

WHO FINANCES WHOM?

THE CONTROVERSIAL ROLE OF EXTERNAL FINANCIAL RESOURCES IN AFRICA

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Abstract

In contrast to the highly developed countries and some developing regions, Africa highly depends on external resources of financing development. According to the saving-investment gap concept, there is a significant gap between savings and investment rates. As domestic resources are limited and their mobilization is slow, the region should rely on external sources of finance (i.e., aid, export revenues, FDI, loans, and remittances) in order to close the finance gap. Despite the massive inflow of external resources, the 200 billion USD yearly financing gap still prevails. The outflow of financial resources from Africa in the form of profit repatriations, debt service, tax dodging, capital flight and illicit financial flow exceeds the inflow, suggesting that Africa is a bottomless barrel. The long-standing concept about the saving-investment gap does not provide a full explanation for the prevailing financing gap. The main research questions are as follows: (a) Why is there a permanent financing gap in Africa? b) Why does the outflow of financial resources exceed the inflow? c) What should be done to close the financing gap and solve the problem of financing development?

The paper is structured as follows: Section 1 is based on the saving-investment-gap concept and explores the validity of this theory in Sub-Saharan Africa. The conclusion of Section 1 is that there is a permanent finance gap in SSA, consequently, the region should rely on external sources of finance. Section 2 introduces the main external sources of finance (aid, FDI and remittances) and reveals the major trends and characteristics of these flows. As the saving-investment gap is smaller than the amount of external financial inflow, two questions arise: Where does the money go? Is Africa suffering from a financial haemorrhage? Section 3 tries to identify those “leaks” which drain Africa’s accumulated domestic and external resources by analysing the main channels of financial outflows such as capital flight and illicit financial flows. In the conclusion we present the financing situation of Africa and answer the question “Who finances whom?” and make recommendations for enhancing development finance. The final conclusion is that not the external world finances Africa, but Africa finances the world. The issue of financing Africa’s development cannot be solved without (a) mobilizing domestic resources (including domestic savings), (b) attracting external resources as well as improving the use and avoiding the misuse of inflowing financial resources, and (c) curbing capital flight and tackling illicit financial outflow.

Keywords

saving-investment gap, aid, FDI, remittances, capital flight, illicit financial flow, financial haemorrhage

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Introduction

Africa should invest 200 billion USD annually¹ in order to achieve the Sustainable Development Goals by 2030, sustain high economic growth, enhance socio-economic development, and decrease poverty (African Economic Outlook, 2020). As domestic resources are limited due to high saving-investment gap and low savings, the continent should rely on external sources of finance. Unfortunately, even the combination of domestic and external resources is not sufficient to meet the financial needs as a significant part of the available resources are flowing out of the African countries legally (e.g., profit repatriation), illicitly (e.g., capital flight or tax evasion), or illegally (e.g., smuggling, trafficking).

The main research questions are as follows: (a) Why is there a permanent financing gap in Africa despite the massive inflow of external financial resources? (Is Africa a bottomless barrel?) b) Why is the inflow of external financial resources exceeded by the outflow? (Is that barrel leaking?) c) Who is financing whom: is the world financing Africa or is Africa financing the world? (d) What should be done to close the saving-investment gap and solve the problem of financing development? Searching for answers, the paper is structured as follows: Section 1 is based on the saving-investment-gap concept and explores the validity of this theory in Sub-Saharan Africa. The conclusion of Section 1 is that there is a permanent finance gap in SSA that cannot be filled by increasing savings only. Consequently, the region should rely on external sources of finance. Section 2 introduces the main external sources of finance related to aid, FDI and remittances. It reveals the major trends and characteristics of these flows with special regard to their implications, including their impact on savings. As the saving-investment gap is smaller than the amount of external financial inflow, two questions arise: Where does the money go? Is Africa suffering from a financial haemorrhage? Section 3 looks at the other side of the balance sheet and tries to identify those “leaks” which drain Africa’s accumulated domestic and external resources by analysing the main channels of financial outflows such as capital flight and illicit financial flows. In the conclusion we present the financing situation of Africa and answer the question “Who finances whom?” and make recommendations for enhancing development finance.

The paper applies an exploratory mixed methods research approach where hypotheses are empirically tested by quantitative statistical data and relevant empirical and analytical literature. Data and our analysis mainly relate to the 45 countries in Sub-Saharan Africa, if it is not indicated otherwise. Due to length limit, there is no separate literature review, though the individual sections are based on the most relevant and up-to-date theoretical and empirical academic sources. Data have been collected mainly from the database of international organizations such as the IMF, the World Bank, OECD, UNCTAD, the UN Economic Commission for Africa, the African Union, and the African Development Bank. While the availability of data is not a constraint with some exceptions, their reliability and coherence are a big challenge for measuring the different phenomena.

The Savings-Investment Gap: Theory and Reality?

According to the endogenous growth model (Domar, 1946; Harrod, 1939), the ability to save capital is a prerequisite for economic growth as it is a source of capital accumulation and investment. Consequently, growth depends on the propensity to save. The neoclassical growth theories developed in the 1950s and 1960s (Solow, 1956) state that higher savings lead to higher levels of capital stock, and higher investments lead to higher rates of growth temporarily in the short run. The post-neoclassical endogenous growth theory of the 1980s (Lucas, 1988; Rebelo, 1999; Romer, 1986/1987; Singh, 2006) postulates that savings and investments (combined with technological progress and human capital) lead to short-term and long-term economic growth (Taye, 1999): higher saving means higher capital investment, which leads to growth and fosters income.

There is a debate in the literature about the causal relationship between saving and economic growth (Elbadawani & Mwege, 1998), and about the direction of this causal link: do savings lead to growth or does growth lead to savings? Some authors (Houthakker 1961, 1965; Modigliani 1970 cited by Aghion et al. 2006; Aytül and Yalcin, 2015; Carroll and Weil, 1993 cited by Elbadawani and Mwege, 1998; Gocer et al., 2016) found a strong positive correlation between savings and growth.

According to Aghion et al. (2006), domestic savings through attracting FDI, increasing equipment import. and enhancing innovation promotes economic growth in a world of capital mobility because private saving functions as collateral (co-financer) for investment projects. Their findings are based on a model with 118 countries between 1960-2000. In contrast Carroll, Overland and Weil (2000) (cited by Aghion et al., 2006) found that higher growth leads to decreasing savings due to the changing pattern of consumption. Singh (2009) examines the long-term impact of savings on income and finds a bidirectional causality between saving and growth in India. Singh (2009) concludes that domestic savings should be accelerated in order to finance capital accumulation and foster higher income and growth. AbuAl-Foul (2010) examines the causal relation between real GDP and real Gross Domestic Saving in Morocco (1965-2007) and Tunisia (1961-2007). According to his empirical results, there is bidirectional causality between economic growth and savings growth in Morocco, while in Tunisia there is unidirectional causality running from savings growth to economic growth.

The conclusion is that there is no growth without savings and investments². Additionally, higher saving rates and a smaller saving-investment gap mean higher growth rates³ leading to higher income which might generate further savings apart from increasing consumption and/or investment. Therefore, it is safe to say that there is a bidirectional relationship between savings and economic growth, as growth is unsustainable without appropriate domestic savings (Elbadawani & Mwege, 1998). However, empirical and anecdotal evidence is rather mixed. In the case of the Newly Industrialized Countries, savings played a significant role in achieving high economic growth. Africa reached high economic growth that was called a “growth miracle” (Rodrik, 2016) after 2010⁴ without any association with higher saving

rates. Such external and internal factors boosted economic growth with increasing world demand for raw materials fuelled by high growth in China, increasing commodity prices, growing FDI inflow, Africa's increasing openness and integration into the world economy, and a decreasing debt burden (Kiss, 2017a).

The conclusion is that there is no growth without savings and investments.

Savings are determined by macroeconomic factors (e.g., economic, financial and fiscal policies, revenue policy, public expenditure policies, budget policy, income redistribution, pension reform, degree of government saving; the socio-economic environment, including economic incentives, financial infrastructure, access to financial markets, activity of financial intermediaries) and microeconomic factors (e.g., income level, family structure, type of asset portfolio, behaviour at personal and household level, rate of return). Decision made by individuals and households are the main determinants of national savings (Taye, 1999). The main motives of savings are related to the following factors: uncertainty of labour and capital income; being prone to weather shock in agriculture and economic uncertainties (e.g., inflation) saving for education, buying assets, and sustaining living standard; being prepared for unemployment, old age, and sickness.

In Africa there is a permanent and large gap between saving and investment rates, fluctuating around 3% of the GDP⁵. The saving rate is rather low – around or below 20% – while the investment rate is 22-23%⁶ (see Table 1). These rates are in stark contrast to developing countries in Asia where the saving rates are around 40% and the investment rates a bit below 40% in the same period of time (IMF World Economic Outlook, 2021). These high rates and small gap contributed to high growth rates. As a result of the low saving rates in Africa, the self-financing ratio⁷ (see Table 1) in general is below 90%, and in some years below 85%. This means that 10-15% of investments could not be financed by domestic sources. According to the research findings of Aizenman et al. (2007) and Aytül and Yalcin (2015)⁸, countries with high SFR managed to grow faster than countries with low SFR. SFR is generally higher in oil and mineral rich countries, while resource scarce countries are characterized by low SFR, which implies a lower growth rate.

Table 1. The saving-investment gap in Sub-Saharan Africa (1980-2026)

	Saving (% of GDP)	Investment (% of GDP)	S-I Gap (% of GDP)	Self-financing ratio (SFR = S/I) (%)
1980-1989 averages	20.0	20.8	-0.8	96.2
1990-1999 averages	15.5	17.6	-2.1	88.1
2000-2012 averages	16.3	19.4	-3.1	84.0
2007-2014 averages	20.9	22.3	-1.4	93.7
2015	17.6	23.0	-5.4	76.5
2016	18.5	21.8	-3.3	84.8
2017	18.9	21.2	-2.3	89.1
2018	19.4	21.9	-2.5	88.6
2019	19.8	23.6	-3.8	83.9
2020	18.4	22.1	-3.7	83.3
2021 (projection)	18.6	21.2	-2.6	87.7
2022 (projection)	19.2	22.9	-3.7	83.8
2023-2026 (projection)	20.6	23.6	-3.0	87.3

Source: author's own compilation and calculation based on Ndikumana (2015) between 1980-2012 and on data from the IMF and the World Economic Outlook (2021)

The main issue is to determine why the volume of African savings is small and the saving rates are low. One of the explanations is that per capita GDP and incomes are low, with not too much capital left for saving. However, there is a positive relation between per capita GDP growth and savings. Households are poor with uncertain income flow as the dominant activity is still agriculture⁹ with volatile output, unpredictable income, and limited monetary income from subsistence farming. The propensity to save is low among the poor due to lack of confidence in the future. The bulk of savings in Africa is household savings with a significant amount from non-financial assets (e.g., livestock like cattle and goods for trading, such as grain and farm inputs), which cannot be easily translated into investment.

The other explanation is the age structure of the African population with a high dependency ratio¹⁰. It is evident from the literature (Taye, 1999) that individuals are able to save during the productive ages (15-64 years). Individuals in the working population are savers, but retirees struggle with saving money. Consequently, there is a negative relation between the dependency ratio and savings. The same holds true for urbanization as precautionary savings related to agriculture is reduced (Elbadawi & Mwega, 1998). One of the main motives of the African migrant labour system targeting urban areas is saving for the other members of the family left in the rural areas.

An additional explanation is embedded in the institutional set-up. This includes the lack of or poor financial infrastructure, especially in the rural areas, as well as

the scarcity of formal financial intermediaries (Adon and Elbahnasawy, 2014), the low rate of household access to basic financial products, the lack of collateral, the costs of financial transactions, and the lack of trust in the banking system. However, there are some microfinance arrangements and well-functioning informal financial intermediaries such as the *Susu* in Ghana, the *Ton Ton* in Sierra Leone, the *Iddir* in the Horn of Africa, the *Esusu* in Western Africa, and the *opatu* in Tanzania that are part of Chagga or Islamic banking (Sawani and Patterson, 2009). It is hoped that financial inclusion will increase significantly due to the increasing internet penetration and the use of mobile banking devices, as is happening in Kenya and Nigeria. Recently in Africa only 39.3% of the population uses internet; however, every day there are 90,000 new internet users (Regional Economic Outlook, 2021).

In order to close the S-I gap and bolster economic growth, domestic savings in both private (household, corporate) and public settings should be encouraged via incentive-based and productivity-based strategies. The former means inducing the motivation to save through offering direct and indirect economic incentives (e.g., attractive interest rates, subsidies for savings, provision of tax incentives on investment incomes to raise net return, and creation of conducive and stable macroeconomic environment). The productivity-based strategy refers to increasing income and strengthening the capacity to save.

Accelerated domestic savings mean higher income and growth, which could generate virtuous circles of high savings and growth. The next step is to translate the increased domestic savings into domestic investment that requires a stable economic environment and a conducive business climate (i.e., access to credit facilities, incentive tax policy, and attractive profitability). Otherwise, domestic savings remain idle or vanish through different channels (see Section 3).

External Sources of Financing Development: Aid, FDI and Remittances

As the “savings catch up” is a long process and Africa’s self-financing capacity is constrained, the region should search for alternative external sources of finance. In contrast to the neoclassical growth model stipulating that foreign savings are a perfect substitute for domestic savings, we agree with Adon and Elbahnasawy (2014) and Aytül and Yalcin (2015) that domestic savings cannot be substituted by foreign savings. However, they could function as a supplement, especially in the context of globalisation. The main advantage of domestic savings over foreign savings is that (a) they are less subject to external factors (the donors’ aid policy) and less vulnerable to external shocks (economic and financial crises); (b) they have more positive implications (multiplier and spill over effects) on the domestic society and economy¹¹; and (c) they are not accompanied or followed by resource outflow (profit repatriation in the case of FDI inflow). Furthermore, foreign inflows are generally short-term and may lead to indebtedness (Gocer et al., 2016). However, the different types of external resources, while contributing to financial asset diversification, are not the same in connection with closing the saving-investment gap. While remittances might contribute to domestic savings directly, the same cannot be said for foreign aid; while

FDI inflow increases domestic investments, it results in resource outflow in the form of profit repatriation.

Keeping in mind the wide portfolio of external sources of finance, this chapter will concentrate on the external resources that might contribute to closing the saving-investment gap by increasing savings or financing investment, which might strengthen the self-financing capacity of the countries. In this regard the most relevant external resources are (a) aid such as Official Development Assistance and other official aid; (b) Foreign Direct Investment (FDI) inflow; and (c) personal remittances. There are additional resources such as portfolio investment and loans which do play a role in financing countries in Africa; however, their impact is not apparent or measurable.

Table 2. Aid, FDI and remittances inflow to Sub-Saharan Africa

	Net aid (bn constant 2018 USD)	Net aid (% of GDP)	FDI net inflows (bn current USD)	FDI net inflows (% of GDP)	Remittances (bn current USD)	Remittances (% of GDP)	Total aid + FDI + Rem. in % of GDP
1960	5.54	2.38
1970	7.71	2.05	0.829	1.34	22.66
1980	17.53	3.14	0.255	0.07	1.40	0.60	3.81
1990	26.56	5.69	1.162	0.28	2.36	0.79	6.76
2000	19.39	3.42	6.875	1.74	4.80	1.38	5.94
2005	36.76	4.48	16.435	1.81	20.12	1.33	7.62
2010	44.35	3.34	32.909	3.40	31.66	2.29	9.03
2011	44.83	3.20	42.039	2.73	37.06	2.39	8.32
2012	45.38	2.99	45.549	2.80	37.23	2.29	8.08
2013	45.72	2.87	40.691	2.34	37.55	2.16	7.37
2014	44.28	2.66	44.275	2.45	39.68	2.20	7.31
2015	47.02	2.78	44.342	2.68	42.19	2.56	8.02
2016	46.95	2.95	30.788	2.01	38.62	2.45	7.41
2017	51.61	3.12	27.581	1.69	42.33	2.57	7.38
2018	50.48	3.04	30.948	1.80	48.82	2.80	7.64
2019	56.29	3.22	31.378	1.80	48.77	2.79	7.81

Source: own compilation and calculation based on World Bank data (data.worldbank.org)

Aid

Official Development Assistance (ODA) and other types of official aid play an outstanding role in Africa’s development finance. In this regard, Africa is overrepresented because in 2019 around 32.4% of the total ODA entered into Africa and 27.2% into SSA, while Sub-Saharan Africa’s share in world GDP was only 3.1% with

13.7% of the world's population living there. Aid flow increased significantly during the last half century, from 5.5 billion USD in 1960 and 7.7 billion USD in 1970 to 56.29 billion USD in 2019 (see Table 2), which was more than a 10-times gain. Its contribution to Africa's development fluctuated around 3% of the region's GDP, with 3.2% according to the latest data for 2019¹², which is a little bit lower than the saving-investment gap in the same year.

In the aid literature (Quartey et al., 2015), there is an intense debate about the role of aid in the socio-economic development of the recipients in regard to aid efficiency and the impact of aid. The issue is especially relevant in Africa where aid is the most important financial inflow: African citizens each receive 50 USD of aid annually. The region highly depends on the yearly aid inflow while Africa is exposed to the donors' aid policies, financial situation, bilateral political relations, and willingness to meet international obligations. Dependence on aid from traditional donors (e.g., the USA, France, UK, Germany, and Japan) is somewhat being minimized by the emergence of new, non-DAC donors such as the BRICS (Brazil, Russia, India, China and South Africa) and Arab countries. However, China's robust presence might lead to further financial dependencies due to increasing indebtedness of the recipients. (In the case of China, aid is combined with concessional loans, export credits, capital export and bank loans.)

There are some main points in aid literature concerning the impact of aid on economic growth and development (Addison et al., 2015; Nkusu & Nanivatzu, 2015; Quartey et al., 2015). According to optimists and the Harrod-Domar growth theory, there is a positive correlation between aid and economic growth because aid inflow might decrease the savings-investment gap if aid is invested. According to Arndt et al. (2011/2013), development aid amounting to 10% of the recipient's GDP might increase per capita GDP by 1% if aid is invested into physical infrastructure and health. Addison et al. (2015) also emphasized the importance of investing into infrastructure to enhance Africa's structural transformation, export growth, and integration into the world economy.

According to pessimistic views (Moyo, 2009), aid inflow does not necessarily lead to economic growth, especially in countries with high aid dependency (i.e., aid/GDP is between 10-15%) due to their low absorption capacity that hinders efficient aid utilization. Some theoreticians (Rajan & Subramanian, 2008/2011) highlight that project level results cannot be easily translated into macroeconomic improvement and warn of the danger of the Dutch disease in the event of massive aid inflow.

The relationship between aid and domestic savings is unclear. The original idea behind providing concessional loans and aid was to augment domestic savings (Taye, 1999). However, aid was used to smooth out consumption instead of investment, and foreign aid became more important than domestic savings instead of complementing it. Elbadawi and Mwega (1998) found a one-for-one offset relationship between foreign aid and savings, meaning that a 1% increase in foreign aid led to a 1% decrease in domestic savings as additional aid was mainly spent on consumption.

Though the debate about the relation between aid and saving as well as between aid and economic growth is still on, the impact of aid depends on the following: (a) the type and modalities of aid, including grants, concessional loans, project aid, tied aid, debt relief, technical assistance, direct budget support, aid in kind (food aid), and humanitarian assistance; (b) the conditions of aid, whether any condition is attached, or it is unconditional with the danger of being abused and misused; (c) the sectoral distribution of aid, whether it is directed to productive sectors (agriculture, manufacturing, services), to government or civil sectors, or to physical or social infrastructure (health, education, sanitation, water and energy supply) (Kiss, 2017b).

Foreign Direct Investment

According to the literature on the theory and practice of FDI (Anyanwu, 2015; Kiss, 2017b; Nkusu & Naniwazo, 2015), foreign direct investment could play a significant role in Africa's economic growth, structural transformation, diversification, and financing development through job creation, technology and knowledge transfer, increasing export and tax revenues, supplementing domestic savings, and promoting Africa's integration into the world economy. However, African countries have rarely taken advantage of these opportunities. Up until the turn of the century, the amount of FDI inflow was marginal. After 2000, FDI inflow accelerated and by 2010 it reached 33 billion USD with the highest amount hitting 45.5 billion USD in 2012 (see Table 2). Since this time, the yearly inflow has fluctuated. Despite the spectacular growth, Africa still plays a marginal role in the world's investment flow. In 1990, only 0.56% of the world's capital export was directed to Sub-Saharan Africa. This share reached the highest value in 2018 with 2.1%¹³. The share of Sub-Saharan Africa in the world's outward FDI stock is even smaller. It was only 1.6% in 2020 (WIR, 2021). Compared to aid flow on other continents, Africa is underrepresented in the world FDI flow due to its latecomer status.

Consequently, the contribution of FDI inflow to Africa's GDP is rather modest, with it fluctuating around 2% (see Table 2). However, it varies from country to country in Africa. Some decades ago, the resource rich countries were the main destinations for foreign investors, but now there is a shift towards non-resource rich countries such as Ethiopia, Kenya, and Tanzania where the contribution of FDI to GDP is above average for African countries. The reason behind this change is that between 2003-2005, 51% of FDI entered extractive industries (mining) following rent-seeking strategies, with 39% going to manufacturing and 10% to services. Recently, between 2017-2019, the share of extractive industries decreased to 12% and the share of manufacturing and services increased to 49% and 41%, respectively. These sectors are attracting market-seeking and efficiency-seeking investors as domestic demand is increasing and a more prosperous middle class is emerging.

As far as the prospects are concerned, there is a great potential for FDI to close the savings-investment gap. First, FDI directly contributes to increasing investment levels in the host countries through financing new investment projects (green field investments), modernizing existing ones (brown field investments), and purchasing

local firms (M & A). However, the main aim of FDI is to generate profit and achieve a high level of return. Unfortunately, there is no data available about the magnitude of income (= profit) on inward FDI in Africa. The income on inward FDI worldwide was 2084 billion USD in 2017, 2,375 billion USD in 2018, 2202 billion USD in 2019, and 1745 billion USD in 2020 (World Investment Report, 2021). As 2% of world capital export is directed to Africa, proportionally at least 4 billion USD leaves Sub-Saharan Africa annually as profit repatriation. As investing in Africa is especially risky, the rate of return should be above the average¹⁴, so the amount mentioned is an underestimation. In addition, apart from legal profit repatriation, there are a great number of channels for siphoning off resources illicitly (see in Section 3).

Secondly, FDI might contribute to increasing domestic private saving via increasing income with labour-intensive investments and augmenting government revenues through increasing the tax base. In addition, according to some research findings (Aghion et al., 2006), higher savings rates play a role in attracting foreign investment as they function as collateral for foreign investors. So FDI-generated savings might lead to additional foreign investments.

Among foreign investors there is a growing interest in Africa. The main competitive advantages of the region include natural resources, minerals, and land; high growth rate; low, competitive wages; an abundant and youthful workforce; an emerging middle class; rapid urbanization; changing consumption structure; and an expansion of local and regional markets¹⁵. In order to attract more FDI, Africa should develop its physical infrastructure¹⁶, improve educational and vocational trainings, create conducive business climates, and increase political and economic stability (6 reasons to invest in Africa, 2016; Policy framework..., 2015). However, attracting foreign capital and relying on FDI to a larger extent could enlarge the region's financial, technological, and foreign trade dependence.

Remittances

During the last half of the century remittances increased globally and significantly: from USD 1.9 billion USD in 1970, to 121.6 billion USD in 2000 and to 714.2 billion USD in 2019 (World Bank, www.migrationdataportal.org). The main driving factor behind this dynamic growth was the increasing number of migrants, having reached 271.6 million (3.5% of the world's population) by mid-2019 (UN DESA, 2019). During the last decade (2009-2019), 6.5-6.8% of global remittances went to African countries South of the Sahara. This region is overrepresented compared to its GDP share (3.1%). International remittances to Sub-Saharan Africa grew significantly, from a very low level to 31.66 billion USD in 2010 and 48.77 billion USD in 2019, surpassing the FDI inflow (see Table 2) and comprising 2.6-2.8% of the region's GDP. However, according to the World Bank latest report (COVID-19 Crisis Through a Migration Lens, 2020), remittances were expected to decrease to 37 billion USD in 2020 and 38 billion USD in 2021 for Sub-Saharan Africa due to economic crises induced unemployment, travel restrictions, and limited movement of people.

In the literature there is a debate about the impact of remittances on economic growth and development in Africa. Empirical results of Fayissa and Nsiah (2010) show that remittances have a positive impact on the level of GDP and economic growth through financing investments and decreasing liquidity constraints at national and household levels. Ojapingwa and Bashhorun (2014) state that savings from remittances lead to more efficient resource allocation and higher economic growth. Lartey (2013) concludes that remittances positively affect growth through the investment channel, but there are threshold values for financial development indicators above which the positive effect emerge. In contrast, Koyame and Marsh (2012) find that remittances do not stimulate economic growth and negatively impact real output growth in Benin, mostly due to recipients' moral hazard and the conspicuous use of remitted funds. Chami et al. (2003) have the same findings, namely that due to moral hazard, remittances have a negative impact on economic growth.

All in all, remittances are not only an important external source of finance in Africa, but a significant contributor to economic growth and development both at national and household levels. Remittances are those financial inflows which directly contribute to closing the saving-investment gap, as they are personal savings *per se* earned outside the country and transferred back to the country of origin in cash or in kind. Without increasing financial dependence, remittances might finance investments and consumption, promote education and health care, contribute to rural development, provide social protection to family members and the extended family, reduce poverty, meet basic needs, and increase living standards. However, one should not forget the "price" of remittances, such as the direct costs of transfers, the brain-drain, the Dutch disease or the disintegration of families.

The Other Side of the Balance Sheet: Capital Flight and Illicit Financial Flows

Comparing the calculations of Table 1 and Table 2 (see the last columns), we may conclude that the inflow of aid, FDI, and remittances (altogether 7-8% of the GDP) is around twice the saving-investment gap (3-4% of the GDP); however, the finance gap still exists and Africa nevertheless lacks financial resources. One of the explanations is the current account balance that is permanently negative (fluctuating around 3% of the GDP)¹⁷ due to foreign trade imbalance caused by high import bills compared to export revenues. Though the financial situation of Africa based on the above three items (S-I gap + aid, FDI, remittances inflow + current account imbalance) appears to be in balance ($-3-4\% + 7-8\% + (-3\%) = +1-2\%$), why is not in balance? A far-reaching explanation could be provided by the massive outflow of financial resources from Africa in the form of capital flight and illicit financial flows.

Capital flight

Capital flight is not a new phenomenon in Africa. During the era of gaining independence, a part of domestic capital in the hands of colonizers left the continent because people feared expropriation and other political risks. This phenomenon occurs during any radical political and economic change (see the example of the South

African Republic in 1994). In these cases, the political *push* effects are the main drivers for honestly acquired capital to leave the country. According to the portfolio theory (Ndikuma, 2015), domestic capital is *pulled out* of the country for higher returns accompanied by less economic risks (e.g., exchange rate risk, inflation, political and financial instability, poor governance) abroad. This leads to the so-called “reverse home bias” (Ndikuma, 2015), which is when domestic wealth holders prefer foreign investment over domestic ones. Among the main drivers of capital flight Ndikumana, Boyce and Ndiaye (2014) highlight the role of domestic and external factors, including structural factors, the macroeconomic environment, risk and return to investment, capital account openness and financial development.

In most cases it is extremely difficult to measure capital flight as it is not recorded, though there could be some estimates based on the “net errors and omissions” of the balance-of-payments (Ndikuma, 2015). By 1991 the stock of capital flight from Sub-Saharan Africa equalled 85% of the region’s GDP (Aryeetey, 2004)¹⁸, which should have been sufficient to cover the S-I gap. According to Ndikuma (2015), between 1970-2000 Africa lost over 1 trillion USD due to capital flight. Most capital fled from the wealthier countries with oil and other natural resources (e.g., Nigeria, Angola, Gabon, Congo, and Sudan).

Beyond the push and pull effect (portfolio theory) that may drive capital flight, there is a third type when the main motivation is to hide capital, find a secure place to accumulate wealth confidentially in fear of prosecution of financial crime, and evade taxes. This type of illicit capital flight can be referred to as capital embezzlement, smuggling, and trafficking. The dividing line between the three types of capital flight is the origin of capital (how it was acquired) as well as the motivation and manner of the capital leaving the country.

Capital flight has a perverse effect on a country’s national economy. It drains government revenue through embezzlement of public resources and reduction of the

All in all, remittances are not only an important external source of finance in Africa, but a significant contributor to economic growth and development both at national and household levels. Remittances are those financial inflows which directly contribute to closing the saving-investment gap, as they are personal savings per se earned outside the country and transferred back to the country of origin in cash or in kind.

tax base; it decreases domestic savings and investment; it retards economic growth; it constrains job creation; it undermines health, education and other social services; and it increases inequality. In addition, outflow of resources perpetuates the financial dependence on external resources. Furthermore, Ndikuma and Sarr (2019) sampled 30 African countries between 1970-2015 and revealed a positive correlation between FDI inflow and capital flight, which they termed *FDI-fuelled capital flight*¹⁹. As FDI flows mainly to resource rich countries, they tend to be the main sources of capital flight due to the high risk of embezzlement of government revenues and serving as transits for unrecorded financial outflow. African countries are trapped in this situation without an easy solution to the problem. Africa needs FDI, but if it leads to additional capital flight then it does not improve, can even worsen the financial situation.

In order to curb capital flight and increase domestic savings, two types of strategies are proposed by Ndikuma (2015). The *incentive-based strategy* aims to discourage domestic investors to opt for foreign assets via decreasing the difference between domestic and foreign returns through increasing domestic interest rates and removing market distortions. The *institutional-based strategy* aims to prevent capital flight by reforming the regulatory framework and the legal system to ensure their political independence.

Illicit financial flows (IFFs)

Though the phenomenon has a long history, the discourse only started in the 90s in connection with abnormal capital flight (the third category above). Different definitions are used in the literature. According to the African Union IFFs are “illegally earned, transferred or used resources moved from Africa to the rest of the world in violation of the laws” (*Domestic resource mobilization: fighting against corruption and illicit financial flows*, 2019, p. 22). The UNCTAD compliments the above definition by adding “exchange and/or flow of value” as a characteristic of IFFs beyond financial transaction (*Tackling illicit financial flows for sustainable development in Africa*, 2020, p. 38.). An even wider definition entails those transactions which are not strictly illegal but are undesirable and unethical because they result in reduced tax revenues (e.g., tax avoidance by MNCs) (Signé et al., 2020). In this latter case not the word but the spirit of the law is violated.

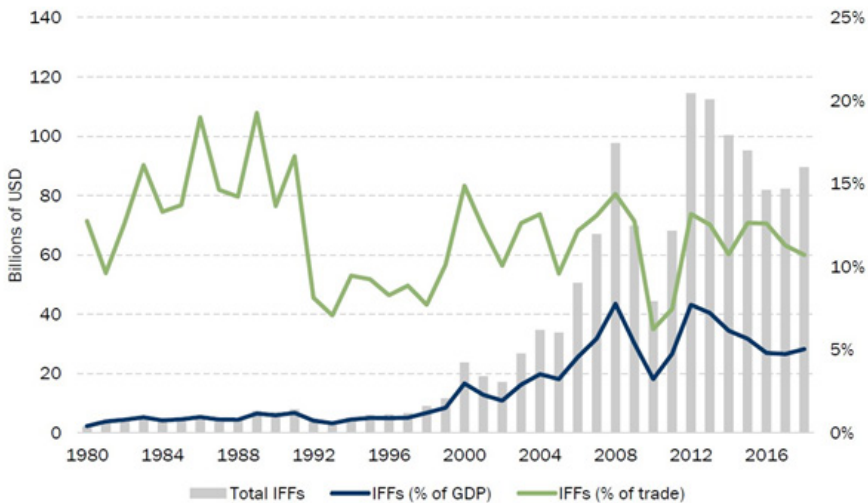
The most widely practiced categories of IFFs are:

- a) *commercial activities (65%)*: false invoicing, trade mis-invoicing (import over-invoicing for hiding capital flight and money laundering; import under-invoicing to avoid import tariffs; export under-invoicing for hiding profit and evade tax; export over-invoicing to benefit from export subsidies), tax evasion, tariffs avoidance, transfer pricing manipulation, profit shifting (*Tackling illicit financial flows for sustainable development in Africa*, 2020);
- b) *criminal activities (30%)*: money laundering, trafficking, smuggling of people, migrants, goods, drugs, weapons, services, cultural property, waste, wildlife;

- illegal fishing, logging and mining; fraud in the financial sector, illegal arms dealing, counterfeiting, forced labour, kidnapping, terrorism financing;
- c) *corruption (5%)*: bribery, theft, embezzlement of national wealth, abuse of functions, and financial malpractices.

Basing their calculation on trade mis-invoicing (partner country/mirror trade trap method) and balance of payments residual (net errors and omissions method), Signé et al. (2020) assessed that between 1980 and 2018, 1.3 trillion USD left SSA in the form of IFFs. The outflow accelerated after 2002 and the peak was reached in 2012 with 114.5 billion USD. Though the absolute numbers are alarming, their share related to GDP was around 5% and their share related to trade was 11% in 2018 (see Graph 1). According to the African Union’s latest study (*Domestic resource mobilization: fighting against corruption and illicit financial flows*, 2019), the yearly outflow from Africa fluctuates between 50-80 billion USD with 84% of this total amount derived from SSA. The 2019 figure for Africa was 88.6 billion USD (*Tackling illicit financial flows for sustainable development in Africa*, 2020, p. 22). SSA is responsible for 9% of the world’s IFFs. The greatest emitter regions are Western and Southern Africa, with special regard to fuel and other resource exporter countries (e.g., Nigeria, Togo, Zambia, South Africa, Democratic Republic of Congo, and Ethiopia). Roughly half of Africa’s IFFs—40 billion USD in 2019—is linked to high value and low weight extractive commodities primarily consisting of gold, diamond, and platinum (*Tackling illicit financial flows for sustainable development in Africa*, 2020, p. 60). The two top emitters are South Africa and Nigeria with a combined share of above 50% of the total IFFs from SSA.

Graph 1. Illicit financial flows from Africa (1980-2018)



Source: *Illicit financial flows from Africa*, 2020, p. 6

The main drivers of IFFs are different macroeconomic, structural, and governance indicators. Signé et al. (2020) found that real GDP growth, inflation, and high share of taxes have a positive correlation with IFFs. Other variables fuelling IFFs are the size of the economy, natural resource endowments, increasing trade openness, government deficit, capital account liberalization, interest rate differentials, real exchange rates, and black-market premiums.

As far as governance indicators are concerned, Signé et al. (2020) surprisingly did not find a correlation between IFFs and corruption, government effectiveness, political stability, rule of law, regularity quality, and accountability. According to the African Union, poor governance, high level of corruption, weak institutions, low government effectiveness, political instability, and low levels of democracy and political freedom increase IFFs. The latest advancements in communication and information technology such as digital currency might facilitate illicit transactions as well.

Destination countries are also responsible for IFFs as they attract and host illegal transfers due to legal, regulatory, standard and transparency gaps and differences (*Tackling illicit financial flows for sustainable development in Africa*, 2020.). For Africa, these regions include East Asia and the Pacific, Europe and Central Asia, intra-African flow and North America. China hosted 16.6 % of IFFs from Africa as Africa-China trade increased, followed by the USA (9.1), UK (5.4%) and India (5%)

IFFs have a detrimental impact on the development potential of African countries as they drain foreign exchange and reduce domestic resources that could be used for financing development and decreasing dependence on external sources of finance²⁰. If funds illegally leaving Africa had remained, per capita GDP could have increased by 15%, capital stock could have grown by 60%, and the domestic investment to GDP ratio could have increased from 19% to 30% (*Domestic resource mobilization: fighting against corruption and illicit financial flows*, 2019 p. 22). In addition, IFFs cut government revenues by eroding the tax base, decreasing investment and saving rates²¹, undercutting labour productivity weakening governance structure and public institutions, undermining transparency and accountability, endangering stability, reducing social expenditures, and worsening poverty and inequality (*Tackling illicit financial flows for sustainable development in Africa*, 2020).

As IFF is a shared problem of developed and developing countries, tackling IFFs requires cooperation at regional and global levels to curb money laundering, end illegal practices, repatriate smuggled funds, and recover stolen assets (*Tackling illicit financial flows for sustainable development in Africa*, 2020, p. 75).

Conclusion

Based on academic sources, relevant statistical data, and calculations in this study and referring to the long-standing conventional concept about the prevalence of the high saving-investment gap in Sub-Saharan Africa, we conclude that there is a permanent finance gap in SSA that cannot be filled by increasing savings only. Consequently, the region should rely on external sources of finance. Though external

financial inflow (7-8% of GDP) is sufficient to cover the savings-investment gap (-3-4% of GDP) and counterbalance the current account deficit (-3% of GDP), African countries still cannot finance sufficiently to sustain high growth rates because of the massive outflow of financial resources in the form of capital flight and IFFs (5% of GDP). That is the saving-investment gap itself counts less in creating the finance gap of Africa than capital flight and illicit financial flows. As the outflow of financial resources exceeds the inflow, the world does not finance Africa, but on the contrary Africa finances the world, this way the “Who finances whom” question is answered.

The final conclusion is that the issue of financing Africa’s development cannot be solved without (a) mobilizing domestic resources²², (including domestic savings), (b) attracting non-debt generating external resources as well as improving the use and avoiding the misuse of inflowing financial resources, and (c) curbing or reversing capital flight and (d) tackling illicit financial outflow. In order to accomplish the above tasks, profound political, economic, structural, institutional, legal, social and moral changes are needed at national, regional and global levels. This might be a topic of further research. ☀

Notes

- 1 This sum is going to be increased due to additional financial needs generated by COVID-19.
- 2 According to the African Development Bank, in Africa more than half of GDP growth is due to investments (African Economic Outlook, 2020).
- 3 It was empirically proven by Adon and Elbahnasaway (2014) in five African countries (Egypt, Ghana, Ivory Coast, Kenya and Nigeria).
- 4 Between 2003-2012 the annual real GDP growth rate was 5.7%, though it declined to around 3% in 2017, 2018 and 2019 (World Economic Outlook, 2021). The estimates for 2020 was 1.9% and the projection for 2021 was 3.4% (Regional Economic Outlook, 2021).
- 5 This gap was even higher earlier: between 1970-1995 it fluctuated around 11% of the GDP due to the below 10% savings rates and 17-20% investment rates. For details see: Elbadawani and Mwega, 1998; Ndikuma, 2015.
- 6 It was almost the same in the 80s and 90s, 20% and 17%, respectively (Adon and Elbahnasawy, 2014).
- 7 Self financing ratio is the fraction of domestic investment financed by cumulative domestic savings (Aytül & Yalcin, 2015).
- 8 This study covers 24 developed and 22 developing countries (representing 90% of the world GDP) in the period of 1993-2010.
- 9 In 2018 the share of agriculture was 16.2% of the GDP in Africa (African Statistical Yearbook, 2020).
- 10 In 2020 around 55% of the population was between the age of 15-64 in Sub-Saharan Africa (UN Population Division).
- 11 For instance, according to Aghion (2009) high saving rates might attract foreign capital with innovative capacity.
- 12 Aid dependence was much higher between 1970-1995, when it was over 10% in general (Elbadawan & Mwega, 1998).
- 13 The share of the African continent was also rather low, at only 3% in 2019 (WIR, 2021).
- 14 Between 2006-2011 the rate of return worldwide was 7%, while in Africa 11.4% (Anyanwu, 2015)
- 15 In this regard the Continental Free Trade Area should be emphasized.

- 16 According to some estimates (Anyanwu, 2015) Africa should invest USD 90-100 billion yearly in order to sustain the pre-COVID level of FDI inflow.
- 17 Between 1980-1999 Sub-Saharan Africa's current account balance was -2.4% of the GDP, between 2000-2012 -4.9%, in 2015 -5.7%, in 2018 -2.6%, and in 2019 -3.7% (WEO, 2021).
- 18 In South East Asia it was only 15%.
- 19 A 1% increase in FDI flow was associated with a 0.26-0.38% increase in capital flight.
- 20 This is called „missed development opportunity” by Cristina Duarte, the UN under-secretary-general and special adviser on Africa (Africa Renewal, 21 February 2021)
- 21 This is called „dissaving” by Nkurunziza (2012).
- 22 This is called a hard option by Aryeetey (2004) referring to the difficulty of the task.

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