

## **Fighting Capital Flight in Ethiopia**

**Dawit Tadesse<sup>1</sup>**

### **ABSTRACT**

*There exists no generally accepted definition of the term “capital flight”. For the purpose of this article capital flight refers to Illegal capital flight, also known as illicit financial flows, which disappear from any record in the country of origin. Moreover earnings on the stock of illegal capital flight outside of a country generally do not return to the country of origin. In this regard, capital flight is creating a serious development challenges for most African economies. Ethiopia is not exceptional for this impact. The analysis of this article led to two major findings. First, African countries have become increasingly indebted; they experienced large scale capital flight. According to studies a group of 33 SSA (Sub- Saharan Africa) countries has lost a total of \$814 billion dollars from 1970 to 2010. This exceeds the amount of official development aid (\$659 billion) and foreign direct investment (\$306 billion) received by these countries. Oil-rich countries account for 72 percent of the total capital flight from the sub region (\$591 billion). Secondly, an upcoming report by Global Financial Integrity 2009, finds that*

*Ethiopia, which has a per-capita GDP of just US\$365, lost US\$11.7 billion to illicit financial outflows between 2000 and 2009. In 2009, illicit money leaving the economy totaled US\$3.26 billion, which is double the amount in each of the two previous years. In conclusion, currently the impact of capital flight for Ethiopia economy is becoming very severe. So, Ethiopian government effort to promoting economic development must be go hand in hand with fighting capital flight*

### **Keywords**

<sup>1</sup> Dawit Tadesse is a Lecturer at St.Mary’s University, Addis Ababa, Ethiopia.

Email:dawittadesse21@hotmail.com or dawittadesse9053@yahoo.com

## Capital Flight, Illicit Financial Flows, Global Financial Integrity, Africa, Ethiopia

### **Introduction**

The problem of illicit cross-border financial flows is not new. In the immediate aftermath of the World War II and then at the height of the Latin American debt crisis in the 1980s, the problem of capital flight was serious enough to attract the attention of policy makers at the highest level. But a lack of initiative and action then has meant that the problem has been allowed to grow. Specially, over the past decades, African countries have experienced massive outflows of private capital towards Western financial centers. Ethiopia is not as exception to this impact (Leonce Ndikumana and James K. Boyce, 2011).

Capital flight from African economies constitutes a serious development challenge for several reasons. First, capital flight diverts scarce resources away from domestic investment and productive activities. Investment levels are substantially lower in African countries than other developing countries. Second, capital flight has a substantial regressive impact on wealth distribution. This is because it is the members of the subcontinent's economic and political elites that take advantage of their privileged positions to engage in capital flight by acquiring and channeling funds. The impact of the resulting shortages of revenue and foreign exchange is borne by the poorest members of society. The regressive impact of capital flight is compounded when financial imbalances result in devaluation: the wealthy that hold external assets are insulated from the effects, while the poor enjoy no such cushion. Third, most sub-Saharan African countries are still heavily indebted as the result of capital flight (Leonce Ndikumana and James K. Boyce, 2011). Ethiopia is one of the countries, which suffer from it.

In this regard, the purpose this article is only to clear out and address the concept of Capital Flight and its overall implications in the Ethiopia Economy. Furthermore the article can shed more light on the misinformation and hasty conclusions that have been given pertinent the problem of Capital flight in Ethiopian media, government bodies and among general public. To that effect, this article can be used as discussion point for intensive study on the problem of Capital flight in Ethiopia. The article is organized in to four sections. The first section provides an overview of the concept and impact of Capital Flight. The second section presents the approach and methodology. The third section deals border overview on impact of capital flight in overall Africa economy with special focus on sub-Saharan African countries economy. The third section assesses the impacts of capital flight on the overall Ethiopian Economy. The last section gives the conclusions.

### **Approach and Methodology**

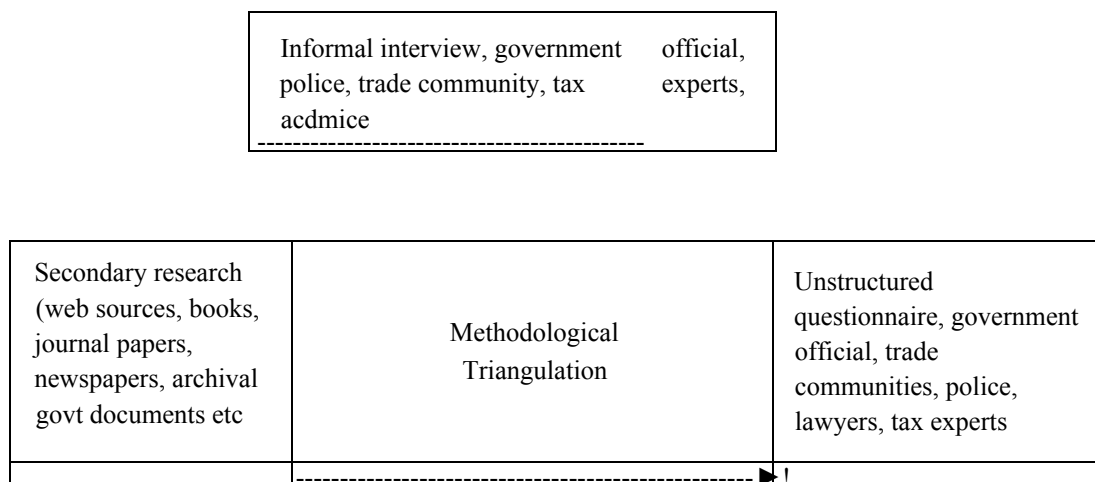
This article intends to assess the concept of capital flight and its overall implication for Ethiopia Economy. In order to see this problem the methods used in this analysis were:

- Review of literature regarding the concept capital flight: This review helps to understand the concept, main mechanisms and the impact of capital flight and gives this article an exploratory nature.
- Unstructured interviews were conducted with Ethiopian pertinent officials such as Police, Customs and Intelligence Officials
- The major inputs for this study were secondary data. Secondary data were collected from books, internet and journals to see the impact of

capital flight in the African economy with special focus on sub-Saharan African countries particularly to Ethiopian Economy.

Considering lack of available data in Ethiopia regarding capital flight, empirical investigation is very important. Because of this reason, the appropriate research strategy for this study is mutually reinforcing ‘triangulation’ method which is put on figure 1.1 below. The three key research elements of this approach are secondary research, unstructured questionnaires and interviews.

**Figure 1.1: Triangulation Research Methodology Model**



### **Concept and Impact of Capital Flight in theory**

In general there exists no generally accepted definition of the term “capital flight”. But when we define capital flight from of financial perspective it is Illegal capital flight, also known as illicit financial flows, which are intended to disappear from any record in the country of origin and earnings on the stock of illegal capital flight outside of a country generally do not return to the country of origin.

Capital flight involves illicit practices such as the falsification of trade documents (trade-ins invoicing), the embezzlement of export revenues, and kickbacks on public and private sector contracts.

Even if these terms may be used differently by different experts, all references to them include a number of shared implicit characteristics which can be broadly listed as:

- these flows are largely unrecorded (not captured by the balance of payment and other official statistics);
- these flows are often associated with active attempts to hide origin, destination & true ownership etc (they seek secrecy);
- these flows are usually associated with public loss and private gain because no (or little) tax is paid on them or because they may be compromised of bribes paid;
- these flows constitute domestic wealth permanently put beyond the reach of domestic authorities in the source country;
- these flows are not part of a 'fair value' transaction and would not stand up to public scrutiny if all information about them was disclosed

### **What is the development impact of capital flight?**

Capital flight undermines the economy:

First, by draining valuable national resources, capital flight widens the resource gaps faced by these countries, perpetuating their dependence on external aid.

Moreover, by deepening the resource gaps, capital flight slows down capital accumulation and long run growth.

Second, capital flight frustrates countries' efforts to increase domestic resource mobilization. It erodes the tax base and public expenditure through illicit transfer of private capital abroad, tax evasion and tax avoidance by individuals and companies, and outright embezzlement of government revenue by corrupt officials. These perverse effects force governments to incur further debts, part of which ends up fueling more capital flight (Sony Kapoor, 2007).

Third, by draining government revenues and retarding growth, capital flight undermines the poverty reduction agenda. It is estimated that if the capital that currently leaves Africa illegally was invested on the continent, the continent could meet the Millennium Development Goal of cutting poverty in half, a target it is otherwise likely to miss (AFDB, OECD, UNECA, and UNDP, 2012).

Fourth, capital flight is both a symptom and an outcome of governance breakdown in source countries as well as in the international financial system. It is a result of corruption, dysfunctional regulation and weak enforcement of rules (Sony Kapoor, 2007).

Fifth, capital flight worsens income inequality and it has important social and equity implications. Insofar as the perpetrators of capital flight, tax evasion and tax avoidance are the economic and the political elites, capital flight makes tax incidence more regressive in that wealthy residents incur relatively smaller tax burdens than would otherwise be the case. Finally, capital flight has important political economy implications for the distribution of power. The political elites are able to consolidate power by financing their oppressive machinery with illicit wealth. As a result, capital flight strengthens dictatorships and provides the means to perpetuate

autocratic regimes, as evidenced by the cases of Mobutu in the former Zaire and the various military dictatorships in Nigeria, Gabon, and Equatorial Guinea (Sony Kapoor, 2007).

### **What are the main mechanisms used for capital flight?**

The mechanisms most commonly implicated in the flight of capital include:

The mis-invoicing of trade transactions. This can be done by:

- Under-invoicing the value of exports from the country from which cash is to be expatriated. The goods are then sold on at full value once exported with the excess amount (constituting flight capital) being paid directly into an offshore account
  - Over-invoicing the value of imports into the country from which cash is to be expatriated, the excess part of which constitutes capital flight and is deposited in the importer's offshore bank account;
  - Mis-reporting the quality or grade of traded products and services to assist value over or understatement for the reasons noted above;
  - Mis-reporting quantities to assist value over or under-statement for the reasons noted above;
  - Creating fictitious transactions for which payment is made. As has been noted: One well-worn wheeze is to pay for imported goods or services that never materialize.
1. Transfer mis-pricing: This is the manipulation of prices of cross-border transactions between related affiliates of MNCs (Multinational Companies). The motives and mechanisms are similar to those above. However, the practice is made easier and is harder to detect as the transactions are now done between related parties - so no outside party is

involved. Around 60 per cent of trade takes place between subsidiaries of MNCs. As these transactions occur between different parts of the same company, there is ample scope for mis-pricing and, as a result, shifting of profits. Detecting transfer mis-pricing is complicated within the highly complex international production networks that exist today and where companies use trademarks, brands, logos and a variety of company specific intangible assets. Finding independent benchmark valuations for many of these is highly problematic ( Leonce Ndikumana and James K. Boyce,2011).

2. Using mis-priced financial transfers, such as intra-corporate financial transactions - for example, loans from parent to subsidiary company at exaggerated interest rates - to shift profit out of a host country is another way illicitly transferring capital out. Real estate, securities and other forms of financial trades can also be mispriced to facilitate capital flight and exaggerated payments for intangible such as goodwill, royalties, franchising rights and use of patents etc is yet another channel for the flight of capital.
3. Unscrupulous wire transfers. These involve a bank or a non-banking financial institution transferring money out of a country illicitly. Wire transfers are of course a legitimate way of moving money between countries but it is when such transfers violate laws, or are used to avoid taxes or hide ill-gotten wealth that they constitute illicit capital flight. Banks can mis-report the source, destination or ownership of funds to help disguise illicit transactions.
4. The payment of bribes and corrupt monies offshore. In many instances involving bribes payable to public officials by commercial organizations there is an element of capital flight involved. The payment of a bribe always means that the recipient country will not get a fair value on the



commercial activity undertaken by the firm paying it and that both tax evasion and capital flight will deprive the country of scarce resources.

5. Other mechanisms. These include the smuggling of cash and other high value mobile assets.

Luxury yachts have been regularly sold and moved across oceans to shift capital from one country to another. While the problem of capital flight and illicit financial flows exists across all sectors of the economy, it is especially acute in the extractive and natural resource sector.

### **Who are the main actors who help facilitate capital flight?**

These facilitators include:

- Complicit business counterparts in western countries (for domestic exporters and importers);
- Armies of well-paid lawyers, accountants and company formation agents who design aggressive tax planning & transfer pricing strategies and incorporate dummy corporations and sham trusts;
- Financial centers which legislate for low taxes and the existence of bank secrecy and provide services such as the incorporation of shell corporations, sham trusts and other impenetrable legal structures with nominee directors
- Bankers and financiers who solicit and enable the flight of capital and manage the illicit wealth
- Government officials

## **Impact of capital flight in overall Africa economy special focus on sub-Saharan African countries economy**

Even as African countries became increasingly indebted, they experienced large scale capital flight.

Some of this was legitimately acquired capital fleeing economic and political uncertainties; some was illegitimately acquired wealth spirited to safer havens abroad.

Over the past decades, African countries have been forced by external debt burdens to undertake painful economic adjustments while devoting scarce foreign exchange to debt-service payments. On the other hand, African countries have experienced massive outflows of private capital towards Western financial centers. Compared to other developing regions, Africans tend to exhibit a significantly higher preference for foreign assets relative to domestic assets; hence Africa has the highest proportion of private assets held abroad (Collier, Hoeffler, and Pattillo 2001).

Some of the private assets held abroad by Africans were legally acquired. But the legitimacy of a significant fraction of these assets is questionable. This is especially the case for the wealth held by African political and economic elites in international financial centers that provide the coveted secrecy of banking operations.

Especially a key constraint to SSA's( Sub-Saharan Africa) growth and development is the shortage of financing. Indeed SSA faces large and growing financing gaps, hindering public investment and social service delivery. At the same time, the sub-region is a source of large-scale capital flight, which escalated during the last decade even as the region experienced growth acceleration. According to James K. Boyce and Leonce Ndikumana

(2012) the group of 33 SSA countries has lost a total of \$814 billion dollars from 1970 to 2010. This exceeds the amount of official development aid (\$659 billion) and foreign direct investment (\$306 billion) received by these countries. Oil-rich countries account for 72 percent of the total capital flight from the sub-region (\$591 billion).

### **Impact of capital flight on overall Ethiopian Economy**

Ethiopia's economy is based on agriculture, which accounts for 46% of GDP and 85% of total employment. Coffee has been a major export crop. Ethiopia's, per capita income is among the lowest in the world. Table 1.

Ethiopia Macroeconomic Performance from 2010- 2012

| Period | GDP<br>(Purchasing<br>power<br>parity) | GDP<br>per<br>capita<br>(PPP) | GDP<br>Composition<br>by sector         | Exports                              | Imports                             | Current<br>Account<br>Balance        | Inflation<br>rate    | Budget<br>surplus<br>(+) or<br>deficit<br>(-) | Public<br>debt     |
|--------|--|-------------------------------|---|--------------------------------------|-------------------------------------|--------------------------------------|----------------------|---|--------------------|
| 2010   | \$89.67<br>Billion                     | \$1.100                       | Agriculture<br>46.6%                    | \$2.9576<br>Billion<br>(2011<br>est) | \$9.694<br>Billion<br>(2011<br>est) | -\$1.965<br>Billion<br>(2011<br>est) | 33%<br>(2011<br>est) | -   | 44.7%<br>of<br>GDP |
| 2012   | \$103.1<br>Billion                     | &1.200                        | Industry<br>14.6%<br>Services,<br>38.8% | \$3.163<br>Billion                   | \$10.6<br>Billion                   | -\$2.95<br>Billion                   | 21.7%                | -2.7%<br>of GDP                               | 44.4%<br>of<br>GDP |

**Source: Author organized figures from World Bank Reports and CIA World Fact book (2013)**

With this level of Ethiopian Economy, one the big challenge the country currently facing is Capital flight. Even if it is very difficult to study the extent and impact of capital flight in Ethiopia because of several reasons, such as lack of data, according to researches the impact of capital flight on overall Ethiopian economy is becoming very severe.

Report by Global Financial Integrity 2009, finds that Ethiopia, which has a per-capita GDP of just US\$365, lost US\$11.7 billion to illicit financial

outflows between 2000 and 2009. In 2009, illicit money leaving the economy totaled US\$3.26 billion, which is double the amount in each of the two previous years.<sup>1</sup> Considering this figure, When we compare the 2009 illicit money leaving the Ethiopian economy with 2011/2012 total Ethiopian export as shown in Table 1, it is greater than by \$ 98 million . With this amount of Capital flight, Ethiopia could cover the 2011/2012 and 2012/2013 current Account Balance deficit which are -\$1.965 billion and -\$2.95 billion respectively as shown in the above Table 1. The report also indicates Ethiopia's losses due to illicit capital flows are on the rise.

Ethiopia is one of the poorest countries on earth. Plagued by famine, war, and political oppression, 38.9% of Ethiopians live in poverty, and life expectancy in 2009 was just 58 years. For example, in 2008, Ethiopia received US\$829 million in official development assistance, but this was swamped by the massive illicit outflows (Sarah Freitas, 2011).

The impact illicit outflows of capital in Ethiopia one of the major causes for reduces tax collection, worsens income gaps, hurts competition, and undermines trade and drains currency reserves which are currently observing in Ethiopia economy. For example the Ethiopian Government tax revenues collection compare to the country Growth domestic product (GDP) still stragglng around 10% which is the lowest in sub-Saharan Africa countries.

According to this report, the main causes for this problem in Ethiopia are as a result of increased corruption, kickbacks, and bribery while the remainder stems from trade mispricing. The global shadow financial system happily absorbs money that corrupt public officials, tax evaders; and abusive multi-national corporations siphon away from the Ethiopian people.

As the par the opinion of this article writer one of the major and solemn cause for illicit financial flow in Ethiopia is corruption. As it is stated according the Global Financial Integrity report in December 2011, “Corruption distorts public policies in that resources are allocated not based on efficiency or internal rates of return but in favor of those who are willing and/or able to bribe or pay kickbacks to public officials.

Weak governance spawns public corruption and encourages corporate malfeasance. Public corruption typically involves the abuse of authority or trust for private benefit. But this is a temptation indulged in not only by government officials but also by rent-seekers in private enterprises and nonprofit organizations. In general, poor governance provides greater latitude for corruption, both in the public and private sectors, so long as the corrupt are convinced that they are likely to get away with the loot. The misallocation of resources also hurts the private sector because infrastructure tends to get neglected even as the corrupt enrich themselves at the expense of the state” Over all from these figures we can understand that the scope of Ethiopia’s capital flight is so severe.

Especially for one of the poorest country in the earth like Ethiopia, this huge amount of, illicit money leaving the Economy has huge cost.

## **Conclusions and Recommendations**

In the age of financial liberalization, capital flight, far from disappearing, has in fact remained high and even increased. In this regard, reducing capital flight and its costs in developing countries is a difficult challenge, but it is one worth trying to confront. As stated in the above analysis of this study the problem of illicit financial flow has been becoming very grave in Africa. Ethiopia is not exceptional to this problem. Illicit capital flight revokes

investment, reduces tax collection, worsens income gaps, hurts competition, and undermines trade and drains currency reserves. This impact has been observing in the Africa countries which have highest illicit outflows such Angola, Cameroon, Republic of Congo, Ethiopia, Gabon, Ghana, Madagascar, Mozambique, Nigeria, South Africa, Sudan, Tanzania, Zambia and Zimbabwe. If this illicit financial flow would ably to control and the properly registered and taxed in these countries of origins, could contribute to sizeable development and make a major difference in the fight to combat poverty. In addition if reinvested, it would contribute to job and growth in those countries.

To combat illicit financial flow in Africa decision makers must take serious actions to tackle corruption, kickbacks, and bribery while the remainder stems from trade mispricing. On the other hand these countries must implement transparent financial and tax systems. In addition, the capital outflow from Africa and the absorption into western countries economies deserve equal attention and required concerted effort.

Regarding Ethiopia, the problem of capital flight seems getting serious. So, the efforts Ethiopian government promoting economic development must go hand in hand with fighting capital flight.

Facing the challenges the government must work with the international community to hamper the ability of corrupt and tax-evading Ethiopian laundering their money in the global financial system.

This could be accomplished by establishing a global system of automatic exchange of tax information. In this way, Ethiopian authorities could much more easily track the bank accounts of tax evaders have established around

the world. In addition, the government must take the following measures to further control capital flight:

- Pricing assessment system must be implemented for export goods from Ethiopia
- Systems must be implemented to tackle under and over invoicing for import and export goods
- Implementation of functional regulation and enforcement of rules: on bank or a non-banking financial institution transferring money, asset transfer etc...
- Fighting corruption

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