent richest people in SSA, 83 percent of child births are attended by skilled health practitioners, compared to 27% for the poorest 20 percent of the population. Malnutrition affects 29 percent of under-five children among the poorest 20 percent of the population compared to only 11% for the top 20% richest people.

In addition to being one of the most unequal regions, and often the most unequal region in the world in terms of access to social services and in social development outcomes, SSA also faces an increasing gap relative to other regions in terms of progress in social development in general and health outcomes in particular. The region shoulders a disproportionately high share of the disease and death burdens relative to its size. While SSA hosts only 12 percent of world population, it accounts for half of child mortality, 90 percent of child deaths from malaria, and 71 percent of people living with HIV/AIDS (Table 4). The trend does not appear to be improving; instead, the gaps between Africa and the other regions seem to be widening.

Two important implications can be drawn from the data presented in this section. First, while Africa has made remarkable progress in social development in general and health in particular over the past two decades, these gains have not been equally distributed among the population.

In fact inequality in development outcomes may very well worsen even as national average performance improves. This may explain the slow overall decline in poverty and persistent deprivation in social development. Second, the gaps between Africa and other regions appear to be worsening as a result of both the relatively slower progress in Africa, especially in sub-Saharan Africa, and the relatively more unequal distribution of the gains from growth and human development among the population both vertically and horizontally. Third, SSA's weaker performance in human development is in major part due to inadequate funding for social services in general and health care in particular, resulting in under-provision of health infrastructure and qualified personnel.

In light of these development inequality outcomes, the observed high and accelerating outflows of unrecorded resources or capital flight from Africa raises serious concerns. The leakage of capital from the continent contributes to exacerbating the underfunding of the social service sector while also deepening vertical and horizontal inequalities. The analysis in this paper calls for further investigation of the development and equity implications of capital flight from African countries. It also highlights the need to go beyond income measures of inequality to consider inequalities along access to social services and human development outcomes both within and across countries. The analysis in the paper already suggests that such an expanded analysis demonstrates two things. First, while Africa is unequal from an income perspective, it is even more unequal in terms of development outcomes. Second the gaps between Africa and the other regions are more pronounced along social development outcomes than in terms of income.

## 5. Conclusion

The emerging evidence of large volumes of unrecorded capital flight from developed countries and accumulation of private wealth in secrecy jurisdictions has not only unveiled major flaws of the capitalist system, but it is slowly generating political support for addressing the underlying problems of tax evasion and corrupt practices in the corporate and banking sectors. This offers an opportunity to raise attention on the problem of capital flight from developing countries in general and from Africa in particular. The acceleration of capital flight from Africa over the past two decades challenges the conventional views of capital flight as a result of normal portfolio choice by savers seeking to protect their assets against losses due to economic and political

uncertainties. The evidence suggests that market forces alone will not cause a reversal of capital flight from the continent.

While substantial progress has been achieved in documenting the magnitude and determinants of capital flight from Africa, there is relatively little work on the implications of capital flight for economic development. The object of this paper was to initiate a shift towards conceptual and empirical investigation on the impact of capital flight on inequality in development. This is highly desirable and urgent in light of the fact that the continent continues to lag behind in terms of most development goals relative to other regions despite the recent growth surge. Moreover, as the data presented in this paper shows, Africa exhibits substantial inequalities both horizontally and vertically with regard to access to social services, and inequalities in terms of human development are even more pronounced than income inequalities. The discussion in this paper outlined conceptual arguments for both quantitative and distributional effects of capital flight on source economies. Specifically, by draining domestic resources, capital flight slows down growth and undermines the provision of social services. Moreover, as the gains from capital flight accrue to the rich and the political elites while the effects of the resulting shortage of social services fall disproportionately on the poor, capital flight is likely to worsen both income inequality and disparities in human development. This suggests that efforts to accelerate growth without dealing with these distributional effects of capital flight are likely to yield suboptimal results. This calls for concerted international efforts to curb capital flight from Africa. Given that capital flight is a global phenomenon that is driven by factors in source countries and pulled or facilitated by factors in destination countries, addressing it requires a global compact aimed at increasing transparency in banking and corporate transactions, automatic exchange of banking and tax information, and greater enforcement of accountability on the part of public and private actors, including banks in major financial centers and multinational corporations operating in Africa.

The analysis in this paper suggests potentially high value added from further knowledge generation focused in the areas of conceptualization and quantifying the impact of capital flight on social development and inequality. This will require increased availability of comparable data on estimates of capital flight and ‘missing private wealth’ from all regions as well as data on social development dimensions of inequality, i.e., inequality in development. Empirical evidence

on the linkages between capital flight and development inequality will provide valuable input into policies aimed at accelerating human development in Africa and it will stimulate efforts to mobilize global compact to address the problem of illicit financial flows.

## References


Action Aid. (2010). Calling time: Why SABMiller should stop dodging taxes in Africa. London: Action Aid.

AfDB and GFI. (2013). Illicit financial flows and the problem of net resource transfers from Africa: 1980-2009. Washington, DC and Tunis.

AfDB, UNECA, OECD and UNDP. (2014). *African Economic Outlook 2014: Global Value Chains and Africa's Industrialisation*. Paris: OECD.

Ajayi, S. I. (1997). An analysis of external debt and capital flight in the severely indebted low income countries in Sub-Saharan Africa. *IMF Working Paper WP/97/68*.

Ajayi, S. I. and Ndikumana, L. (Eds.). (2015). *Capital Flight from Africa: Causes, Effects and Policy Issues*. Oxford: Oxford University Press.

Boyce, J. K. and Ndikumana, L. (2001). Is Africa a Net Creditor? New Estimates of Capital Flight from Severely Indebted sub-Saharan African Countries, 1970–1996. *Journal of Development Studies*, 38 (2), 27-56.

Chang, K. P. H. and Cumby, R. E. (1991). Capital flight in sub-Saharan African countries. In I. Husain and J. Underwood (Eds.), *African external finance in the 1990s* (pp. 162–187). Washington, DC: World Bank.

Fofack, H. and Ndikumana, L. (2010). Capital flight repatriation: Investigation of its potential gains for Sub-Saharan African countries. *African Development Review*, 22 (1), 4-22.

Fosu, A. K. (2009). Inequality and the Impact of Growth on Poverty: Comparative Evidence for Sub-Saharan Africa. *Journal of Development Studies*, 45 (5).

Fosu, A. K. (2010). The Effect of Income Distribution on the Ability of Growth to Reduce Poverty: Evidence from Rural and Urban African Economies. *The American Journal of Economics and Sociology*, 69 (3), 1034-1053.

Fosu, A. K. (2015). Growth, Inequality and Poverty in Sub-Saharan Africa: Recent Progress in a Global Context. *Oxford Development Studies*, 43 (1), 44-59. doi: 10.1080/13600818.2014.964195

German Ministry of Education and Research. (2014). German-African Cooperation in Education and Research. BMBF Africa Days 16 – 18 March 2014. Berlin: BMBF, Division of Cooperation with Developing and Emerging Countries, Africa and the Middle East.

Henry, J. S. (2012). The price of offshore revisited. London: Tax Justice Network.

Hermes, N. and Lensink, R. (1992). The magnitude and determinants of capital flight: The case for six sub-Saharan African countries. *De Economist*, 140 (4), 515-530.

Johannesen, N. and Zucman, G. (2014). The end of bank secrecy? An evaluation of the G20 Tax Haven Crackdown. *American Economic Journal: Economic Policy*, 6 (1), 65-91.

Kahn, B. (1991). *Capital flight and exchange controls in South Africa*. London School of Economics: Centre for the Study of the South African Economy and International Finance.

Kalwij, A. and Verschoor, A. (2007). Not by growth alone: The role of the distribution of income in regional diversity in poverty reduction. *European Economic Review*, 51 (4), 805-829.

Kar, D. and Cartwright-Smith, D. (2010). Illicit financial flows from Africa: Hidden resource for development. Washington DC: Global Financial Integrity

Ndikumana, L. (2013). The private sector as culprit and victim of corruption in Africa. Amherst, MA: Political Economy Research Institute, PERI Working Paper 330.

Ndikumana, L. (2014a). Fuite des capitaux et paradis fiscaux : impact sur l'investissement et la croissance en Afrique. *Revue d'économie du développement*, 2014/2.

Ndikumana, L. (2014b). International Tax Cooperation and Implications of Globalization *CDP Background Paper No. 24* (Vol. CDP Background Paper No. 24 ST/ESA/2014/CDP/24.). New York: UNDESA.

Ndikumana, L. and Boyce, J. K. (2011). *Africa's Odious Debts: How Foreign Loans and Capital Flight Bled a Continent*. London: Zed Books.

Ndikumana, L. and Boyce, J. K. (2012). Rich Presidents of Poor Nations: Capital Flight from Resource-Rich Countries in Africa. *ACAS Bulletin*, 87, 2-7.

Ndikumana, L., Boyce, J. K. and Ndiaye, A. S. (2015). Capital flight from Africa: Measurement and drivers. In S. I. Ajayi and L. Ndikumana (Eds.), *Capital Flight from Africa: Causes, Effects and Policy Issues* (pp. 15-54). Oxford: Oxford University Press.

Nkurunziza, J. D. (2012). Illicit Financial Flows: A Constraint on Poverty Reduction in Africa. *ACAS Bulletin*, 87.

Nkurunziza, J. D. (2015). Capital flight and poverty reduction in Africa. In I. Ajayi and L. Ndikumana (Eds.), *Capital Flight from Africa: Causes, Effects and Policy Issues* (pp. 81-110). Oxford, UK: Oxford University Press.

Palan, R. (2002). Tax havens and the commercialization of state sovereignty. *International Organization*, 56 (1), 151-176.

Palan, R., Murphy, R. and Chavagneux, C. (2010). Tax Havens: How Globalization Really Works. from http://oclc-marc.ebrary.com/id/10663132

Piketty, T. and Goldhammer, A. (2014). *Capital in the twenty-first century*.

Ravallion, M. (1997). Can high-inequality developing countries escape absolute poverty? *Economics Letters Economics Letters*, 56 (1), 51-57.

Sharife, K. (2011). Transparency' hides Zambia's lost billions. 18 Jun 20, 2011. *Al Jezeera.Net, June 18.*

Thorbecke, E. (2013). The interrelationship linking growth, Inequality and poverty in Sub-Saharan Africa. *J. Afr. Econ. Journal of African Economies*, 22 (SUPPL. 1), i15-24.

UNECA. (2013). *Economic Report on Africa 2013: Making the Most of Africa's Commodities: Industrializing for Growth, Jobs, and Economic Transformation*. Addis Ababa, Ethiopia: UNECA.

UNICEF. (2014). *State of the World Children 2014*. New York: UNICEF.

Zucman, G. (2013). The missing wealth of nations: Are Europe and the US net debtors or net creditors? *The Quarterly Journal of Economics*, 128 (3), 1321-1361.

Zucman, G. (2014). Taxing across borders: Tracking personal wealth and corporate profits. *Journal of Economic Perspectives*, 28 (4), 121-148.

**Table 1: Capital flight from Africa, 1970-2010 (billion, constant 2010 $)**

| Decade | FDI | ODA | Capital flight | | |
|---|---|---|---|---|---|
| | | | Total | Oil-rich countries | Non-oil countries |
| 1970-1979 | 29.8 | 128.0 | 225.2 | 152.2 | 73 |
| 1980-1989 | 39.1 | 182.8 | 307.4 | 218.1 | 89.3 |
| 1990-1999 | 73.9 | 246.5 | 230.3 | 117.6 | 112.7 |
| 2000-2010 | 316.3 | 317.5 | 510.9 | 423.3 | 87.6 |
| Cumulative | 459.1 | 874.8 | 1273.8 | 911.2 | 362.6 |

Source: www.peri.umass.edu

## Table 2: Development outcomes and capital flight: Ranking of SSA countries – bottom/top 40 in the world

| Indicator | Number and % of SSA countries among 20 worst performers | Number and % of SSA countries among 40 worst performers | Number of SSA countries among 40 worst performers that are also in top 15 highest capital flight (% of GDP) for SSA |
|---|---|---|---|
| Life expectancy (WDI) | 20 (100%) | 39 (97.5%) | 10: Sierra Leone, Burundi, Congo Dem. Rep., Côte d'Ivoire, Mozambique, Guinea-Bissau, Nigeria, Central African Republic, Zimbabwe, Congo Rep. |
| Under-5 mortality Rate (WDI) | 19 (95%) | 35 (87.5%) | 9: Sierra Leone, Congo Dem. Rep., Côte d'Ivoire, Zimbabwe, Guinea-Bissau, Nigeria, Central African Republic, Burundi, Mozambique |
| Maternal mortality (IHME) | 18 (90%) | 36 (90%) | 13: Central African Republic, Sierra Leone, Côte d'Ivoire, Congo, Guinea-Bissau, Zimbabwe, Congo Rep., Nigeria, Mozambique, Burundi, Congo Dem. Rep., Gabon, Rwanda |
| Physicians per 1,000 people (WDI) | 19 (95%) | 35 (87.5%) | 10: Sierra Leone, Burundi, Mozambique, Guinea-Bissau, Rwanda, Central African Republic, Zimbabwe, Congo Rep., Congo Dem. Rep., Côte d'Ivoire |
| Access to improved water sources (WDI) | 16 (80%) | 31 (77.5%) | 9: Congo Dem Rep., Mozambique, Sierra Leone, Nigeria, Rwanda, Guinea-Bissau, Burundi, Congo Rep., Zimbabwe |
| Access to improved sanitation (WDI) | 19 (95%) | 31 (77.5%) | 11: Sierra Leone, Congo Rep., Guinea-Bissau, Mozambique, Central African Republic, Côte d'Ivoire, Nigeria, Congo Dem. Rep., Sao Tome and Principe, Zimbabwe, Gabon |
| Rural/urban ratio for access to improved water sources (WDI) | 17 (85%) | 27 (67.5%) | 10: Congo Dem. Rep., Congo Rep., Mozambique, Sierra Leone, Guinea-Bissau, Central African Republic, Nigeria, Gabon, Zimbabwe, Côte d'Ivoire |
| Rural/urban ratio for access to improved sanitation (WDI) | 18 (90%) | 25 (62.5%) | 7: Central African Republic, Angola, Mozambique, Guinea-Bissau, Congo Rep., Sierra Leone, Côte d'Ivoire |
| Total health expenditure (WDI) | 17 (85%) | 28 (70%) | 6: Congo Dem. Rep., Central African Republic, Burundi, Guinea-Bissau, Mozambique, Rwanda |
| Public health expenditure (WDI) | 13 (65%) | 29 (72.5%) | 8: Guinea-Bissau, Congo Dem. Rep., Central African Republic, Burundi, Sierra Leone, Mozambique, Côte d'Ivoire, Nigeria |
| Public education expenditure (WDI) | 17 (85%) | 27 (67.5%) | 7: Central African Republic, Congo Dem. Rep., Burundi, Zimbabwe, Sierra Leone, Mozambique, Rwanda |

Sources: World Bank, *World Development Indicators* (online database: http://databank.worldbank.org/data/home.aspx)*;* Institute for Health Metrics and Evaluation (IHME) (online database: http://www.healthdata.org/).

## Table 3: Selected indicators from State of the World Children 2014

| | Skilled attendant at birth (%), 2008-12 | | | Underweight prevalence in children under 5 (%), 2008-12 | | | Skilled attendant at birth (%), 2008-12 | | | Underweight prevalence in children under 5 (%), 2008-12 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Urban | Rural | Urban/Rural | Urban | Rural | Rural/Urban | poorest 20% | richest 20% | ratio of richest to poorest | poorest 20% | richest 20% | ratio of poorest to richest |
| Sub-Saharan Africa | 78.2 | 40.0 | 2.0 | 14.8 | 23.9 | 1.6 | 27.0 | 83.2 | 3.1 | 29 | 11 | 2.6 |
| Middle East and North Africa | 89.1 | 62.8 | 1.4 | – | – | – | – | – | – | – | – | – |
| South Asia | 72.3 | 39.7 | 1.8 | 31.2 | 43.0 | 1.4 | 21.8 | 82.4 | 3.8 | 56 | 20 | 2.8 |
| East Asia and Pacific | 96.3 | 88.1 | 1.1 | 5.1 | 10.0 | 2.0 | 50.0 | 96.0 | 1.9 | 24 | 10 | 2.5 |
| Latin America and the Caribbean | 96.0 | 76.0 | 1.3 | – | – | – | – | – | – | – | – | – |
| Least developed countries | 75.5 | 38.5 | 2.0 | 17.5 | 26.7 | 1.5 | 29.1 | 77.9 | 2.7 | 32 | 14 | 2.3 |
| World | 87.0 | 54.1 | 1.6 | 14.3 | 27.1 | 1.9 | 32.0 | 86.0 | 2.7 | 37 | 14 | 2.7 |

Source: UNICEF (2014) (available online).

**Table 4: Sub-Saharan Africa's share of world disease and death burden**

| Indicator | Number | % of world |
|---|---|---|
| Population | 831.5 million | 12 |
| Under-5 child deaths per year | 3.2 million | 50 |
| People living with HIV/AIDS | 25.1 million | 71 |
| Child deaths from malaria per year | 594000 | 90 |

Sources: Population: United Nations Population Statistics Division (online); UNICEF (2014); UNICEF, Stylized facts on malaria: http://www.unicef.org/health/index_malaria.html.