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Effect of Capital Flight on Real GDP Growth in the East African Countries (2000-2022)

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Abstract
Countries in the East African region have had high capital flight both in its absolute value and relative to the GDP. The extent to which this increased volume of capital flight in the region has impacted economic growth is not well established. This study, therefore, sought to determine the effect of capital flight on real GDP growth in the EAC countries over the period 2000-2022. The study used fixed-effect estimation method to examine the determinants of study variables. The Levin-Lin-Chu (LLC) panel unit root test was applied to examine the order of integration, where all variables were found to be stationary at the level. The Hausman test preferred fixed effects over random effects. The results showed that the capital flight, external debt, terms of trade, and investment had a significant (at 5% level) effect on real GDP growth with coefficients of -0.37, -0.18, 0.29, and 0.56. Capital flight and external debt had a negative influence, while terms of trade and investment had a positive effect. It is therefore recommended that the East African countries should, on the one hand, enhance policies that would reduce capital flight and external debt, and, on the other hand, improve the countries' terms of trade and investment levels so as to realize real GDP growth. Future studies should consider causality tests to establish the causal direction of the relationship between economic growth and capital flight.

Introduction

Global economies have remained ensnared in a long-drawn-out period of slow economic growth at an average of 2.6 per cent in 2024, just above the recession threshold against the projection of at least 3.2 percent per World Economic Outlook (IMF, 2024). In addition, economic growth is also projected to remain below pre-pandemic levels for the third year, highlighting the need for structural reforms and global collaboration to address the rise in debt and the debt service crisis globally. In the last two decades, there has been a dramatic increase in capital outflows from developing economies following the 1999 implementation of National policy encouraging outward foreign investments globally (Leykun, 2022). African countries have experienced significant outflows of capital towards advanced economies. In fact, these private assets surpass the continent's foreign liabilities, ironically making Sub-Saharan Africa a 'net creditor' to the rest of the world (Fine, 2024).

From the year 2000 to 2019 alone, roughly $230 billion in capital left East African countries to develop economies (UNCTAD, 2020). These figures are prolific in the East African economy, so it has rendered the countries a net creditor to the world. With increased capital flight, East African economies have experienced a reduced tax revenue base, thus making it impossible for both the public and private sector to meet their financing needs. Curtailing this capital flight in its many forms could open up resources for spending on human development priorities like education and health.

Capital flight has been viewed as a constraint on economic growth because it implies a loss of resources that could be used for domestic investment. Moreover, it is often argued that a reversal of these capital outflows could significantly contribute to the solution of the debt crisis and thereby to renewed access by developing countries to international capital markets. Compared to other regions, capital flight from the East African Community represents a more severe problem, causing heavy losses in government revenue, forgone investment, and lost output (Ngunjiri, 2019). Based on this background, this paper therefore seeks to use more recent data to add to the literature on the effect of capital flight on the economic growth of East African countries.

The EAC Vision 2050 is its blueprint for economic development and foreign direct investment promotion. However, the slow growth of the global economy over the last three years affected the achievements of the annual targets under the EAC Vision 2050. The East African Community is one of the world's fastest-growing economic communities (IMF, 2024). Over the last decade, from 2000 to 2023, the community has enjoyed an average annual growth rate of 5.9%. However, the enormity of capital flight has been astounding in both relative and absolute values. According to Ndikumana and Sarr (2016), EAC lost approximately $9.3 billion between 2000 and 2016 alone in capital flight.

In 2018, real GDP in East Africa grew by an estimated 5.62 per cent, slightly more than 4.6 per cent in 2016, which was the highest among African regions. The region is implementing a Common Market protocol and has put in place the right fiscal architecture to achieve a monetary union by 2023 and adopt a Political Confederation as a transitional model for the East African Political Federation. Foreign direct investment outflows to the EAC partner states increased to US$31.4 million in 2017 from US$4.5 million in 2016 (Otieno et al., 2021). As the fastest-growing region on the continent, EAC recorded an annual average growth rate of 6.7 per cent between 2013 and 2017, more than double the African average. Article 24 of the EAC Common Market Protocol requires the region's Partner States to eliminate restrictions on the free movement of capital. That includes restrictions based on nationality, place of residence, current payments, and the location of capital, because such restrictions undermine the realisation of the common market. This will pave the way for the EAC partner states to start the debate on capital flight, which has been missing in the EAC policy deliberations.

EAC has remained the principal source of capital flight with an estimated value going beyond $40 billion from the year 2000 to 2022 (World Bank, 2020). The extent of capital flight from EAC is astounding, both in its absolute and relative value, compared with GDP growth. The increased volume of capital flight in EAC represents a more severe problem, causing heavy losses in government revenue, forgone investment, and lost output (Ndikumana *et al.*, 2016). This is because with its retention domestically, the amount would be significant for infrastructural development, which is an accelerator for economic growth and development. According to UNCTAD (2020), revenue loss from capital flight in EAC is, on average, the second-highest in Africa after the West Africa block at a percentage of 2.7 per cent of GDP. According to Ndikumana (2016), overall, approximately 30% of EAC foreign direct investment income on equity was repatriated to the home countries of foreign investors in 2010. Further, over the past two decades, the magnitude of capital loss has increased economic depreciation, with at least 2 per cent GDP loss (Domfeh, 2015). Within the EAC, Burundi seems to have the highest level of capital flight as a percentage of GDP, followed by Tanzania. The high levels of capital flight in Burundi can be attributed to the persistent political instability in the country. Le and Zak (2006) observed that violent conflict or political instability does increase capital flight. Kenya is leading in terms of capital flight in the region because of the size of its economy.

Some of the capital flight was legitimately acquired capital fleeing economic and political uncertainties; some was illegitimately acquired wealth spirited to safer havens abroad, mostly in Switzerland, the Caribbean, Jersey and Guernsey (World Bank, 2023). Due to the fact that the region has always lagged behind in its budgeting, the budget deficits faced in the region are alarming, while capital flight to more developed nations has kept increasing; it is therefore prudent to find a solution to tame capital flight from fleeing to developed economies and use it to finance economic developments in the state regions of EAC.

From the year 2000 to 2019 alone, roughly $230 billion in capital left East African countries to develop economies (UNCTAD, 2020). These figures are prolific in the East African economy, such that it has rendered the countries a net creditor to the world. With increased capital flight, East African economies have a tendency to reduce their tax revenue base, thus making it impossible for both the public and private sector to meet their financing needs. Exporting capital to developed economies may have also led to a reduction in domestic investment by constraining savings. The extent to which the capital flight, external debt and investment have affected economic growth in the region is not well established. As a result of higher capital flight from the EAC, the current account deficit may therefore widen while the need for capital to promote economic growth remains unresolved. Even though the IMF has encouraged debt relief for most EAC member states, the policy may not have been sufficient to boost long-term economic growth. However, capital retention will be the best option to help increase the investments and increase the government operations in terms of availability of cash that is essential to the economic growth and development. It is therefore on the grounds of these findings that this study attempts to determine the impact of Capital Flight on Economic Growth in the East African Community.

The general objective of this study was to analyse the effect of capital flight and foreign debt on Real GDP Growth in the EAC countries. Specific objectives were to establish the influence of capital flight, external debt, terms of trade and investment on the economic growth of the EAC countries Kenya, Uganda, Tanzania, Burundi and Rwanda over the period 2000-2022.

Significance, Scope and Limitations

Over the past two decades, EAC countries have experienced massive outflows of private capital towards developed Economies. The private assets surpass these countries' foreign liabilities, ironically making EAC a net creditor to the rest of the world (Ali & Walters, 2011). East African Community shows a significantly higher preference for foreign assets relative to domestic assets when compared to other developing regions; hence, EAC has the highest proportion of private assets held abroad, just like any other SSA member state (Lawal *et al*., 2017). Capital flight from EAC economies constitutes a serious development challenge for so many reasons, which include tax diversion and unstable macroeconomic policies. The phenomenon diverts scarce resources away from domestic investment and productive activities, and also has a substantial regressive impact on wealth distribution among others. Against this background, the study is intended to critically explore the relationship between capital flight and economic growth across EAC communities. As a result, the study will help policymakers formulate macroeconomic policies to mitigate capital flight from these economies.

A comprehensive study will therefore be carried out due to the following factors: first, the previous researchers neglected the EAC region from the study area while focusing on the determinants of capital flight for SSA members, given its economic state. Secondly, most of the previous researchers failed to include the real Total Saving Rate and corruption as determinants of real GDP growth relative to the effect of capital flight on economic growth. However, these factors have been found empirically significant to influence economic growth and development in most economies, including EAC. This can be noted in the following ways: that is, poorer countries are essential to corrupt leaders who make them have higher capital flight with the economic burden of paying the tax to cater for the government expenditures left in the hands of the poor citizens (Emmanuel *et al*., 2018). Finally, this study will add to the existing body of knowledge and can serve as a reference document for institutions, students, policy makers and other professionals, as well as contribute to the empirical and theoretical debate.

The study will be carried out using panel data analysis since it is for different countries that form the EAC. It will focus on the East Africa region with the five founding members of countries, i.e. Kenya, Tanzania, Uganda, Burundi, and Rwanda, being the engine studied countries. However, South Sudan and DRC, which is also a member of the EAC, are excluded from the study due to a lack of data dating back to the year 2000. The study will be restricted to the period of 2000 to 2022 based on the availability of data for capital flight and real GDP growth from EAC member states. However, given that some important data for economic growth and capital flight are missing for some nations as a result of political and natural uncertainties, there will be inconsistency in data collection for some period. This study will therefore rely on the IMF database and the World Bank database to retrieve crucial information related to the study variables. To rectify the gap for the missing data, the study will extrapolate the missing data by standardising the average values for the previous and following years to estimate the significant values.

Literature Review

Theoretical review

The debt-overhang theory, investment development cycle theory and Harrod–Domar theory were used in this study. The theory was first applied to development economics by Krugman (1988) after the Latin American debt crisis in the 1980s. Krugman (1988) argues that when external debt exceeds the expected present value of the potential future payments to the creditors, the country no longer has any incentive to implement the necessary financial and macroeconomic changes to improve its economic growth and repay the creditors (Karadam & Akin, 2021).

Debt-overhang refers to a situation where a firm's debt is so large that any returns generated by new investments are entirely absorbed by existing debt holders, such that projects with a positive net present value do not reduce a country's stock of debt (Dawood *et al*., 2024). The debt-overhang hypothesis postulates that there is a possibility that in future, external debt will be larger than the country's repayment capability, and the expected debt servicing expenses will discourage both local and foreign investments. The theory demonstrates that the stock of public debt, as well as the debt repayments, affect economic growth and alter the priorities of public spending, thereby discouraging investment in the country. Krugman (1988) discussed debt-overhang as situation in which a country's expected debt repayment exceed the originally contracted levels.

Markowitz introduced portfolio management theory (PMT) in 1952 as a finance and investment theory, advocating for analysing individual securities to determine how they contribute to the portfolio's overall risk (Kolari et al., 2024). Investors always have an appetite for less risky investments in their portfolio balance. Financial globalisation offers a pool of investment options that yield a high expected return with low risk levels. This stimulates investors to review their investment portfolio. Often, the investors opt to shift their investments abroad in search of higher profits and minimum risk in foreign assets (Bredillet *et al*., 2018). The proponents of this theory opine that investors have the right to choose where to hold their wealth. The variances in perceived risk-adjusted returns from originating and destination countries accelerate overseas investments (Orji et al., 2020).

Sutiene et al. (2024) opine that any capital flight occurrence globally is in response to portfolio-choice and risks. The foreign exchange rates, as well as the rate of return, always influence the portfolio-choice. The research posited that the existing portfolio composition of net foreign financial assets is a significant cause of capital flows. In the portfolio-choice context, these factors point to an increasing risk of losses in the real value of private investors' domestic financial assets, forcing them to favour foreign financial assets.

The Harrod–Domar model was developed by Domar in 1946 as a solution for developed countries and international financial institutions to play a major role in the reconstruction of countries after the Second World War and the Great Depression, first in Europe and later in the Asian, African, and Latin American continents. The model emphasised savings, investments, economic growth, and capital-output. The model postulates that economic growth is a subject of savings and investment, and therefore, developing countries are able to find the output required in order to realise a particular level of growth (Zrilić, 2023).

Empirical Literature Review

The empirical relationship between economic growth and capital flight has been the thrust of several empirical studies. Ampah and Kiss (2019) analysed the impact of the simultaneous occurrence of external debt and capital flight on economic policy effectiveness in Heavily Indebted Poor Countries (HIPCs) in sub-Saharan Africa, employing the Panel-Corrected Standard Error regression model for the period 1990 to 2015. The empirical results reveal that both monetary and fiscal policies in the region have been undermined in achieving their intended purposes because of increasing capital flight and external debt. Also, the concurrent occurrence of capital flight and external debt has been a hindrance to progress on the continent, particularly by undermining domestic investment.

Sodji (2022) analysed the impact of capital flight on economic growth in the West African Economic and Monetary Union (WAEMU) over the period 1970-2016 through the use of dynamic fixed effects estimation and found that in the long run, capital flight has a negative effect on economic growth. Macheru (2023) did a study on the nexus between capital flight and economic growth of Kenya over the period 1986-2021 and found that capital flight had no effect on economic growth. A study on the risk of capital flight on economic growth and national solvency of Palestine by Faza and Badwan (2023) over the period 1981-2021 through the use of the ARDL model revealed that capital flight has a significantly negative effect on economic growth, whereas domestic investment has a positive influence in the long-term.

The studies by Orji *et al*. (2020) and Idris (2021) on the impact of capital flight on Nigeria's economic growth using the ARDL model for the periods 1981-2017 and 1980-2019 found that capital flight had a negative effect on economic growth. The latter study established that external debt and domestic investment had a positive impact on economic growth.

The study by Agyeman *et al*. (2022) on the influence of external debt and capital flight on selected sub-Saharan African countries employed a dynamic system generalised method of moments on data for the period 2000-2015, and found a negative effect of capital flight and external debt on economic growth. Fatema et al. (2023) used the residual method to estimate capital flight in Bangladesh as an empirical approach with an aim to explore the effect of capital flight on the GDP growth rate, which is a proxy of economic growth. The causality test between capital flight and GDP growth was conducted using the Granger-Causality test. The aim of the study was to dissect the influence of capital flight on Bangladesh's economic advancement, with a focus on detecting the interconnected roles of determinants driving capital outflows. The empirically driven findings reveal a surprising positive correlation between capital dispersal and Bangladesh's economic development, contradicting the initial hypothesis of a negative association. However, the causality test shows that GDP growth does not have any impact on capital flight in Bangladesh

Badwan (2021) examined the impact of capital flight on economic growth and Financial Stability in Palestine from the period 2000-2020 using time-series data on capital flight, foreign exchange reserves, foreign debt, and real GDP, as well as ordinary least squares estimation technology to analyse the research data. Johansen co-integration and error correction mechanism was used. The findings indicated that there is a co-integration relationship between the research variables, including the foreign exchange rate and capital flight, which has harmed the Palestinian economic growth for a very long time.

Ogundipe et al. (2021) examined the effect of capital flight on macroeconomic performance in Nigeria for the period 1981 to 2019. It also ascertained the determinants of capital flight in Nigeria for the period 1981 to 2019. The error correction model was used for this study because the unit root test revealed all variables were stationary. The findings showed that external debt in the current period, foreign direct investment in the current period, current account balance in the current period, interest rate in the current period and reserves in the first lag are significant determinants of capital flight in Nigeria. Also, the study revealed that capital flight negatively affects economic growth and investment in Nigeria.

Gwatidzo (2017) investigated the impact of election timing on capital flight. It uses panel data estimation methods and covers SADC's 15-member states over the period 1980-2010. The study found that there is an increased capital flight prior to elections, suggesting that the economic agents responsible for capital flight transfer their funds outside the country as they may fear unjust appropriation of wealth after elections. Also, some of the resources held by the economic agents, especially the elite and politicians, may be ill-got wealth, and elections may come with changes that may result in such wealth being appropriated by the new government.

Kipyegon (2004) investigated the factors that account for capital flight from Kenya using time-series data between 1971 and 2001. Employing the Ordinary Least Squares (OLS) technique, the study found external borrowing as the most significant factor in determining capital flight from Kenya. The outcome of the study revealed that inflation rate, real exchange rate, real economic growth, and financial development are determinants of capital flight from Kenya. As a result, the study suggests that the Kenyan government should ensure accountability and transparency in the borrowing and management of external borrowings in order to promote economic growth.

The main objective of the study was to analyse the effect of capital flight on economic growth using panel data analysis in the EAC. The independent variables to be used will be Capital Flight, External Debt, Terms of Trade, and Investment rate. Intervening variables are variables which may affect the model but are not controlled and they include: Political instability and Forex Fluctuations. Real Gross Domestic Product (GDP) will be the dependent variable.

Methodology

The study applied a historical design to evaluate the influence of capital flight on economic growth in East Africa, using panel data from 2000-2022. The study area covered the East African Community (EAC), comprising five-member states: Kenya, Uganda, Tanzania, Burundi and Rwanda, and the period was chosen based on the availability of data. The block was chosen because the countries have had a long history of budget deficit given that lots of capital flew from the region while their economic growth has been slowing down over the decade.

Data Analysis and Presentation

Since the data to be collected was quantitative, inferential statistical estimation was done based on the fixed effects estimation technique, as found appropriate given the Hausman test. The study was guided by Harrod–Domar model that was developed by Evsey Domar (1946) which expounded on the saving rate, investment rate and the capital-output ratio effect on economic growth. The model shows that growth is directly related to saving and indirectly related to the capital formation output ratio. The study used panel data regression analysis whereby a linear regression analysis was used to estimate the relationship between real GDP and Capital Flight, External Debt, Total Saving Rate, Terms of Trade, and Investment rate, which is regressed using the following functional form;

$$LnRGDP_{it} = \beta_0 + \beta_1 LnCF_{it} + \beta_2 LnED_{it} + \beta_3 LnToT_{it} + \beta_4 LnINV_{it} + \varepsilon_{it}$$

Where:
RGDP = Real Gross Domestic Product
CF = Capital Flight,
ED = External Debt,
ToT =Terms of Trade
INV= Investment Rate
ε_{it} = Error term, β_0 =Intercept term, and $\beta_{1,}$ $\beta_{2,}$ $\beta_{3,}$ and β_4 are slope coefficients.

Results and Discussion

The Levin-Lin-Chu (LLC) panel unit root test was applied to examine the order of integration of the study variables and to avoid inconsistent estimates and spurious regression findings. Table 1 below presents the panel unit root test results.

Table 1: LLC Unit Root Results

	LLC test at Level	Order	P-Value	LLC at First Difference	Order
Variables	Unadjusted t	Adjusted t		Unadjusted t	Adjusted t
$lnRGDP_{ij}$	-4.12	-3.75	I(0)	0.000	-
$lnCF_{ij}$	-9.68	- 8.52	I(0)	0.000	-
$lnED_{ij}$	-7.94	- 6.27	I(0)	0.000	
$lnToT_{ij}$	- 5.21	- 4.46	I(0)	0.001	-
$lnINV_{ij}$	-6.82	- 5.03	I(0)	0.000	-

All the study variables, RGDP, CF, ED, ToT, and INV, were found to be stationary at the level and statistically significant at the 1 per cent level. This implies that all variables are integrated of order zero, I(0). Consequently, there was no need to conduct a co-integration analysis since all variables were stationary at the level.

The Hausman test (Prob > Chi-square = 0.019) confirmed that the FE model is preferred over the random effects alternative, indicating that the unobserved country-specific factors are indeed correlated with the regressors. The FE approach controls for unobserved country-specific heterogeneity, such as differences in institutional quality, governance effectiveness, policy frameworks, and geographic factors that are constant over time but vary across countries. Therefore, the FE model provides consistent estimates for analysing the relationship between capital flight and real GDP growth. The regression results are presented in Table 2.

Table 2: Fixed Effects Model Estimates and Diagnostic Tests

Regressor	Coefficient	Standard Error	t-statistic	Prob.
lnCF	-0.37	0.061	-6.07	0.000***
lnED	-0.18	0.067	-2.69	0.008***
lnToT	0.29	0.078	3.72	0.001***
lnINV	0.56	0.185	3.03	0.003***
CONS	1.02	1.04	0.98	0.328
Test			**Statistic**	**Prob.**
Adjusted R-squared			0.88	-
F-test			712.45	0.000
Hausman test (Prob > Chi-square)			6.38	0.019
Wooldridge test (serial correlation)			37.22	0.071
Breusch-Pagan LM test (cross-sectional dependency)			14.96	0.056
Modified Wald test (Heteroskedasticity)			12.84	0.078

The findings reveal that capital flight (lnCF) exerts a statistically significant negative effect on real GDP growth in East African economies. Specifically, a 1 per cent increase in capital flight associated with an estimated 0.37 per cent decline in real GDP ($p < 0.01$). This suggests that persistent capital outflows reduce domestic investment, erode productive capacity, and weaken growth potential. The result is consistent with the empirical evidence from Orji et al. (2020), Badwan (2021), Ogundipe et al. (2021), Sodji (2022), Idris (2021), Agyeman et al. (2022) and Faza et al. (2023), which also found that capital outflows hinder growth, although some studies, such as Fatema et al. (2023) and Macheru (2023), report either a positive effect or no significant impact.

External debt (lnED) also exhibits a negative and significant relationship with GDP growth, indicating that higher debt burdens may crowd out productive public investment and exacerbate fiscal vulnerability, and is consistent with Agyeman et al. (2022), but contrasts with Idris (2021). In contrast, terms of trade (lnToT) and investment (lnINV) both have positive, significant effects on growth. A one per cent improvement in the terms of trade raises real GDP by approximately 0.29 per cent, while a one per cent increase in investment enhances GDP by about 0.56 per cent. These results highlight the growth-enhancing role of favourable trade conditions and capital formation and are consistent with the results of Idris (2021) and Faza et al. (2023).

Diagnostic tests confirm the robustness and validity of the FE model. The Wooldridge test indicates no serious serial correlation ($p = 0.071$), the Breusch-Pagan LM test suggests limited cross-sectional dependence ($p = 0.056$), and the Modified Wald test shows no significant heteroskedasticity ($p = 0.078$). The model explains a substantial proportion of the variation in real GDP (Adjusted $R^2 = 0.88$), and the overall F-statistic is highly significant ($p < 0.01$), implying strong joint explanatory power.

Conclusion

The empirical findings revealed that capital flight exerts a significant negative impact on real GDP growth among East African countries. Similarly, external debt was found to have a negative and significant effect on economic growth, suggesting that excessive borrowing undermines productive investment and macroeconomic stability. Conversely, both terms of trade and investment demonstrated positive and significant effects on real GDP growth, implying that favourable trade conditions and higher levels of domestic investment stimulate economic performance. These results are consistent with theoretical expectations and prior empirical studies on developing economies.

Based on these findings, it is recommended that East African countries adopt comprehensive policy measures aimed at curbing capital flight through improved financial governance, transparency in capital markets, and stricter monitoring of international financial flows. In addition, governments should restructure and manage external debt prudently to ensure that borrowed funds are directed toward productive and growth-enhancing sectors. Policies that promote favourable terms of trade, such as export diversification and value addition, should also be strengthened; while domestic investment incentives should be expanded to encourage both private and public sector investment.

Future research should extend this analysis by incorporating Granger-causality tests or panel vector error correction models (VECM**)** to determine the direction and dynamics of causality between economic growth, capital flight, and external debt. This would provide deeper insights into the long-term interrelationships among these variables and support evidence-based policy formulation for sustainable growth in the region.

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