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Capital flows and the distribution of income in sub-Saharan Africa

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ABSTRACT

In this study, we examine the differential effects of capital flows on the distribution of income in 21 sub-Saharan African (SSA) countries over the period 1984–2013. The empirical results show that FDI has a moderate positive effect on income inequality, which suggests that FDI increases income inequality in both the short and the long-run. Remittances, external debt and aid flows, however, do not have robust impact on income inequality. Further, our findings indicate unidirectional causality from FDI to income inequality in the short-run when we account for heterogeneity. Finally, our country-specific estimates indicate that capital flows have mixed effect on inequality in SSA.

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1. Introduction

Over the last few decades, researchers and policy analysts have concentrated on the benefits of capital flows to developing countries. For many Sub Saharan African (SSA) countries, domestic resources are often inadequate to fund projects due to the low level of development and its associated low savings rate. The United Nations Economic Commission for Africa's [UNECA] (2006) report shows that the investment rate in SSA had to increase from the then level of 20%–22.5%, to promote development. Accordingly, many developing countries embarked on market reforms to attract foreign capital. Foreign capital inflows to SSA increased from $8 billion in 2000 to $45 billion in 2006, which is nearly 6% of its gross domestic product (GDP). The figure increased to $46.5 billion in 2008 and reached $73.6 billion in 2012 (UNECA, 2006; World Bank, 2014a). In 2013, capital inflows to SSA accounted for 5.3% of the region's GDP (World Bank, 2014b).

Inequality is also on the agenda of many developing countries because of the failure of the past policies to significantly reduce global poverty in an era of increasing liberalization despite robust economic growth (Milanovic, 1999). Azis and Shin (2015) claim that the volatility of global liquidity and capital flows could have detrimental effects on growth, income inequality, and poverty. Many studies have examined the growth effects of capital flows but little on income inequality (Castells-Quintana and Larrú, 2015). The study fills the gap in this light. The motivation for this study is based on the assumption that distributional effects drive the competition for resources by various interest groups (Joskow and Rose, 1989). Evidently, the interrogation into who gains and who is held back by capital flows is an important issue especially in SSA because of its power and wealth effects. However, how capital flows to SSA affect the distribution of income has not been studied. Accordingly, this study examines empirically the differential effects of the individual components of capital flows (FDI, aid, debt, and remittances) on the distribution of income in SSA, the first to our knowledge to do this. It is important

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to note many studies have examined the individual effects on income inequality. For example, Anyanwu (2011) and Adams and Klobodu (2016) investigate the effect of remittances and inequality in Africa, while Herzer et al. (2014) and Herzer and Nunnenkamp (2011) analyze the effect of FDI on inequality and others (Chong et al., 2009; Castells-Quintana and Larrú, 2015) examine the aid—income inequality nexus for Latin American countries.

With respect to the individual components, Foreign direct investment (FDI) inflows to SSA have increased persistently from an amount of $18 billion in 2004 to $29 billion in 2010 and $42 billion in 2014, compared to the total value of $54 billion and $381 billion for East and South-East Asia respectively and $159 billion for Latin America and the Caribbean (United Nations Conference on Trade and Development [UNCTAD], 2015). The net private capital flows on the whole increased by 3.3% and the net portfolio equity decreased by 29% in 2013 (World Bank, 2015). Although the services share in Africa's FDI is still lower than the global and developing-country averages, in 2012, services accounted for 48% of the total FDI stock in the region, more than twice the share of manufacturing (21%). The increase in the flow of FDI to SSA is attributed to the increased global competition for natural resources, higher commodity prices, and a fast rising middle class. Similarly, debt inflows have increased consistently in the last fifty years. For example, the external debt stock of SSA which stood at $213.5 billion in 2000 increased to $234.4 billion in 2005 and $296 billion in 2010, compared to the total developing country net debt flow of $542 billion in 2013 (World Bank, 2013, 2015).

The SSA region as the poorest in the developing world also received the largest amount of official development assistance. For example, out of a total ODA of $192.5 billion in 2013, the SSA region received $45.2 billion (23.47%). In particular, SSA countries have received roughly the same amount of ODA (around 23% of the world ODA) since 1985 (Pham, 2015). It is not surprising therefore that the share of aid in national budget has maintained an upward surge since 2000, and reaching over 50% for many SSA countries, with Liberia's ODA/GNI ratio exceeding 130% in 2013. Thus, SSA could be described as the most dependent region in the world. Additionally, for the first time in 2013, recorded remittances to developing countries were estimated at $404 billion surpassing official development assistance (ODA) as well as private debt and portfolio equity making remittance a key resource flow. In the same year global remittance flows, including those to high-income countries were estimated at $542 billion (World Bank, 2014a, b).

Obviously, understanding how this massive inflow of capital is impacting on the distribution of income has policy implications in terms of the appropriate targeting for particular types of capital in promoting socioeconomic development. Our study makes a contribution in this light. The focus on SSA is important because the region is increasingly recognized as an investment destination, due to its natural resources endowment and recent discovery of oil in many of the countries in the region. Further, rising inequality is known to slow the rate at which growth reduces poverty (Africa Progress Panel, 2013; Adams and Atsu, 2015). Consistent with this view, Adejumobi (2014) argues that increasing inequality may threaten not only the little progress the African continent has made but its collective sense of humanity and decency which defines Africa's value system. According to the International Monetary Fund [IMF] (2007) and complementary works by the (United Nations, 2013), high income inequality can be detrimental to economic stability as well as economic growth. Although inequalities have diminished over the period, Africa still remains the poorest in the world and the second continent on the income inequality chart after Latin America (African Development Bank [AfDB] 2012). Evidently, being one of the most unequal regions in the world, it is important to understand what factors could reduce or worsen the condition. The AfDB (2012) report reveals that six out of ten most unequal countries were in Sub-Saharan Africa, with South Africa being the highest with a Gini coefficient of about 70 (World Bank, 2012). The World Bank has noted that no country has managed to transition beyond a middle-income status while maintaining high levels of inequality as the resulting risk-levels may distort public spending towards security measures and away from those essential for human development progress.

The argument of this paper is that if capital flows do not have the same socioeconomic effects and that the national policy matters, it is of great importance for these differences to be examined so that the appropriate targeting of particular capital flows could be encouraged to promote sustainable development. To achieve this objective, the study employs a panel vector autoregressive (PVAR) technique and for robustness, additional tests that account for heterogeneity and cross-sectional dependence. The rest of the paper is organized as follows. The next section presents the literature review after which the methodology is described. The results are then presented and discussed and policy implications given.

2. Literature review

Isolating the effects of capital flows on income inequality or establishing a relationship between the two variables is a difficult task, however, two main perspectives (optimist and pessimist) stand out in explaining how capital flows impact the distribution of income. The optimist view relates to the neoclassical or modernization paradigm which suggests that liberalization of capital account and integration in to the world economy should lead to reduction in income inequality within and across nations (Wade, 2001; Heshmati, 2005). The free flow of capital, according to this view allows capital to seek out the highest rate of return and benefits the host country in terms of reducing the funding constraint, spreading of best practices of corporate governance, and limiting the ability of governments to pursue bad policies (Hecht et al., 2002).

Further, the influx of capital could reduce the cost of capital and thereby raise investment and curb unemployment. Additionally, because labor earnings are the primary source of income for most low-income households, capital inflows is expected to improve the distribution of income (Coibion et al., 2012; United Nations Development Programme (UNDP) 2014). Beer (2015) made a similar argument in the assertion that continued influx of capital to resource constrained countries could help to expand the middle class and increases employment and the savings rates among the poor, leading to reduction in

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