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## Economic development in Africa

### Reclaiming policy space: Domestic resource mobilization and developmental States<sup>1</sup>

Overview by the UNCTAD secretariat

#### *Executive summary*

The objective of this year's report is to examine the potential of African countries to increase their total domestic resource envelope, in order to reduce dependence on official development assistance and diversify their development resources. A complementary objective is determining how to channel these resources into productive investments to increase their efficiency. Most of the challenges to development in general, and to domestic resource mobilization and investment in particular, are manifestations of market failures plaguing African economies. Addressing these challenges requires an appropriate "policy mix" or "diversity of policies" tailored to the specific situation of each country, rather than a one-size-fits-all approach. The present report highlights the need for "developmental States" in Africa with the required policy space to design and implement policies that address their priorities and make optimal use of available resources in a way that leads to a virtuous circle of accumulation, investment, growth and poverty reduction. The report argues that it is only by reclaiming its developmental role that African States can give true meaning to the rhetoric of "ownership" in macroeconomic and resource management.

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<sup>1</sup> The information in this document should not be quoted by the press before 26 September 2007. It should be read in conjunction with UNCTAD/ALDC/AFRICA/2007/1.

1. Recent economic performance in Africa has been strong, with a growth rate of 5.7 per cent in 2006. Encouraging as this performance is, these rates are insufficient for African countries to reach the first Millennium Development Goal of halving poverty by 2015. Indeed, it has been estimated that growth rates of 7 to 8 per cent are necessary to achieve this goal.
2. To achieve such growth rates, African countries require a significant and sustained increase in resources devoted to promoting development. Recent editions of the *Economic Development in Africa* series have outlined the problems of excessive dependence on external resources such as foreign direct investment and official development assistance.
3. A focus on improving domestic resource mobilization and improving the quality of its use would not only increase the level of resources available for development and poverty alleviation, it could also create the policy space necessary for African States to claim real ownership of their development processes.
4. Three aspects need to be taken into account. Firstly, the amount of domestic resources should be maximized where possible. Secondly, these resources must be made available for productive use. Finally, these resources must be utilized efficiently and effectively.
5. Savings rates are lower in sub-Saharan Africa than in any other region. Though the savings rate for the region has improved slightly in recent years, from about 14.6 per cent of gross domestic product in 1992 to 17.6 per cent in 2005, it is still far below the 26 per cent achieved before Africa's "savings collapse" in the early 1980s. Gross domestic savings rates, however, provide only a partial image of the reality of savings in African countries. It is necessary to examine savings at the household and firm levels in order to understand the current situation and identify ways to increase the impact of private savings as a development resource.
6. For many households in Africa, especially in rural areas, incomes are very volatile. Many of these households do not have access to credit or insurance. Accordingly, saving is a necessary strategy for such households to smooth their consumption over time. These savings are for the most part held in non-financial assets such as livestock, real estate or jewellery. This partly reflects the symbolic value of such assets, but also reflects the difficulties of access to and confidence in the financial sector. The informal financial sector accounts for a majority of household financial saving. It offers households a variety of saving instruments that are tailored to meet their needs. The small proportion of household savings held in the formal financial sector reflects difficulties of access, lack of trust, and the inadequacy of formal sector saving instruments to meet most households' saving needs.
7. Corporate savings in Africa are an under-researched topic and, in the absence of data, it is difficult to go beyond a discussion of stylized facts. Large formal sector firms have their financial needs generally well catered to by the financial sector. However, smaller firms that are most representative of African enterprises report lack of access to and cost of finance as major constraints to their growth. As a result, corporate investments are mainly financed out of firms' own savings. This situation constrains the development of both the corporate sector and the financial sector.

8. Public sector resources have a distinct and complementary role to play vis-à-vis private savings. Public expenditure is essential for human capital development through its funding of essential public services such as education and health provision. Public investment can provide the resources for infrastructure which are indispensable for the private sector to thrive. Tax revenue, which represents almost all of government domestic revenue in African countries, is therefore an important factor determining the amount of public resources that can be used for development. Tax revenue is low in most sub-Saharan African countries, and recent reforms have had limited success in increasing it. This is due in part to structural features of sub-Saharan Africa economies which make tax collection difficult. It is also a reflection of low levels of State legitimacy, as taxes are not generally seen as being spent on improved public service provision.

9. Financial intermediation provides the crucial link between savings and investment. Despite households' demands for adequate savings instruments and firms' needs for credit, the financial sector in Africa performs poorly in terms of intermediation. The formal financial sector suffers from poor risk-management capacity, which translates into its activities being limited to meeting the needs of Governments and a small number of formal sector firms. While the informal sector succeeds in mobilizing considerable resources from households and small businesses, its institutions do not generally make these resources available for further investment. The considerable gap between formal and informal sector activities may be gradually narrowing, due to the emergence of microfinance institutions in the semi-formal sector, as well as to new information technologies that lower the costs of providing services to rural and poor areas.

10. Workers' remittances are increasingly being recognized as important sources of finance for development. Averaging 2.5 per cent of Africa's gross national income, remittances represent an important capital inflow, although their significance varies from country to country. They have been steadily growing and there are good reasons to believe that unrecorded remittance flows that transit through informal channels are at least as important as recorded flows. Remittances are mainly being used to meet basic needs and schooling. There is also, however, some investment in real estate and, to a lesser degree, in financing small and medium-sized enterprises or small infrastructure projects.

11. Capital flight currently denies African countries a considerable amount of domestic resources. It is driven principally by the high perceived risks of holding assets domestically, as well as by the dearth of safe and profitable investment opportunities in the region.

12. The low productivity of investment and high level of liquidity of banks in Africa suggest that the availability of domestic resources is only one side of the equation. Maximizing the impact of such resources on development will require much greater attention be given not only to increasing their volume, but to their use as well. Improving the mobilization and use of domestic resources is likely to have a strong and positive impact on development in African countries. Increased levels of domestic resources and the corresponding decrease in dependence on aid and donors should enable them to increase their "ownership" of the development process. It should also enable them to identify priority sectors for investment which generate sustained growth within the context of a developmental State.

13. Raising the amount of domestic resources available for development is necessary but unlikely to be sufficient to have a significant impact on development in Africa. Indeed, domestic savings are only weakly correlated with investment in the region. The reason for this is that much of the investment in African countries is financed with external resources, particularly official development assistance. Increasing domestic savings will also give countries more policy space to implement strategies that correspond to their development priorities.

14. There are several ways for countries to increase their levels of domestic savings. Firstly, they could limit demographic growth while maintaining high growth rates, in order to increase savings, as incomes are shared among fewer people. However, the pandemics afflicting the region, most notably HIV/AIDS, malaria and tuberculosis, are currently having the opposite effect, as the active population is most at risk and resources are being used to provide care to the sick.

15. Secondly, financial sector reforms should seek to tackle the segmentation of the financial market in Africa by developing the informal and semi-formal sectors in a way that builds on their complementarities. They should also aim to increase the level of stable resources that can be used to fund long-term investments.

16. Thirdly, efforts should be made to increase investment opportunities in African countries. Indeed, low investment is probably one of the causes of low savings, as economies get trapped in a low-growth trajectory. The large number of banks in Africa that have excess liquidity confirms that the problem is not only a lack of financial resources, but also a lack of suitable investment opportunities. The fact that banks' resources are dominated by short-term deposits that cannot be invested in long-term maturity projects further restricts investment possibilities, especially investments in areas that are most needed in African countries, such as infrastructure.

17. Fourthly, measures should be taken to reduce capital flight and wasteful allocation of resources. This will involve tackling the issue of debt, as it is closely linked with capital flight levels. Steps should also be taken to improve the highly unequal distribution of wealth, which contributes to capital flight. It has been contended that declining factor productivity in the region, which has been attributed to particular patterns of political economy that have prevailed for much of Africa's post-colonial history, has cost Africa most of its growth potential. To remedy the situation and avoid a repetition of this, the State must be empowered to fully play its role in a context of clearly defined obligations and prerogatives.

18. Finally, the tax sector must be reformed to increase the revenue that Governments can draw upon to fund essential public services and investments. Improvements in taxation should be built upon three pillars. The first is a contract between taxpayers and the State that clearly links taxes to public service delivery. The second is coercion, in order to limit opportunistic avoidance. The third pillar is a credible mechanism to detect and punish tax evaders. The second pillar is enforced through the third.

19. Credit is the main channel through which savings are transformed into investments. In Africa, not all savings are used to finance investment, despite high demand for credit. The credit market is rationed and these constraints affect both the level and the efficiency of investment. Two major factors that limit firms' and households' access to finance are high transaction costs associated with credit

delivery to small customers, and high levels of information asymmetries between banks and borrowers due to the absence of credit information systems. Banks do not have mechanisms and infrastructure that are well suited for catering to the needs of small, low-income and rural-based economic agents. Accordingly, small borrowers are heavily reliant on the informal financial sector, and recent reforms have done little to remedy this fragmentation. Microcredit institutions are more efficient in rural credit markets, with loan administration costs up to 10 times lower than those of commercial banks. However, these institutions have limited financial resources and cannot respond to the needs of sizeable investment projects. Credit constraints are particularly severe for small firms, which dominate the size distribution of firms in Africa. Appropriate measures should therefore be implemented in order to address small firms' financial needs. In the absence of credit information, banks tend to concentrate their lending on a small group of clients who have developed a reputation for creditworthiness through past interactions. Ensuring creditworthiness *ex ante* is particularly important in the light of the difficulties of contract enforcement.

20. Financial policy reforms should acknowledge the existence and usefulness of a segmented credit market and incorporate measures that create more synergies between the formal and informal financial sectors. Furthermore, putting in place credit information infrastructure and developing a legal system that enforces credit contracts should be priorities in future reforms.

21. Access to credit is not the only factor affecting firms' performance in Africa. High risk and a generally poor business environment are key determinants of low investment in the region. Firm entry costs are particularly high in Africa, which may help explain the traditional prevalence of the public sector. The high entry costs that prevent firms from setting up in the formal sector can be cut drastically and quickly, as the experience of Equatorial Guinea and Ethiopia demonstrates.

22. Labour market regulations are highly rigid in a number of African countries. Even though these regulations effectively cover very few workers, due to the small proportion of formal sector employment, they send a negative signal to potential investors. Accordingly, labour market regulation should seek to balance the need for workers' protection against the need for investment.

23. Africa stands out as the region with the lowest level of investment protection, defined in terms of contract enforcement. Businesses cannot rely on the legal system and are forced to rely on unpredictable informal mechanisms.

24. The high tax rates on firms in Africa are a significant burden on firm growth and investment, and are a major factor in keeping firms in the informal sector. High taxes also encourage tax avoidance and capital flight. A simplified and predictable tax system should be developed that balances the profit interests of investors and revenue generation for the host country.

25. It would be naïve to expect that one could create an investment boom just by reducing the barriers discussed above. Nonetheless, a good investment climate is good for local business, and many of these barriers could easily be reduced if the political will existed. Indeed, Africa needs a developmental State to put in place the policy and physical infrastructure needed to reach savings and investment rates required to attain its development targets. It is such a State that enabled the

countries in East Asia to reach a level of economic performance that was dubbed a “miracle”.

26. The extraordinary economic performance since the 1960s of a group of developing economies in East Asia, labelled Newly Industrializing Economies (NIEs), has attracted many, often competing, explanations. The heterodox school of economics has pointed out that the performance of these countries was underscored by strategic development and industrial policies deriving from a symbiotic relationship between the political elite and entrepreneurs. Interventionist measures mediated through various institutions and policies were used to alter the long-term development trajectory. This simultaneous and specific combination of economic, political and institutional structures was overseen by what has come to be described as the “developmental State”.

27. The developmental State is characterized by its “developmentalist” ideology, putting economic growth and development at the forefront of government preoccupations. It is also defined structurally by “embedded autonomy” with regard to society, which gives it both the legitimacy and the capacity to pursue its objectives. UNCTAD’s research on NIEs has uncovered three common features that were crucial to their success. The first was a profit–investment nexus, creating a pro-investment environment and boosting profits of successful firms. The second was an export–investment nexus that linked investment to export performance, seeking to make domestic firms competitive in the global economy. The third feature was the creation and management of economic rents to reward the industries that were performing well with above-market profits in order to boost domestic savings, investment and exports. What is clear from the experience of NIEs is that neither the market nor the State can, by itself, achieve the ultimate goal of development. Rather, it is a pragmatic mix of market mechanisms and State actions, guided by an active development strategy, that best explains the success of these late developers.

28. The financial sector has an important role to play in the development process. Donor-induced reforms of the 1980s and 1990s have made African countries’ financial sectors more amenable to commercial principles in their operations. Beyond this, however, they have failed to meet many of their objectives. Few innovative financial products have been developed, oligopoly continues to be the norm, and coverage beyond urban areas has actually declined in many countries. There is a need to re-engineer financial institutions in a way that addresses the specific developmental issues in African countries. To start, the role of the central bank should be revisited with a view to making it a leading institution for development. There should be determined financial sector action or policies in favour of long-term financing and credit provision to the neglected small and medium-sized enterprises for which access to credit is a problem. Long-term public debt instruments will not only encourage the financing of public investments in infrastructure, but will also facilitate the management of government debt. The Government should also encourage the growth of different types of non-bank financial institutions to serve those segments of the market that are at present unattractive to the commercial banks. There is reason to believe that some form of government action to fix the weaknesses of the financial sector in Africa will be welfare-enhancing. This should take the form of a flexible monetary policy that emphasizes job creation rather than strict inflation containment. Fiscal and monetary policies could be complemented with measures to underpin a profit–investment

nexus. The capacity of Governments to implement this type of policy will depend on the quality of institutions and governance, as well as on macroeconomic stability.

29. Several observers have expressed doubts not only about the quality of institutional infrastructure, but also about the capacity of sub-Saharan African States to design, implement and monitor such complex and demanding policies. Behind this is a view of the African State as unable to escape patterns of corrupt, predatory or even kleptocratic rule. This is a partial and distorted perspective on the African State that fails to take into account the significant differences between State histories and performances. Neither does it consider the debilitating influence of external factors such as oil price shocks, volatile and generally declining real prices of commodities, and interest rate hikes on external debt. Accordingly, it has also been noted that the negative view of the African State that has prevailed since the early 1980s is more a reflection of an economic ideology that is inherently distrustful of the State than an accurate portrayal of most African States. This same economic ideology, neoliberalism, informed the structural adjustment programmes undertaken in many African countries during the 1980s and 1990s.

30. A closer look at the political and economic history of the continent reveals strong economic performances, achieved under the auspices of strong States, in the 1960s and early 1970s. Starting in the mid-1970s, a combination of oil price hikes and export commodity price falls seriously affected African economic performance, leading to increased international borrowing. The subsequent rises in interest rates on external debt led to economic collapse in much of the region. One of the reasons African countries were hit so hard by the deteriorating international economic conditions of the late 1970s and 1980s was lack of economic diversification. African countries, in many ways following the textbook advice of exploiting their comparative advantage, were highly dependent on unprocessed primary products. Asian NIEs, which were just as dependent on external trade as a driver of the economy, had a more diversified export sector with a higher technological content, and weathered the global recession of the 1980s with considerable success.

31. This was not the only difference between African countries and Asian NIEs that might contribute to explaining their divergent performances. The geopolitical context of East Asia in the 1950s and 1960s gave NIEs such as the Republic of Korea and Taiwan Province of China considerable strategic importance that translated into large flows of official aid and preferential market access to the United States. In Africa, the Cold War context led instead to proxy wars and support for kleptocratic dictatorships. Another important difference between African countries and Asian NIEs was the respective legacies inherited in the domains of State formation and national economic integration. These political/economic features proved crucial in conditioning the coping strategies or abilities of the two regions. The structural adjustment programmes further contributed to weakening State capacity and neglecting domestic capital formation in Africa.

32. Poor domestic policies cannot then be said to be the only factor in Africa's poor economic performance. Strong growth in the 1960s and early 1970s as well as in recent years shows that African countries are able to thrive in a propitious external environment. The time is now ripe for nurturing developmental States in Africa. This requires a degree of policy space that countries can use to identify their priorities and develop the strategies to meet the challenges they face. Currently, African countries do not have this policy space. Their dependence on external

funding gives donors considerable influence over policy formulation. Moreover, membership in the World Trade Organization also limits the array of policies that African States can pursue.

33. Advocating the use of government policy to correct some of the excesses of the market is not tantamount to a return to statism and protectionist economic policies. Rather, it is a call to move away from preoccupations with the ideological divide between State and market, between “dirigisme” and “laissez-faire”. African countries should seek to develop more refined and eclectic policy measures tailored to the specific circumstances and development challenges they face. To create the policy space necessary for the formulation and implementation of such policies, countries must start by seeking to improve the mobilization of domestic resources and become less reliant on external resources. Policies must be designed to promote enhanced domestic resource mobilization, encourage domestic investment, and engender a profit–investment nexus, in addition to an export–investment nexus as a basis for rapid capital accumulation and export promotion.

34. This is not a call for a replication of the East Asian developmental State. Even if this were possible, the initial conditions and external environments are of a different nature. African countries should rather seek to develop and pursue strategies that are tailored to their own institutional (economic, political and social) arrangements.

35. The main goal is to maintain macroeconomic stability while shifting the economy onto a higher growth trajectory. This will require a pro-investment environment predicated on political stability and consistency, as well as a robust legal and regulatory framework. Just as important is to create a competent and technocratic civil service that isolates decision-making from political pressure. There should be regular interaction between the domestic entrepreneurial class and the ruling elite, with civil society providing an oversight role and preventing abuse of power and State resources. The developmental State must above all be truly committed to its development ideology as a predictable long-term strategy. Escaping from poverty is not an easy task, and it may well prove more challenging in Africa than it has been for Asian NIEs. Fatalism is unwarranted, however, and developmental States could yet be an important element in meeting this challenge.

36. The debate over the direction of development policy in Africa should be underscored by a historical understanding not only of the institutions that underpin market development, but also of the evolution of the State in Africa. African countries should choose development strategies against the background of the available institutional options and their specific historical circumstances.

37. The discussion in this report suggests that there are financial resources in African economies which, if properly mobilized and channelled to productive investments, could boost economic performance. African countries could adopt a financial sector charter based on an arrangement between Governments, the business community and the financial sector. The charter should define the expected contribution of the financial sector to the national economic development agenda with clear implementation modalities. It could include the following elements:

- (a) A long-term investment fund based on the mobilization of the large amounts of unused financial resources in the banking sector: Additional funds could be sourced through voluntary contributions by the most profitable private and

public companies, as well as through pension funds, where available. In resource-rich countries, windfall gains accruing from periods of high commodity prices could be deposited in this fund. In the medium to long term, the development of stock exchanges and bond markets could also increase the access of firms to long-term resources.

- (b) Development banks: The failure of many development banks through mismanagement in the past should not divert attention from the fact that these banks could serve as an important conduit for the implementation of some government development policies, in particular focusing their activities on development sectors that are not traditionally attractive to commercial banks. They could be principally funded through overseas development assistance.
- (c) Microfinance: Countries should consider creating a microfinance fund dedicated to small credit applicants. This would serve to reduce the currently high interest rates paid on microcredit. It could be funded through overseas development assistance as well as voluntary contributions from the banking sector.
- (d) Capital repatriation and remittances: Capital flight could be reversed if African countries generated enough investment opportunities that could interest its diasporas. To counter the fear of some potential investors, countries could consider setting a time-bound capital flight amnesty with a “no questions asked” policy on capital repatriation. With regard to remittances, countries should seek to encourage the senders to use formal channels and at the same time develop programmes or a framework that facilitates an increase in the share allocated to investment rather than to consumption. To this end, they should encourage the development of remittance-related financial services at competitive costs, and encourage countries from which remittances originate to promote the use of official channels through tax breaks and low-cost transfer facilities.

38. Investment strategies must combine the requirements of a viable credit market with a good investment environment. For example, they should seek to lower credit transaction costs through the promotion of greater bank density in rural areas. While this could be done through one-off subsidies for branch establishment, there would be the need for complementary policies on infrastructure development in order to ensure the viability of these rural branches. Encouraging rather than hindering the operation of microfinance institutions would also help limit credit transaction costs. Encouraging links between microfinance institutions and commercial banks could help to deepen the financial sector as well as lower credit transaction costs.

39. The poor endowment of African economies in “information capital” has a high cost in terms of economic inefficiencies and the reach of the financial sector. As such, Governments should consider collaborating with the private sector in setting up and maintaining a comprehensive borrowers’ database.

40. Law and order and a credible legal system that enforces property rights are very important instruments of investor protection. In the short term, the creation of credible special commercial courts, sometimes called “fast-track” courts, capable of speeding up procedures in cases relating to investment disputes, could help. In the long term, increasing transparency and simplifying the procedures relating to foreclosure would be necessary to safeguard the interests of investors.

41. Savings and credit cannot boost investment in a climate that is not friendly to investors. Since the investment climate has different dimensions, there are several actions that could be taken to improve it. These include the provision of reliable infrastructure; the reduction of unnecessary bureaucratic barriers; a simplification of labour market regulations; and a redesign of tax policies to make tax fairer, more effective and administratively convenient. Such a tax policy should be accompanied by efficiency improvements in the use of government revenue as part of a broader policy of improving State–society relations.

42. Most of the challenges to domestic resource mobilization and investment discussed in the present report are manifestations of market failures plaguing African economies. This report argues that addressing market failures in Africa requires developmental States that carry out Africa’s development agenda. State action could be organized around the following three main objectives: fostering domestic economic integration, increasing strategic external integration, and allocating resources effectively to achieve clear development goals. African economies first need to be integrated internally before they can integrate gainfully into the world economy. Internal integration means that African economies strengthen their weak domestic linkages, particularly between urban and rural segments, as well as their sectoral input–output linkages. This will entail considerable amounts of public investment. Infrastructure development is key to the efficiency of the exchange of goods and services – in other words, the efficient functioning of markets. The State should prioritize investments in the rural economy, not only to redress current neglect, but also because of its size and importance in the development process and the potential for job creation by rural non-agricultural activities.

43. New investments should be carefully judged in terms of their potential contribution to internal integration and productivity growth within a context of capital accumulation based on a profit–investment nexus. Diversification rather than specialization is associated with the most successful development experiences in Asia and elsewhere. Policy measures in this regard would have to provide incentives for small and medium-sized firms already engaged in activities in these areas to upgrade, thereby addressing the issue of the “missing middle” in African productive sectors.

44. Countries should seek to design policies for a strategic and phased external integration congruent with the overall development strategy of each country. These should promote technological upgrading and skills formation. All flexibilities in the various WTO agreements should be fully exploited when trade and industrial policy are designed.

45. African countries need a “strong State” to carry out the continent’s development agenda. States should re-engage in the development business from which they have been marginalized. More particularly, the State must define a clear development vision and translate it into actionable policies. The State’s strategic intervention is needed to ensure that the country’s limited resources are mobilized and allocated in a way that is compatible with its overall development priorities and strategy. Strategic intervention combines subsidies, protection and free trade in proportions that are determined in accordance with the specific national situation. All industrialized and industrializing economies implemented various forms of protection of their infant industry in early stages of development. However, there

should be time limits to protection so that, once an industry becomes reasonably competitive, it should be allowed to face world competition.

46. The State needs a number of attributes so that it can play its rightful role in the process of Africa's development. Firstly, the State's legitimacy is an important prerequisite for its empowerment to act responsibly on behalf of the population. Secondly, the State should be able to define and implement development policies with some degree of flexibility. Development should be approached as a learning-by-doing process, so some failures are inevitable. Thirdly, training should be at the centre of development policy. Empowering the State means that those acting on its behalf have the necessary training and objectivity to design and implement policies that address their country's development challenges.

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