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# Public Debts and Private Assets: Explaining Capital Flight from Sub-Saharan African Countries

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**Summary.** — We investigate the determinants of capital flight from 30 sub-Saharan African countries, including 24 countries classified as severely indebted low-income countries, for 1970–96. The econometric analysis reveals that external borrowing is positively and significantly related to capital flight, suggesting that to a large extent capital flight is debt-fueled. We estimate that for every dollar of external borrowing in the region, roughly 80 cents flowed back as capital flight in the same year. Capital flight also exhibits a high degree of persistence in the sense that past capital flight is correlated with current and future capital flight. The growth rate differential between the African country and its OECD trading partners is negatively related to capital flight. We also explore the effects of several other factors—inflation, fiscal policy indicators, the interest rate differential, exchange rate appreciation, financial development, and indicators of the political environment and governance. We discuss the implications of the results for debt relief and for policies aimed at preventing capital flight and attracting private capital held abroad.


*JEL classification:* F34, O16, O55
*Key words* — capital flight, debt, sub-Saharan Africa, debt relief, capital control

Africa is suffering from multiple crises... Billions of dollars of public funds continue to be stashed away by some African leaders, even while roads are crumbling, health systems have failed, school-children have neither books nor desks nor teachers, and the phones do not work. (United Nations Secretary-General Kofi Annan, 2000).

## 1. INTRODUCTION

The high level of external indebtedness is both a symptom and a cause of the poor economic performance in sub-Saharan African (SSA) countries in recent decades. In the 1990s, average debt service payments amounted to roughly 6.5% of national income in the 30 SSA countries discussed in this study. At the same time, these countries have experienced massive private outflows of funds, a phenomenon often described as "capital flight." [1] Recent estimates show that the region is a "net creditor" to the rest of the world in the sense that private assets held abroad as measured by accumulated capital flight exceed total liabilities as measured by the stock of debt (Boyce & Ndikumana, 2001). The existing evidence also indicates that compared to other developing regions, SSA has a larger share of private wealth held abroad (Collier, Hoeffler, & Pattillo, 2001). For these reasons, it is important to examine the causes of capital flight from the region.

This study investigates the determinants of capital flight from 30 SSA countries for 1970–96. For this purpose, we use estimates of capital flight reported by Boyce and Ndikumana (2001) for 24 countries that are classified as severely indebted low-income countries (SILICs), plus comparable estimates for six other SSA countries. [2] The estimates of capital flight are obtained using a modified version of the "residual" method, which is based on the

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difference between inflows of foreign exchange and the recorded uses of foreign exchange. Our econometric results indicate that foreign borrowing is positively and significantly related to capital flight, and that to a substantial extent capital flight is debt-fueled. Capital flight also exhibits a high degree of persistence, in that past capital flight is correlated with current and future capital flight. The growth rate differential between the African country and its OECD trading partners is negatively related to capital flight, as is an index of voice and accountability.

These results have important implications for debt relief and for policies aimed at addressing the problem of capital flight from African countries. The use of foreign borrowing to finance the accumulation of private external assets raises questions as to the legal and moral legitimacy of the external debt—that is, its treatment as a public obligation as opposed to a private liability. Debt relief will bring sustainable benefits to African people only if it is accompanied by strategies designed to prevent a new cycle of external borrowing and capital flight in the post-relief period. These strategies must involve enforcing responsible lending practices on the part of creditors and transparent and accountable debt management on the part of African governments. At the same time, the success of African countries in preventing further capital flight and in attracting private capital held abroad will depend on their success in implementing policies that promote economic growth and a stable macroeconomic environment.

## 2. LITERATURE REVIEW

### (a) *Capital flight from indebted countries: a paradox?*

Developing countries have experienced simultaneously high levels of external borrowing and massive outflows of private capital. This phenomenon has been particularly notable in SSA. Recent estimates indicate that compared to other regions, Africa has a larger proportion of private wealth held abroad (Collier *et al.*, 2001). At the same time, this region includes the largest number of countries defined by the World Bank as "severely indebted low-income countries" (SILICs). [3] Estimates by Boyce and Ndikumana (2001) for 1970–96 reveal that this group of countries is a "net creditor" to the rest of the world in the sense that accumulated capital flight exceeds the stock of external debt. This poses the question of why countries borrow heavily at the same time that capital is fleeing abroad.

From a theoretical point of view, capital movements can be attributed to portfolio choice decisions by individual investors guided by profit maximization based on risk-adjusted returns to capital. In a world of complete information and negligible transactions costs, the rates of return to capital would be expected to equalize across countries and markets, so that agents are indifferent between investing domestically and investing abroad. In such a world, evidence of systematic capital outflows would imply that returns to capital are systematically higher abroad than at home. Following the logic of diminishing returns, the rate of return to capital should be higher in capital-scarce developing countries than in richer countries, and capital should flow from the latter towards the former. If investment is riskier in developing countries, the net risk-adjusted returns may be lower, and this could explain why capital continues to flow in the opposite direction. But if the risky environment discourages domestic investment, it might be expected to discourage investment by foreigners as well. The question, as Pastor (1990, p. 7) puts it, is "if the investment climate in a country is negative enough to push out local capital, why would savvy international bankers extend their own capital in the form of loans?"

The literature on capital flight has offered a range of explanations for this apparent paradox in international capital movements. One set of explanations focuses on asymmetric risks of expropriation of domestic and foreign assets (Cuddington, 1986; Khan & Ul Haque, 1985). Domestic agents are assumed to face a risk of government expropriation of their assets, while foreign capital is guaranteed against this risk by the debtor government and/or by international institutions. Risk asymmetry could also arise from differential tax treatment of domestic and foreign assets. In such a context, private agents maximize portfolio gains by investing abroad, even as foreign lenders find it profitable to issue loans, so that capital flight and foreign borrowing occur simultaneously. Alesina and Tabellini (1989) add political economy considerations to this explanation, suggesting that the incumbent government is happy to accumulate foreign debt since it does not internalize the