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Abstract

This study critically examines the implications of capital flight on investment growth in Nigeria between 1970 and 2006, because of the consequential effect it has on economic growth. The time series data properties incorporated were examined using the Augmented Dickey-Fuller (ADF) unit root test and the results revealed that Investment, capital flight, interest rate and exchange rate were stationary at levels excluding exchange rate found to be integrated at first difference. The Augmented Engle-Granger (AEG) co-integration test employed to investigate the dynamic relationship between capital flight and investment level in Nigeria, revealed that there exist long-run interaction. Though, capital flight was found to exert positive but insignificant effect on investment growth during the review period. While, the short-run dynamic interaction as a result of the structural instability in the long-run was captured by the Error Correction Mechanism (ECM) model which was found inestimable due to the high collinearity existing among the incorporated variables. Policy recommendations were proffered base on the research findings.

Key words: *Capital flight, Investment behaviour, Long-run, Stationarity, ECM, Cointegration, Nigeria*

Section 1   INTRODUCTION

The issue of capital flight has become a worrisome issue among researchers. According to Berger (1987), Capital flight connotes illegal movement of capital from one country to the other. This implies that there may be 'normal' or 'legal' and 'abnormal' flow of capital. The question of legality, then implies that the country in question imposes exchange or capital control. Lessened and Lessard and Williamson (1987) also refer to capital flight as capital that 'runs away' or 'flees' abnormal risks at home regardless of whether or not the flight is legal.

Empirical views on the concept of capital flight are largely unsettled. While some analysts view it as an indication of sick society characterized by breakdown of social cohesion, reduction in growth potential, erosion of the tax base, failure to recover from the debt problems and a redistribution of wealth from the poorer to the richer social groups. Others consider the very use of the word 'capital flight' as unnecessarily pejorative description of natural, economically rational response to the portfolio choices that have confronted wealthy residents of some debtors countries in recent years (Lessend and Williamsons, 1987; and Pastor; 1990). Ajayi (1996) has attributed sluggish growth and persistent balance of payment deficit in most developing countries including Nigeria, despite private transfer and long terms capital inflows to capital flight. Therefore, financial repression and constraint are causes of capital flight and prior to the financial sectors reform in Nigeria, interest rate were administratively determined. This affects investment below the market determined rate.

In a related dimension, if fiscal deficit is financed through bond sales, domestic residents may expect that at some future date, their tax liability may

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increase in order to pay for national debt. This would encourage domestic investors to avoid potential tax liability by moving their assets to foreign countries (Ajayi, 2001). Gordon and Levine (1989) further explain that declining terms of trade is a major cause of capital flight. Declining terms of trade leads to a contraction in the economic activities and fall in government revenue. Consequently, since government can no longer meet its obligation without an increase in taxes, investors anticipate higher taxes and therefore divert their investment abroad. Resident capital outflows which also lead to mismanagement in the form of expansive fiscal and monetary policies and exchange rate overvaluation create uncreative and make the domestic environment unattractive for investment (Ajayi 2001).

Capital flight in whatever form will affect investment negatively in an economy like Nigeria due to abnormal/illegal capital outflow. This is because capital ought to be used to finance either current account deficits, increase in official reserves or to provide necessary infrastructure such as good road, power, security etc in order to make the economy more attractive and conducive for investors to invest, will be moved abroad by the wealthy people who have control over these resources. While those without resources are subjected to the consequences of investment inabilities in the country. Eventually, this will lead to a fall or reduction in the rate of investment. However, the trend in investment in Nigeria has not been stable (Fluctuating) due to political instability and inconsistencies in government policies in increasing investment rate. The main thrust of this study is to examine the impact of capital flight on investment dynamics in the Nigerian economy, and also to evaluate the mechanism of effect of capital flight on investment level both in the short and long-run as a result of

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shock. This is to proffer policy measures that can be adopted by concerned authorities in enhancing investment rate in the economy towards economic growth.

The remaining part of this paper is divided into four sections. Section 2 discusses literature review and theoretical framework. Section 3 highlights the methodology employed in carrying out the research. Section 4 analyses the result while the last section concludes and proffers policy recommendations.

Section 2

2.0   LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1   THEORETICAL FRAMEWORK

2.1.1 MEASUREMENT OF CAPITAL FLIGHT

One of the key macroeconomic objectives of any nation is to achieve accelerated growth and development. To realize this goal, efforts must be made to provide a conducive and attractive environment for investors to invest as most economists have noted that investment is the machinery for economic growth and development. But capital flight has been regarded as a major factor contributing to the mounting foreign debt problem and inhibiting growth and development effort in developing countries such as Nigeria (Cuddington, 1986). Since there are no empirically agreed definitions of capital flight, even though its activities have been identified for periods dated back to the seventeenth century. Although, there have been theoretical misconception in respect to measure of capital flight because of two main reasons. One, the concept itself is ambiguous which makes it glare that different definitions of capital flight may yield different

measures or magnitude of the problem. Two, even if there were to be consensus that 'Capital flight' means "money that runs away" such capital is in most cases may not be reported to the compliers of balance of payment statistics. This makes it difficult to deduct capital that flees abnormal risks at home from total capital outflows. In the light of these, we shall not attempt to distinguish "normal" from" abnormal" capital outflows. Rather, we shall concentrate on measuring resident capital outflow. There are three main approaches to the quantification of capital flight; namely, the balance of payments accounts approach, the residual approach, and the bank deposits approach. These approaches are briefly discussed below:

1. **The Balance of Payment Account Approach**

In the pioneering studies on capital flight, the phenomenon was measured using the balance of payment account (Cuddington, 1986). In the balance of payment approach, capital flight is measured as the sum of recorded short term capital outflows (K) and unrecorded net flows or net errors and commission (M)

$$KF(BOP) = K + M$$ ……………………………………………….. (1)

Where KF (BOP) is capital flight measured by the balance of payment approach. Cuddington (1986) further observed that private short -term capital movement is either imprecisely or not reported at all especially in countries which impose capital controls. The failure to precisely record short-term positive capital flows show up in net errors and omissions of the country's balance of payment.

2. **The Residual Approach**

The residual approach was developed by the World Bank (1985) and Erbe (1985). It was further modified by Morgan Guaranty Trust (1986).This approach arose out of the feeling that the balance of payment accounts were not sufficient

to estimate resident capital outflows. In the World Bank (1985) and Erbe (1985) version of the residual approach, capital flight is calculated as the difference between sources and uses of capital inflows. The sources of capital inflows are increases in external debt and foreign direct investment. These capital approaches arose out of the feeling that the balance of payment accounts approach was not sufficient to estimate resident capital outflows. Capital inflows are used to finance either current account deficits or increase in official reserves. The inflows that finance neither current account deficits nor increase in reserve constitute capital flight.

In essence, capital flight in the World Bank (1985) and Erbe (1985) version of the residual approach is measure as:

$$KF - WB = EDEBT + G + F - N \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (2)$$

Where: EDEBT is external debt; G: foreign direct investment; F: current account balance; and N: increase is reserve.

Positive values of KF-WB represent capital flight while negative value is capital re-flows or the reverse capital flight.

Morgan Trust (1986) adjusted the World Bank (1985) and Erbe (1985) measure for changes in foreign assets held by domestic agents other than the banking system. According to Morgan Trust (1985), capital flight is measured as:

$$KF - MORG = EDEBT + G + F - N - I \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (3)$$

Where: KF-MORG is the Morgan Trust (1986) measure of capital flight; and I is increase in foreign assets of the domestic banking System.

3. Bank Deposit Approach

The third approach to the measurement of resident capital outflows involves measuring the increase in recorded foreign bank deposits of a country's

residents. However, this is a controversial measure since even if there are statistical sources which distinguish between official and private holdings, it cannot be argued convincingly that all private funds held abroad are recorded by the relevant authorities. The difficulty in compiling the bank deposits data is compounded by the fact that some funds deposited in banks do not report to the IMF or other relevant authorities while others may be held in non bank foreign assets. Another problem arises from the desire of the depositors to conceal to their nationality in order to minimize any potential risk they may perceive. Consequently, foreign banks deposit owned by a country's residents is likely to under estimate resident capital outflow.

The three approaches to the measurement of capital flight have been criticized in the literature. Hence, none can be considered satisfactory.

2.2 EMPIRICAL REVIEW

2.2.1 DETERMINANTS OF INVESTMENT

In attempting to identify the key determinants of investment in the Nigerian economy, it's desirable to draw on current directions and trends in investment theory concerning less developed countries such as Nigeria. In addition to investment determinants, recent theories as exemplified in the work of Cones (1987) and Williamson(1987), suggested that investment can be significantly affected by such factors as micro economic instability, macro economic policy (monetary ,fiscal and exchange rate), uncertainty and irreversibility, and credibility of policy reforms. A particular attention will be given to an exploration of the effect of uncertainty, external debt and exchange rate policy on investment determination in Nigeria .It has been established in the

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theoretical analytical literature that uncertainty plays a critical role in investment decision because they are irreversible.

Accordingly, it favours investment decision when uncertainty is high or increasing. Thus, the main consequence of uncertainly is to reduce the level of investment .In Nigeria, uncertainty arises from many sources including: high and unpredictable inflation and price variability, uncertain demand for fluctuating real output, exchange rate variability, interest rate volatility, macro economic instability arising from external shocks, incomplete credibility of policy reforms, foreign debt burden and socio political instability.

High external debt shock and external burden have been shown to have dampening effect on investment (Gordon and Levin, 1989). The existence of high external debt shocks and debt servicing affect investment mainly through debt over hang and credit rationing .The debt over hang refers to a situation in which a high debt burden discourages investment especially in developing countries like Nigeria since they view the accumulated debt stock as tax on their income or production.

Even though, numerous studies have been conducted to identify the determinants of capital flight in developing countries such as Nigeria .Epstein (1985), Pastor (1990) and Ajayi (1992, 2001) found that exchange rate misalignment is a critical determinant of capital flight .To them, if a currency were overvalued economic agents would expect the currency to be devalued in the future and in order to protect their assets against exchange rate risks, domestic. Wealth holders would shift out the domestic assets into foreign assets to avoid potential loss. Ajayi (2001) examines the narrowness of the domestic money and capital markets in terms of their financial instrument and proclaims that narrow

market limits the availability of investment opportunities which is further compound by 'financial repression .This renders investment in developing economies less attractive to investors.

According to Epstein (1995), large fiscal deficit also provides attractive medium for capital out movement since it induces inflationary expectation. Similar to the exchange rate risks highlighted above, he noted that to avoid inflation, tax and the erosion of their money assets by inflation, domestic: wealth owners usually convert their domestic assets into foreign assets. Outside the domestic policy shortcoming as explained above, Olopoenia (1996) looks at the external factors promoting capital flight in developing countries such as Nigeria. His findings were that array of financial instrument, existence of political and economic stability in foreign countries as well as favorable tax climate are critical factors.

Awung (2003) observes that one of the factors in the capital flight literature is loan disbursement or debt service payment .Some economists have argued with him that disbursement is a major cause of capital flight in the sense that the availability of foreign exchange to pay foreign debt obligation increases the potential for graft and corruption.

Ajayi (2001) also noted that the abuse of office through the misuse of such funds could lead to capital flight. This is noted when highly placed public officials usually use the paraphernalia of their office to siphon public funds to foreign countries solely for their private use. Sequels to the facts that the above factors identified are important determinants of capital flight, the relative impact of these factors on Nigeria and their effects on investment have not been adequately investigated.

2.2.2 CAPITAL FLIGHT AND INVESTMENT DYNAMICS IN NIGERIA

The economic mis-management in the form of expansive fiscal and monetary policies, and exchange rate overvaluation create uncertainly and make the domestic environments unattractive for investment. This will reduce the rate of investment in countries such as Nigeria .Since expansive monetary and fiscal policies are inflationary while exchange rate overvaluation creates condition for expected devaluation, residents in such situation usually have no confidence in announced policies to deal with the economic problems, preferring instead to take their assets out of the country. This macroeconomic environment is influence by economic and non-economic factors as well as internal and external factors. The economic factors include declining terms of trade, exchange rates over valuation, fiscal deficit, financial repression and constraints, and increasing foreign real interest rate. Non- economic factors are the corruption of political leaders and lack of accountability (Ajayi 2001).

Declining terms of trade is a major cause of capital flight. It leads to a contraction in economic activities. This occurs when there is reduction in investment, exchange rate over valuation and thus, the fears of expected devaluation.

Consequently, there is macroeconomic disequilibrium which is manifested in balance of payment problem, fiscal deficit and decline in investment. This usually forces the governments to change its programme. Since declining term terms of trade leads to a fall in government revenue and government can no longer meet its obligation without an increase in taxes, as such, investors anticipate higher taxes and therefore divert their investment abroad (Gordon and

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Levine, 1989). With the diversion of investment abroad, the rate of domestic investment will fall.

More so, exchange rate misalignment also encourages capital flight which in turn has effect on investment. Where the local currency is over valued, it leads to real exchange rate appreciation. In order to correct the over-valuation when a currency devaluation is forecast, investors usually move out their domestic;, assets and invest in foreign countries in order to avoid the capital loss that will results from devaluation . Ajayi (2001) found that the degree of appreciation of the Nigerian naira facilitated capital flight. Consequently, this sets investment below expectation .Budget deficit is another cause of capital flight .In order to trance the budget, government usually prints money; a practice which is inflationary. If inflation persists, individuals will likely choose to reduce their real holding of domestic currency in order to protect themselves against the so called inflation tax.

Some of these reduced holdings will appear as capital flight (Pastor 1990). In a related dimension, when fiscal deficit is financed through bond sales, domestic residents may expect that at some future date, their tax base liability may increase in order to pay for national debt. This would encourage domestic investors to move their assets to foreign countries to avoid potential tax liability (Ajayi 2001).

Financial repression and constraint is another cause of capital flight. In most developing countries like Nigeria, prior to the financial sector reform, interest rates were administratively determined and this sets return on investment below the expected market determined rate. Also in most developing countries, there is the absence of a well developed capital and money market

.These markets have limited instruments in which investors can invest (Khan and Hague, 1987). Conversely, investment is discouraged and people prefer moving their investment abroad.

External factors such as rising foreign real interest rate, economic stability and diversified investment opportunities all contribute to attract capital from developing countries. Rising foreign real interest rate facilitates capital flight by changing the relative return in investment. As foreign real interest rate rises, public sector foreign liability increases. Also, private sector liability increases as national output falls due to the decline in investment. Most residents, who expect increase in taxes, divert their investment abroad because they have foreseen that the return on capital flight will be suffered by investors paying high tax base. Consequently, the rate of investment is reduced and as such, general output is affected.

Section 3

3.0   DATA DESCRIPTION AND METHODOLOGY

3.1   DATA DESCRIPTION AND SOURCES

This paper mainly make use of secondary data and the time series variables selected for this study are selected based on theoretical and empirical existing work, in other to examine the effect of capital flight on investment dynamics in Nigeria between 1970 and 2006. Investment (INV) and three determinant variables- Capital flight (CFL), Interest rate (INT) and Exchange rate (EXR)-are considered in our analyses. Data on the selected time series variables are sourced from various issues Annual Abstract of Statistics of National Bureau of Statistic (NBS) and Central Bank of Nigeria Statistical Bulletin.

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3.2 EMPIRICAL METHODOLOGY

In order to capture the precise dynamic effect of capital flight on investment level in Nigeria, as a system of equation the empirical model is specified as:

$$INV_t = \theta_0 + \theta_1 CFL_t + \theta_2 INT_t + \theta_3 EXR_t + u \qquad (1)$$

Where: θ_0 is the constant; θ_{1-3} is the co-efficient of the effects and u_t is the stochastic error terms.

The model (1) is specified to examine the long-run dynamic effect of capital flight on investment level in Nigeria.

However, from the specified model (1) a negative relationship is expected between investment and the three independent variables. It is symbolically expressed below as:

$$\frac{\partial INV}{\partial CFL} < O; \quad \frac{\partial INV}{\partial INT} < O; \text{ and } \frac{\partial INV}{\partial EXR} < O$$

The stationarity properties of the time series variables are examined using the Augmented Dickey-fuller (ADF) approach and the Augmented Engle-Granger (AEG) co-integration is employed to determine whether the selected explained variables are co-integrated with investment in Nigeria.

3.2.1 AUGMENTED DICKEY-FULLER TEST

The time series variables characteristics and order of integration are determined using ADF unit root test developed by Dickey and fuller (1979). This is based on the following model:

For Intercept:

$$\Delta X_t = \delta_0 + \delta_1 \Delta X_{t-1} + \sum_{i=1}^{n} \gamma_i \Delta X_{t-i} + \varepsilon_{t1} \qquad (2)$$

For Trend:

$$\Delta X_t = \delta_0 + \delta_1 \Delta X_{t-1} + \delta_2 t + \sum_{i=1}^{n} \gamma_i \Delta X_{t-i} + \varepsilon_{t2} \qquad (3)$$

The tau-statistic test the null hypothesis of $\delta_1 = 0$ (i.e. no stationary) against the alternative that $\delta_1 < 0$ (i.e. stationary). If the series is not stationary at level i.e. $I(0)$ it will be differenced d times to be stationary to determine its order of integration.

3.2.2 ENGLE-GRANGER COINITEGRATION TEST

The Engle-Granger (1987) cointegration test is employed to determine if the variables in equation (1) are cointegrated or linearly stationary. This is to investigate the long-run dynamic effect of capital flight on investment level in Nigeria. The test requires the estimation of the residual term (U_t) in equation (1) based on the model below:

$$\Delta \ell_t = \phi \ell_{t-1} + \sum_{i=1}^{k} \lambda_i \Delta \ell_{t-i} + \omega_t \qquad (4)$$

in which the presence of unit root is examined. If the estimated residual term is stationary i.e. $I(0)$, then the relationship between investment and explained variables-capital flight, exchange rate and interest rate are said to be cointegrated.

3.2.3 ERROR CORRECTION MECHANISM (ECM)

To investigate the short-run dynamic behaviour of the relationship between investment and capital flight, the error correction model is employed. This is specified as:

$$\Delta INV_t = \varphi_0 + \varphi_1 \Delta CFL_t + \varphi_2 \Delta INT_t + \varphi_3 \Delta EXR_t + \varphi_4 U_{t-1} + \varepsilon_t$$

The equation (4) is to explain the short-run behaviour of the specified model in equation (1) as a result of changes from the long-run equilibrium and the mechanism is capture by the error term (U_t).

Section 4

4.0   EMPIRICAL RESULT ANALYSIS

4.1   UNIT ROOT TEST RESULTS

The ADF unit root test result shown in table 1 indicates that the Investment (INV), Capital flight (CFL) and Exchange rate (EXR) in levels reject the null hypothesis of non stationary at the 1% and 5% Mackinnon (1988) critical value. This implies that they are integrated of order zero i.e. $\mathrm{I}(0)$. The interest rate (INT) was the only time series found to be stationary at first difference. These results are consistent with previous literature that found most of the time series variables stationary and mean reverting. Therefore, for the essence subsequent tests all the considered time series variables in this study are regarded to be integrated of the same order.

Table 1:   ADF UNIT ROOT TEST RESULT[1]

Variables	Level		First Difference		Order of Integration
	Intercept	Trend	Intercept	Trend	
INV	-3.946* (3)	-3.940** (8)	-3.816* (9)	-4.152** (9)	I(0)
CFL	-4.087*(1)	-4.016** (1)	-5.010* (5)	-5.049* (5)	I(0)
INT	-2.688 (1)	-3.075 (1)	-6.338* (1)	-6.261* (1)	I(1)
EXR	-4.284* (1)	-4.268* (1)	-6.812* (1)	-6.709* (1)	I(0)

Note: 1. Result extract from the E-view 5.1 Output. The value in brackets show the no of lags which selection is based on minimum AIC and SIC.
*significant at 1%   ** significant at 5%

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4.2 COINTEGRATION TEST AND SHORT-RUN MECHANISM ANALYSIS

The Augmented Engle-Granger (AEG) cointegration test is carried out based on the estimated model 1, which result is shown in table 2. The residual term (U_t) series generated from it was found to be stationary at level for both the intercept and trend models. The result presented in table 3 shows that the null hypothesis of no cointegration is rejected at the 1% and 5% Asymptotic critical level for intercept and trend models respectively. Therefore, there exist long-run relationship between investment dynamics and capital flight in Nigeria. Also, all the factor variables-capital flight (CFL), interest rate (INT) and exchange rate (EXR) were found to have long-term insignificant effect on investments in Nigeria both partially and simultaneously. Although, the positive effect of capital flight (CFL) on investment is not in tandem with a-priori expectation because capital flight in whatever form will affect investment negatively in an economy like Nigeria due to abnormal/illegal capital outflow. Likewise, the overall estimated model was found to be statistically unstable and unreliable to explain the long-run behaviour of the relationship between investment and capital flight.

As a result of the structural instability in the long-run specified model, the short-run analysis through Error Correction Model (ECM) mechanism was found to be statistically inestimable using the E-Views 5.1 because the ECM is close to a singular matrix as a result of the trend pattern of capital flight over the years. Other statistical packages like Statistical Package for Social Science (SPSS) was used to establish the short run dynamic interaction between investment and capital flight in Nigeria as a result of shock mechanism but capital flight as a factor variable was excluded from the estimated result due to its high collinearity with other factors. Therefore, the short-run behaviour between investment and capital

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flight can not be established without the inclusion of other perceived and significant factors like economic stability in the analyses.

Table 2:   COINTEGRATING REGRESSION RESULT[1]

Dependent Variable: INV

Method: Least Square

Sample: 1970-2006

	C	CFL	INT	EXR
	-218.406	19.1338	-40.8139	-0.00089
Std.Er:	1076.27	41.0727	44.7324	0.35418
T-Stat:	-0.2029	0.46585	-0.9124	-0.00252
Prob:	0.8404	0.6444	0.3682	0.9980

R^2= 0.0264   Adjusted R^2= -0.0622   F-Statistic= 0.2977

Prob(F-Statistic)= 0.8268   Durbin-Watson Stat= 1.3822

1. Extracted from the E-View 5.1 output

Table 3:   ENGLE-GRANGER COINTEGRATION TEST RESULT

Model	No of Lag	Tau Statistic
Series: $U_t = INV_t - \eta_0 - \eta_1 CFL_t - \eta_2 INT_t - \eta_3 EXR_t$		
Intercept: $\Delta U_t = \phi_0 + \phi_1 U_{t-1} + \sum_{i=1}^{n} \lambda_i \Delta U_{t-i} + \omega_{t2}$	3	-3.9649
Trend: $\Delta U_t = \phi_0 + \phi_1 U_{t-1} + \phi_2 t + \sum_{i=1}^{n} \lambda_i \Delta U_{t-i} + \omega_{t2}$	8	-3.9483

Note: the selection of lag is based on minimum AIC and SIC.

Section 5

5. CONCLUSION AND POLICY RECOMMENDATION

This study critically analyzes the impact of capital flight on investment dynamic behavior in the Nigerian economy using the time series data between the periods of 1970-2006. A relatively large factor that can potentially influence investment is considered in the econometric analyses like Interest rate (INT), Exchange rate (EXR) and Capital flight (CPF). Our econometric evidence revealed that all the considered time series variables excluding interest rate were found to be stationary at levels from the Augmented Dickey Fuller unit root test result and also, the Engle-Granger cointegration test was used to exert the long-run relationship between investment and capital flight in Nigeria.

From the empirical findings of this study policy options are recommended to enhance a stable rate of investment in an economy like Nigeria, all efforts should be geared by the government towards checking the ineffectiveness of investment caused by capital flight. Such efforts include indigenization policy, improved investment climate, consistency in government policies, and political stability among others. This will eventually help to reduce capital flight and encourage both domestic and foreign investment.

More so, this will also help to attain economic growth and development in less developed countries (LDCs). However, investment being the major determinant of economic growth can highly be increased in Nigeria by providing a more

conducive and attractive investment climate, provision of infrastructures and an encouraged savings.

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