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ECONOMIC DEVELOPMENT IN AFRICA

RECLAIMING POLICY SPACE Domestic Resource Mobilization and Developmental States



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Chapter 1

DOMESTIC RESOURCE MOBILIZATION: ISSUES AT STAKE

A. Domestic resources

Low levels of domestic resource mobilization are believed to be caused by low levels of income, demographic factors and the structure of financial markets, which are generally difficult to influence in the short to medium term. It has often been assumed, therefore, that it is unrealistic to expect a large and sustained increase in domestic resource mobilization in Africa. As a result, increasing domestic resource mobilization has been described as the “hard option” for closing Africa’s resource gap (Aryeetey, 2004). Discussions on how to fill the resource gap have consequently tended to focus heavily on the increase of external flows such as ODA and FDI, as well as on debt reduction.

Such a focus is problematic in the African context for several reasons. ODA, while it remains a major source of finance in the region, is volatile, heavily concentrated and dependent on the priorities (often geopolitical or strategic, including security considerations) of development partners (UNCTAD, 2006a). FDI, which has attracted a lot of attention recently, is even more highly concentrated in Africa than is ODA. FDI is also relatively volatile and tends to focus on extractive industries with very few linkages to the domestic economy (UNCTAD, 2005). Portfolio investment, with the exception of South Africa, is of insignificant magnitude in the region (UNECA, 2006).

Strengthening domestic resource mobilization offers many potential benefits to African economies. Firstly, it will reduce the dependency on external flows, thereby reducing one of the sources of damaging volatility in resource availability, and reduce vulnerability to external shocks. Secondly, it will give African countries greater policy space, increasing their ownership of the development process as well as strengthening their State capacity. Thirdly, successful endeavours to increase the importance of domestic resources in the development process depend on the State’s ability to improve the domestic economic environment, creating important positive externalities. Finally, these efforts are also likely to be seen as a positive sign by donors and investors, thereby augmenting external resource inflows.

Three distinct issues must be considered for domestic resources to play an increased role in the economic development of African countries. Firstly, there is the matter of the amount of existing resources. Secondly, these resources must be held in a form that facilitates economically and socially beneficial allocation. Finally, available resources must be used effectively and efficiently.

The principal sources of domestic resources are private savings and government revenue. Workers' remittances, though not generated domestically, can represent a significant source of domestic resources once in the receiving country. Conversely, capital flight directly reduces the amount of domestic resources available for investment. It is important to examine these financial flows in our analysis of the total volume of domestic resource availability, as their impact could be positive, as in the case of remittances, or negative, as in the case of capital flight.

B. Trends in savings

Sub-Saharan Africa has the lowest savings rate of any developing region. In 2005, gross domestic savings in the region represented 17.6 per cent of GDP, compared with 26.0 per cent in South Asia, 24.0 per cent in Latin America and the Caribbean, and nearly 42.9 per cent in East Asia and Pacific countries (World Bank, 2007a).

This average savings rate for Africa, however, masks important disparities across the continent. In 2005, Algeria and the Republic of the Congo both achieved gross domestic savings rates of more than 50 per cent of their GDP, while Eritrea and Sao Tome and Principe both had rates far below minus 20 per cent, indicating dissaving on a massive scale (World Bank, 2006).

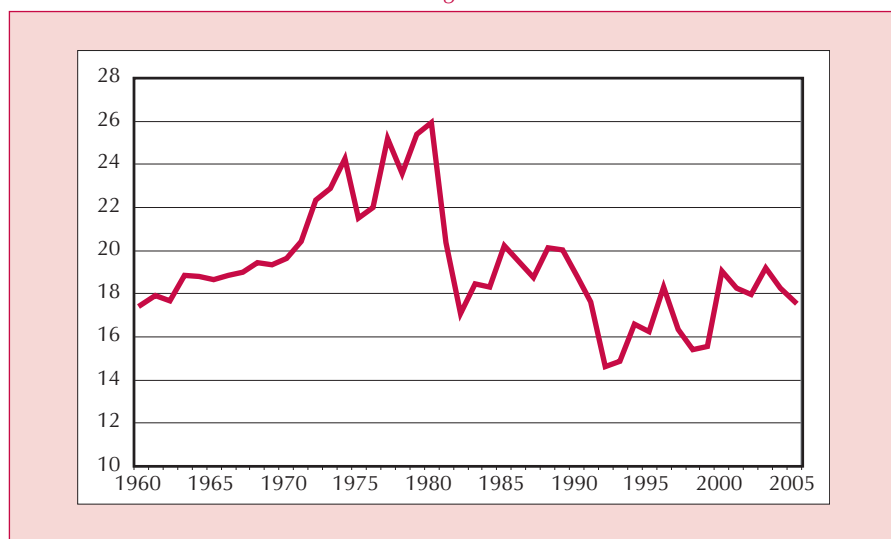
The savings rate for sub-Saharan Africa has broadly evolved over the years in the following pattern. From 1960 to 1974, it increased steadily from 17.5 per cent to 24.3 per cent of GDP (World Bank, 2007a). It then experienced much higher volatility before reaching its highest rate (nearly 26 per cent) in 1980. Then came Africa's "savings collapse" (Eldabawi and Mwega, 2000), as the rate fell to under 15 per cent in 1992. Since then, there has been a tentative recovery, yet the rate has remained low, and was only 17.6 per cent in 2005 (World Bank, 2007a).

Table 1
Distribution of savings rates in Africa, 2000–2005
 (Number of countries)

Negative	0–10% of GDP	10–20% of GDP	20–30% of GDP	Over 30% of GDP
11	14	13	7	5

Source: *World Development Indicators, 2007.*

Figure 1
Gross domestic savings in sub-Saharan Africa, 1960–2005
 (Percentage of GDP)



Source: *World Development Indicators, 2007.*

The trend has also been one of increasing disparity between developing regions, especially after 1980. Africa's saving rates have fallen, Latin America's have stagnated and East Asia's rates soared. These trends mirror the general economic performance of these regions over the past four decades or so (Hussein and Thirlwall, 1999).

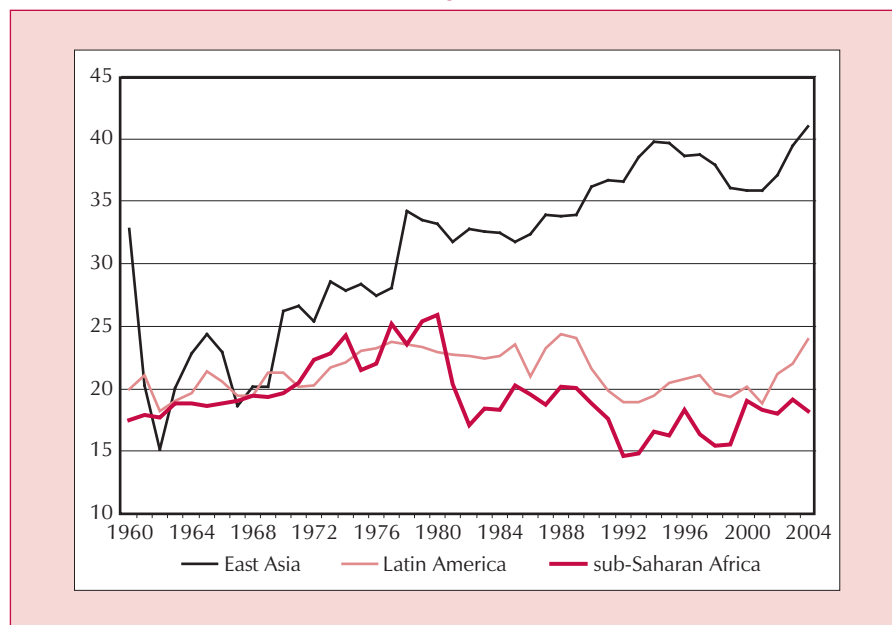
In addition to savings rates, stability over time is crucial for smooth and predictable investment, and Africa again fares worse than other developing regions in this area. A major reason for this is the volatility of the sources of income, which is higher in Africa than in other developing regions, due mainly

to exogenous shocks. The standard deviation for gross national savings as a share of GDP from 1965 to 1992 was 8.7 per cent for Africa, 6.6 per cent for the East Asian “Tigers” and 6.0 per cent for Latin America and the Caribbean (Schmidt-Hebbel et al., 1994).

The *capacity* to save is mainly determined by income level, rate of income growth and the dependency ratio, i.e. the ratio of population under 16 or above 60 years old to that of the working-age population (Loayza et al., 2000). A positive relationship exists between savings rate and per capita income (Hussein and Thirlwall, 1999). Savings rates have also been found to increase in response to rises in the rate of growth of per capita income. Finally, savings rates appear to respond negatively to increases in the dependency ratio.

Willingness to save, meanwhile, is believed to depend on the ease of access to savings instruments, the attractiveness of such instruments and the prevailing economic conditions (Wright, 1999; Hussein and Thirlwall, 1999).

Figure 2
Gross domestic savings by developing regions, 1960–2004
(Percentage of GDP)



Source: World Development Indicators, 2007.

Gross savings rates provide a useful insight into the general picture of savings in a national economy. They are not, however, necessarily reliable indicators of the domestic resources available for investment in African countries. This is partly due to problems of accuracy in the national account data for savings. Indeed, the calculation method, which derives savings as a residual from other variables, yields high margins of error (Deaton, 1990). In addition, private saving in African countries is often precautionary in nature and is inadequately captured by national account data (Aryeetey and Udry, 2000).

Considering that savings can exist in many different forms, the nature of savings instruments has a large impact on the possibilities for transforming savings into productive investments. To understand the nature of savings and their relation to investment, it is necessary to look into the details of saving options and choices at the household and firm levels.

C. Household savings

Improving the mobilization of household savings could free up significant amounts of resources for investments that promote development. Indeed, household savings dominate savings in Africa but are at present not sufficiently channelled into productive use (Aryeetey and Udry, 2000). Understanding why and how households save, especially poorer households, can help to identify policies that increase the amount of resources available for development.

Households, especially in rural areas, rely on volatile income sources. In the absence of accessible credit and insurance services, drawing on saved assets is a necessary strategy for households to smooth their consumption patterns (Deaton, 1990; Dercon, 2002).

Saving as a precaution implies that even at low disposable income levels and in the absence of attractive savings instruments, poor households need to save a substantial part of their income. In Ghana, for example, it was found that the median household in rural areas in the South of the country saved over 30 per cent of their income (Aryeetey and Udry, 2000).

This kind of precautionary saving is the main motivation for household saving in Africa. Research from Ghana shows that financial savings increase with

income only in the wealthiest 10 per cent of households (Aryeetey, 2004). This suggests that for a large proportion of households, saving is a necessary form of self-insurance. This has important implications both for the pattern of saving that it generates and for the asset choice of households. The pattern of household saving tends to be irregular, with frequent swings between saving and dissaving. This irregular saving pattern tends to generate a preference for saving instruments that are highly liquid and accessible (Deaton, 1990).

Saving instruments for households fall into four categories: non-financial savings, informal financial savings, formal financial savings and semi-formal financial savings. The composition of household savings portfolio determines availability of funds for investment, and is therefore relevant to a country's development.

In Africa, household savings consist mainly of physical assets and some financial savings held in the informal financial sector. Thus, only a small part is available for productive investment.

Non-financial savings

Households often hold considerable diverse portfolios of non-financial assets, such as livestock, stocks of goods for trading, grain and construction materials that are acquired as stores of wealth, and are often bought or sold in such a way as to smooth consumption patterns. While the evidence is limited, studies suggest that non-financial assets represent around 80 per cent of all household assets in rural areas (Aryeetey and Udry, 2000).

The choice of non-financial assets as saving instruments can reflect a variety of factors. Some non-financial assets, such as livestock, real estate or jewelry, carry symbolic value or serve as indicators of status and/or wealth. The accumulation of non-financial assets as saving instruments, however, can also reflect rational portfolio decision in a context of high risk, uncertain financial environment and lack of access to adequate financial instruments. Thus, whilst a certain amount of non-financial assets is likely to remain as a part of the saving portfolio of households in African countries, an improvement in access, adequacy and reliability on the part of the financial sector could trigger an increase in savings held in a financial form through substitution from non-financial to financial saving instruments.

Informal financial savings

The informal financial sector offers a wide range of saving instruments, from simple deposit collection to large, self-organized saving groups and saving pools (Wright, 1999). Mostly, savings tend to be made in small but frequent deposits that correspond to the needs of households and small businesses. Problems of access and reliability are limited in comparison to the formal financial sector as informal financial institutions operate in geographically and socially confined community settings (Nissanke and Aryeetey, 2006).

In contrast to the formal financial sector, it is rare for informal sector savings to accrue interest. Resources mobilized through saving in the informal sector are generally not used for further investment and therefore tend not to generate any income. In most cases therefore, depositors are required pay for the saving service. The fact that poorer households save despite receiving what are in effect negative interests is testimony to the importance of saving services for poorer households and to the willingness of such households to save. Households in Africa tend to combine a number of saving instruments with different institutions, offering different deposit and withdrawal conditions. This helps them spread default risk and meet their changing need for financial resources (Wright, 1999).

Formal financial savings

In sub-Saharan Africa, savings held in the formal financial sector generally represent a small proportion of household assets. Evidence from Northern Ghana suggests that, of the 20 per cent of household assets that are held in financial form, 12 per cent are held in the informal sector and 8 per cent in the formal sector (Aryeetey, 2004). This reflects the difficulties in access to formal saving instruments and, more importantly, the lack of trust in formal financial institutions, as well as the inadequacy of formal saving instruments to fulfil poorer households' savings needs.

Banks are the principal type of formal financial institutions engaging in savings mobilization in Africa. In some countries, post office branches have also been used, taking advantage of their extended network. Recent reforms to the financial sector in many African countries have led to a reduction in branch numbers as banks, free from government interference, have focused on more profitable often urban-based activities even though an increase in branches in rural areas could promote savings in the formal financial sector (Ikhide, 1996).

Physical distance from banking institutions is not the only limiting factor to the growth of formal financial savings. High minimum deposit and balance requirements, the time that it takes to make transactions and the administrative work involved also discourage depositors. Furthermore, the reluctance of banks to provide credit to poorer households and small businesses lessens the incentive to save in the formal sector (Wright, 1999).

There are some encouraging signs, however, that technology may be able to overcome some of the remoteness and processing-cost barriers to providing services to poor and rural areas. Mobile phone banking enables banks to provide basic financial services to poor people, including in rural areas. Though it is only a recent development, mobile phone banking is already reaching thousands of customers in countries such as Botswana, Kenya and Zambia (Honohan and Beck, 2007).²

The level of trust in banking institutions is low in most African countries. Banks have been subject to pervasive government intervention in their operations, especially before the recent financial sector reforms. Political expediency was often preferred to commercial viability, resulting in banks having enormous liabilities threatening their operations. Banking crises beset many African countries between the mid-1980s and mid-1990s. In their review of banking crises in 10 African countries between 1985 and 1995, Daumont et al. (2004) found that non-performing loans exceeded 50 per cent of total loans in Benin, Cameroon, Côte d'Ivoire, Guinea, Senegal, Uganda and the United Republic of Tanzania, with Ghana and Nigeria not far behind. In many countries, these crises were large enough to deeply affect the national economy. In Benin, for example, the banking crisis of 1988–1990 saw all three of the country's banks collapse due to 78 per cent of their loans being non-performing, resulting in an estimated cost to the economy of 17 per cent of GDP. The most important features behind banking crises in Africa have been extensive government interference, poor banking supervision and regulation, and shortcomings in management (Daumont et al., 2004).

Despite reforms, banks have not noticeably improved their loan portfolios, and public trust has not improved. The saving that does take place in the formal sector generally favours short-term deposit accounts and the proportion of savings held in longer-term deposit instruments remains low (Nissanke and Aryeetey, 1998).

Semi-formal financial savings

An emerging semi-formal financial sector in Africa specializes in providing financial services to households and small businesses that do not have access to formal financial institutions. This sector is made up of institutions that, while legally registered, are not regulated as banks. While this semi-formal sector could become an important actor in savings mobilization for households, its coverage is at present too limited to respond effectively to the financial needs of many households in Africa.

The semi-formal sector, however, holds great potential in terms of improved savings mobilization in the region. Indeed, if semi-formal institutions succeed in offering safe and reasonably liquid savings instruments that generate positive returns for many households, there could be a substantial increase in financial savings available for profitable investments due to reallocation from both non-financial assets and financial assets currently held in the informal sector.

In sum, the choice of saving instrument reflects issues of access, reliability and relevance of available saving instruments to meeting households' saving needs. Households in Africa save essentially for precautionary reasons. The assets they hold are substitutes for insurance and credit, which are not available to them. The saving pattern thus created is one of irregular and short-term saving in which, over time, there can be as much saving as dissaving (Deaton, 1990). The financial requirements of households therefore call for safe saving instruments that allow small transactions at frequent intervals. The very high proportion of non-financial assets in household savings portfolios suggests that the financial sector is currently not adequately fulfilling these needs.

D. Corporate savings

Corporate savings have received much less attention than household savings and remain an area that is generally underresearched, particularly with regard to developing countries. In most African countries, the data necessary to disaggregate private savings into household and corporate components is unavailable. One of the few countries in Africa with sufficient data to permit a detailed examination of corporate savings is South Africa. Evidence in this case suggests that corporate savings respond to changes in the rate of profits, inflation, interest rates and availability of credit (Aron and Muellbauer, 2000). The corporate and financial sectors in South Africa are, however, markedly more developed than those in most

African countries. There are therefore serious limitations to the transferability of these findings to other countries in the region.

In most African countries, the corporate sector is strongly dualistic, with a small number of legally registered firms and a much larger number of enterprises operating in the informal sector. The limited information that exists on the corporate sector in the region too often focuses only on the first category, giving a distorted view of the reality facing most enterprises.

Large firms are much more likely than small or micro firms to receive bank loans (Bigsten et al., 2003). Access and cost of financing are problems for most enterprises in Africa, however. This is especially the case for the small domestic enterprises in the informal sector that represent the vast majority of firms in the region³. As a result, firms are dependent on their retained earnings to fund not only their working capital but also new investments. Firms in sub-Saharan Africa fund between one half and three quarters of their new investments from their internal savings (Nasir et al., 2003; Blattman et al., 2004; World Bank, 2007b).

Corporate savings are therefore essential to the security and growth of firms. Faced with a financial system that does not meet their needs, firms have to depend on their own savings to insure against temporary falls in earnings and to fund further development. Fafchamps et al. (2000) found that, in Zimbabwe, firms use large inventory stocks and, to a lesser extent, financial savings as self-insurance in the face of a risky operational environment. Given the crucial role of savings for the firms that produce them, there can be very little intermediation of these funds towards other purposes. Indeed, the inability of many firms to secure outside financing means that savings will need to be either directly reinvested in the firm that produces them, or kept in highly liquid form in order to be easily accessible in times of need.

Financing new investments from retained earnings can be highly efficient. In fact, as savings are made up of retained profits, they are often primarily generated by successful and profitable enterprises that are therefore reasonably unlikely to invest in low-yielding investments.

There are nonetheless reasons to believe that the current situation of corporate savings and investment in Africa is far from optimal. Firstly, the number of firms that are credit-constrained testifies to the fact that their retained earnings are not a sufficient source of funds to meet their perceived needs (Bigsten et al., 2003). This is borne out by the fact that the graduation rate from micro to more complex

enterprises is lower in Africa than in other regions (Nissanke, 2001). Secondly, self-investment may be productive, but other investment opportunities might be more profitable or more suited to the firms' immediate needs. Finally, the lack of credit and insurance possibilities for many firms means that savings need to be kept in highly liquid form and can therefore not be easily reinvested by the financial system into productive investment. The current situation therefore not only constrains the growth of firms, but also contributes to low levels of development of the financial sector.

A financial system that better meets firms' financial needs may lower the level of savings that occur for self-insurance and self-investment reasons. On the other hand, it is likely to make available a much larger proportion of corporate savings for productive investment.

E. Public sector revenue: taxation

The amount and efficiency of government spending is an essential part of making domestic resources the engine of African development. Public sector resources have a distinct and complementary role to play vis-à-vis private savings. While a distinction can be made between public expenditure, which covers recurrent costs, and public savings, which fund longer-term investments, the needs that both address are immense in most African countries. Public expenditure is essential to human capital development through its funding of essential public services such as education and health care. Public investment, on the other hand, can provide the resources for infrastructure that is indispensable for the private sector to thrive.

The balance between expenditure and investment therefore matters less than the amount of resources involved and the efficiency with which they are utilized. Taxes account for almost all of government revenue in most African countries. Increasing tax revenue can therefore have a significant impact on improving domestic resource mobilization provided it does so without discouraging private economic activity.

The amount of tax revenue as a percentage of GDP in Africa was 22 per cent in 2002 (World Bank, 2005a). This is lower than the average for developed countries. Europe/ Organization for Economic Cooperation and Development (OECD) had rates of 32 per cent for the same year. Africa's tax ratio, however,

is higher than that of other developing regions (Tanzi and Zee, 2000), although there are considerable differences within the region. The tax ratio is considerably lower in sub-Saharan Africa (20 per cent) than in North Africa (25 per cent). Moreover, if South Africa is excluded, the tax ratio for sub-Saharan Africa is only 16 per cent (World Bank, 2005a). Furthermore, there are important differences between countries in the region with regard to their tax performance. Tax as a share of GDP in 2002 ranged from more than 38 per cent in Algeria and Angola to less than 10 per cent in Chad, Niger and Sudan (World Bank, 2005a).

The tax-to-GDP ratio in a given economy is broadly determined by a set of structural features. Chief among these are the level of per capita income, urbanization, literacy, the shares of the industrial, agricultural and mining sectors, as well as the importance of trade (Tanzi and Zee, 2000).

In sub-Saharan Africa specifically, the main determinants of the tax-to-GDP ratio have been found to be per capita income, trade levels, and the shares of agriculture and mining in the economy (Stotsky and WoldeMariam, 1997). Per capita income reflects not only the taxable capacity of the population, it also serves as an indicator for the general development of an economy. For both these reasons, per capita GDP has been found to be positively correlated to higher tax to GDP ratios. Although they have been decreasing in recent years due to trade liberalization, taxes on trade remain important sources of revenue for African States. Levels of exports and imports are therefore both positively correlated with higher taxes. The share of agriculture in the economy has been found to have a significant and negative effect on the tax-to-GDP ratio. Agriculture in African countries is mainly carried out by small farmers who operate in the informal sector and generate only small levels of taxable income. The share of mining in the economy has also been found to have a negative effect on taxes, although the reasons for this are unclear (Stotsky and WoldeMariam, 1997).

One way of comparing taxation across different countries is to determine the tax share that can be “expected” in a country given the various determinants. This expected tax-to-GDP ratio is then compared to the actual one. This is known as the “tax effort”. The international comparison of tax efforts carried out by Piancastelli (2001) finds that the tax effort is higher in Africa than in other regions, despite the low tax-to-GDP ratios achieved. This would suggest that the tax rates achieved in Africa, while low, are higher than expected given the structure and development levels of African economies. However, measures of tax effort are strongly dependent on the model used to determine the expected

tax rate, so tax effort measures suffer from serious limitations and are at best indicative.

High tax-to-GDP ratios are not necessarily a measure of a successful tax system. Rather, fiscal policy is about who gets what from the State, how public spending is financed and who pays for it (Addison et al., 2006). As such, it is at the heart of the wider problem of resource mobilization and use. Public revenue should be mobilized in a way that preserves incentives for private sector actors to work and save. An optimal tax system should strive for equity, efficiency and administrative convenience (Thirlwall, 2003).

The tax reforms that many African countries have undertaken in the past two decades have tended to treat taxation as a technical and administrative exercise, ignoring its political nature. These reforms have mainly been donor-driven and have sought to change the composition of taxation to favour taxes that are easier to collect and perceived to be less distorting to the economy. Typically, this has translated into a focus on indirect taxes such as value added tax, a reduction of direct tax rates combined with measures to increase their reach, and a reduction of the importance of taxes on international trade. On the administrative side, reforms have concentrated on trying to enhance the institutional capacity of tax administration by increasing the number and salary of staff, training, technical equipment and simplification of procedures.

These reforms, however, have had limited success in increasing the tax revenue of African countries. It is, of course, essential to improve the technical and administrative aspects of taxation, especially improving the capacity of tax administrations and tackling corruption. By focusing exclusively on those aspects, however, the reforms have ignored the fact that taxation represents a political relation between the State and society (DiJohn, 2006).

The low tax levels in Africa are in part due to features that make tax collection more difficult. These include low levels of per capita income; large agricultural sectors; and a sizeable share of production, transactions and employment taking place in the informal economy, which in 2001 was estimated to account for 78 per cent of non-agricultural employment in Africa (Xaba et al., 2002). Low tax rates also represent a relative weakness of the State with regard to certain sections of the society. Taxable capacity in Africa tends to be highly concentrated in a small number of people and firms that can often evade taxes by using their power and influence. The majority of the population, while it may not have

much political power and influence, typically has low taxable capacity that is costly to collect, especially in rural areas (Fjeldstad and Rakner, 2003; Fjeldstad, 2006). In Uganda, for example, only middle-size firms tend to pay taxes. Large firms can use their influence and relations within the State to evade taxes and small firms can dodge taxes by staying in the informal sector (Gauthier and Reinikka, 2006).

State legitimacy is ultimately at the heart of taxation. Applying criteria of efficiency, effectiveness and fairness not only to the tax system but also to the use of government resources can create a virtuous cycle of improving fiscal performance, service delivery and state legitimacy. Recent research in the United Republic of Tanzania, for example, reveals that a large majority is willing to pay more taxes if the resources visibly improve public services (Fjeldstad, 2006). Thus, while reforming the tax system is an essential part of improving domestic resource mobilization, it is unlikely to succeed in the absence of more profound changes to State–society relations.

F. Financial markets and intermediation

Financial intermediation provides the crucial link between savings and investment. A well-functioning financial system should be able to mobilize resources effectively and allocate them to the most productive investment opportunities. Without effective financial intermediation, the incentive to hold financial savings is depressed and investment tends to concentrate on the sector in which the savings take place, which may not be the most productive. As a result, there are fewer resources mobilized and these are allocated to less productive investments.

The demand for financial services in Africa is high, despite the low income levels. Households need financial services to manage the risks linked to the volatility of their income sources, and firms need financing in order to grow. The financial system in Africa, however, has largely failed to meet the demand for efficient financial intermediation.

Central to the failure to meet these needs is the fragmented and segmented structure of the financial sector in Africa. Financial services tend to be provided mainly by a small formal financial sector that concentrates on the higher market-end, and a larger informal financial sector that concentrates on the lower

market-end. There is very little interaction between the two sectors and there is a considerable gap in the financial services market in between the two market-ends.

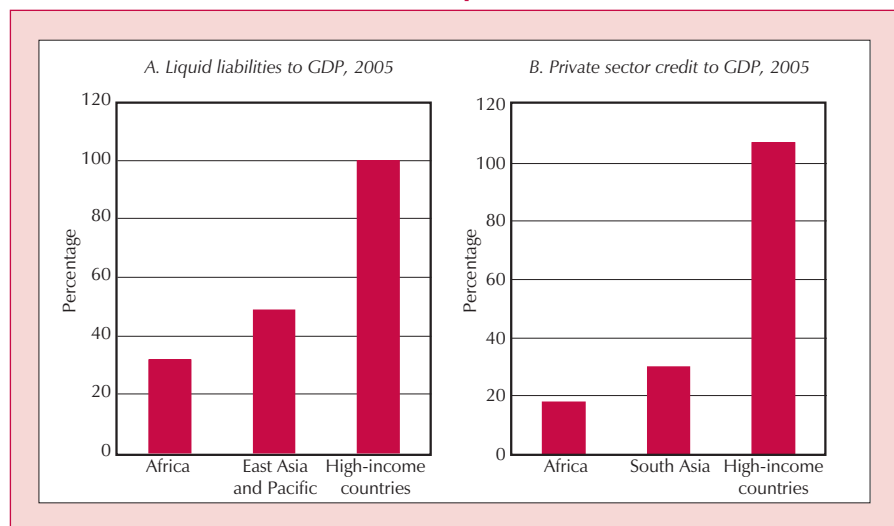
The formal financial sector

The formal financial sector in Africa, as in other regions of the developing world, essentially consists of banks. Although non-bank financial institutions and stock markets have been developing in some African countries, their influence generally remains marginal compared to the banking sector (Brownbridge and Gayi, 1999; Aryeetey, 2004).

In comparative terms, the formal financial sector is performing poorly in Africa. In 2005, the ratio of liquid liabilities (M3) to GDP, an indication of the monetary resources mobilized by the formal financial sector, was 32 per cent in Africa, compared with 49 per cent in East Asia and the Pacific, and 100 per cent in high-income countries (Honohan and Beck, 2007). The comparison is even starker with private sector credit, a key to the intermediary performance of the financial sector. In 2005, private sector credit as a ratio of GDP was 18 per cent in Africa, compared with 30 per cent in South Asia, and 107 per cent in high-income countries (Honohan and Beck, 2007).

Figure 3

Selected indicators of financial depth and financial intermediation



Source: Honohan and Beck, 2007.

Additionally, in Africa banks tend to be concentrated in the principal cities, with few branches in rural areas. Furthermore, they often have rules and procedures for both deposits and loans that prevent poorer households and small businesses from gaining access to their services. Such barriers include minimum deposits and balance for deposits, and high collateral requirements and interest rates for loans. As a result, the banking sector in many African countries is effectively closed off to a large part of the population. In Ghana and the United Republic of Tanzania, for example, only 5 to 6 per cent of the population has access to the banking sector (Basu et al., 2004).

One of the major constraints to the expansion of bank operations in African countries is their limited capacity to manage risk (Nissanke and Aryeetey, 2006). Systemic risks are high in the region, as economies are vulnerable to large externally or internally induced shocks such as terms of trade losses, conflict, extreme climatic events and abrupt policy changes. Honohan and Beck (2007) report that large shocks such as economic or political meltdowns associated with conflict, famine and politico-societal collapse, and external factors occur in sub-Saharan Africa at a rate of one to two per decade per country. Additionally, idiosyncratic risks linked to potential borrowers are also high in the region. There is generally no borrower registry and information on borrowers' risk profiles is difficult if not impossible to obtain, particularly for large centralized banks. Furthermore, contract enforceability is often weak in African countries, making legal recourse against defaulting borrowers an uncertain, lengthy and costly exercise.

The low risk-management capacity of banks in Africa is in large part due to the legacy of pervasive State interventionism in the financial sector. Prior to recent reforms, banks were mostly government-controlled and political imperatives were consistently given priority over commercial viability. Competition between banking institutions remained stifled and banks had little incentive to develop their activities. As a result, the institutional capacity of banks to manage the systemic and idiosyncratic risks in African financial systems has failed to develop sufficiently (Nissanke, 2001).

In part to remedy these problems, many African countries underwent financial sector reforms starting in the mid-1980s. These reforms, which were part of a broader set of market-oriented, often donor-led reforms, generally entailed financial liberalization and institutional reforms to prudential regulation systems and distressed government-owned banks (Brownbridge and Gayi, 1999). They

have succeeded in limiting the scope of government intervention in the financial sector and in strengthening prudential regulation of financial institutions. Mostly, however, they have not succeeded in significantly deepening or diversifying the financial sector. In fact, competition has not increased significantly and the banking sector in many countries remains oligopolistic (Senbet and Otchere, 2005). The combination of the low risk-management capacity of banks and the increased emphasis on profitability has induced greater reluctance to take on what are considered costly and risky activities. These include providing banking services to rural households or small informal sector businesses. Banks have therefore closed many of their branches in rural areas and increasingly concentrated their lending on large firms and government bonds. In fact, credit to the private sector as a proportion of GDP decreased in many African countries following the reforms (Steel et al., 1997).

Governments issue bonds at high rates of return in order to attract private funding to cover their fiscal deficits because they no longer have direct access to the resources of the financial sector.⁴ These relatively low-risk and high-return assets now make up a significant portion of bank assets. The fact that claims on the private sector represent a significantly lower share of bank assets in Africa, while claims on the Government and State-owned enterprises are higher, suggests that government bonds are crowding out private investment in the region (Honohan and Beck, 2007). Banks in Africa today are largely failing to play their essential role of savings mobilization and financial intermediation. This is evidenced by the fact that despite excess demand for credit, banks often hold high levels of excess liquidity,⁵ often in the form of government bonds, and their lending portfolios are dominated by loans to large, often high-risk, private clients (Nissanke and Aryeetey, 2006).

Recently, capital markets have developed considerably in Africa. In 1992, there were 10 stock markets operating in Africa. By 2002, that figure had reached 24 and listed firms numbered 2,216 (Senbet and Otchere, 2005). Nevertheless, African stock markets remain the smallest of any region and are severely illiquid. Of the 15 stock markets in sub-Saharan Africa, seven have market capitalization worth less than 10 per cent of GDP, all except the Johannesburg Stock Exchange have trade values amounting to less than 3 per cent of GDP, and all but three have turnover rates of less than 10 per cent (Honohan and Beck, 2007). This is partly due to the small size of the economies in which they operate. Indeed, it has been found that stock markets appear to emerge and develop only when economies reach a certain size and the level of capital accumulation is high

(Capasso, 2006). It may also be the case that the regulatory requirements imposed on stock markets in the region are unduly high and discourage many firms from using the securities market for raising funds (Honohan and Beck, 2007).

The establishment and relatively good growth performance of African stock markets is nonetheless an encouraging sign. Stock markets can contribute to the deepening and diversification of the financial system and play an important role in risk allocation and risk sharing. It appears, however, that at the current level of development of most African countries, stock markets are unlikely to have a significant impact on the financial system or indeed on economic growth.

The informal financial sector

The informal financial sector refers to all institutions and transactions occurring outside the country's official financial services system. Studies suggest that, in Africa, it is larger than the formal financial sector in terms of influence, coverage and even value of transactions (Nissanke and Aryeetey, 2006). It is estimated that at most only 20 per cent of African households have access to formal finance (Honohan and Beck, 2007).

Institutions offering financial services in the informal sector range from large savings groups to individual moneylenders. The range of services offered is similarly vast, with a large array of different savings collection instruments and lending arrangements, including non-commercial financial transactions between friends and relatives. Some of the most prevalent institutions in this sector are deposit collectors, moneylenders and credit associations. There are also micro-insurance groups that pool small contributions from members and make funds available for particular events such as weddings or funerals (Wright, 1999; Dercon, 2002). Institutions in the informal financial sector typically focus either on deposit collection or on loan extension. The few institutions that offer both services are generally open only to members.

Financial transactions in the informal financial sector are typically small and frequent, reflecting the low level of disposable income and the high liquidity preference of poor households and small businesses. The sector is dynamic, varied and responsive to the needs of the population in terms of financial services. It does not, however, play a significant role in financial intermediation, despite its strong capacity for savings mobilization. It appears that the risk management strategies employed by informal financial institutions, which allow them to operate in the lower end of the financial market, also constrain their expansion.

Informal financial institutions rely on personal relations and repeated transactions as principal risk-reducing strategies. The social pressure exerted by the community in which transactions take place is also of key importance in reducing the likelihood of fraud or default (Nissanke and Aryeetey, 2006). This reliance on personal relations and social pressure constrains the expansion of informal financial institutions beyond the community level. With the advent of new information and communication technologies (ICTs), however, the transaction costs that limit the scale of operations of these institutions should be reduced to a minimum.

Semi-formal financial sector

An important recent phenomenon in African financial systems has been the emergence of microfinance institutions. These are commonly defined as financial institutions dedicated to assisting small enterprises, the poor and households that have no access to the more institutionalized financial system, in mobilizing savings and obtaining access to financial services (Basu et al., 2004). They include institutions from the informal sector as well as a small but growing part of formal financial sector institutions. A number of microfinance institutions, however, fit in neither the informal nor the formal sector. These are institutions that are registered and often regulated to some degree, yet are not treated as banks or subject to the strictest application of prudential regulation.

The emergence of this semi-formal sector holds great potential for bridging the financial services gap that still exists between the informal and formal financial sectors. Many microfinance institutions use the methods and sometimes even the agents of the informal financial sector in providing financial services to poor and rural areas without incurring prohibitive costs. There are also linkages emerging between microfinance institutions and banks as microfinance institutions use large formal banks for deposit and credit facilities.

Semi-formal microfinance institutions deal with risk partly by using agents and methods, such as group-based lending, from the informal financial sector. The main form of risk management, however, is the development of a large client base and the limitation of loan amounts. The portfolio quality of microfinance institutions in Africa is high. It is estimated that the portfolio at risk over 30 days as a proportion of gross loan portfolio is only 4 per cent in Africa, while it is above 5 per cent in East Asia, South Asia and Latin America (Lafourcade et al., 2005).

The strengthening of this semi-formal sector can potentially help deepen and diversify African financial systems. These institutions can play a crucial role in financing small and medium-sized enterprise growth. They can also participate in increasing the mobilization and pooling of financial resources, thereby contributing directly to increasing the amount of domestic resources available for productive investment.

In sum, financial markets remain fragmented and segmented and are not playing their role in the economic development of African countries. Financial intermediation is limited and inefficient in the formal sector, almost non-existent in the informal sector and only emerging in the middle ground between the two. While households have access to some financial services from the informal sector, these remain costly and the resources mobilized are not used for investment purposes. Small and medium-sized firms, meanwhile, are still heavily constrained by their difficulties in accessing financial services that meet their needs, especially in terms of credit. Large formal sector firms and wealthy individuals living in urban centres have less of a problem gaining access to financial services. The resources that banks mobilize, however, tend to be invested in low-risk and high-return government bonds, or lent to “good clients”, irrespective of the profitability of the investment (Senbet and Otchere, 2005).

An essential part of enhancing the role of domestic resources in economic development will be increasing the quantity and quality of financial intermediation. Greater integration between the formal and informal financial sectors, possibly through the expansion of the semi-formal sector, would increase the coverage of the financial sector and ensure that the financial needs of more households and firms are met. A more integrated financial sector would be better able to pool mobilized resources and perform essential maturity transformation between volatile savings and stable long-term investments. An efficient financial system with better coverage could raise the level of financial resources in the economy, make a larger proportion of these resources available for investment and improve the allocation of funds for productive investment.

G. Workers' remittances

Remittances, which are monetary or non-monetary resource transfers by migrants to their home countries, are increasingly recognized as an important source of financing for development. They are now the second largest source of

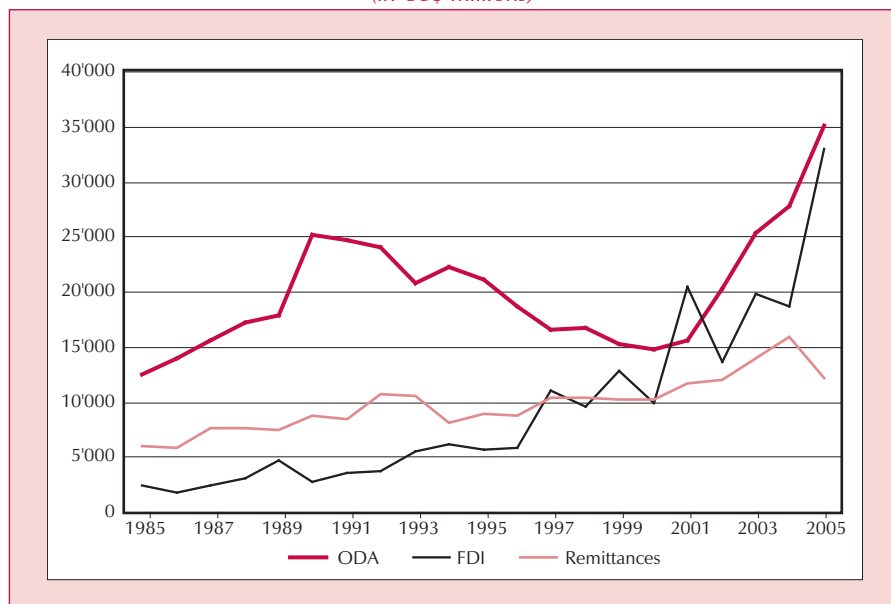
capital flows to developing countries, behind FDI but ahead of ODA (Solimano, 2003). As a development resource, remittances have a number of advantages compared with other foreign capital flows. Their stable growth through the growth cycle compares favourably with the volatility of both FDI and ODA flows. They are non-debt-generating and free of conditionalities, and suffer from fewer leakages compared with ODA and FDI. In addition, remittance flows appear to have no negative effects on the export sector of receiving economies (UNECA, 2006).

Data for remittances as reported in International Monetary Fund (IMF) Balance of Payments Statistics fail to accurately measure remittance flows (Solimano, 2003). By including all private transfers to the non-corporate sector, the IMF data tend to include transfers that are not strictly speaking remittances. Nonetheless, as remittances through formal channels are often under-reported, and the large proportion of remittances flowing through informal channels tends to be unreported, it is generally believed that official remittance figures underestimate the actual flows. Official figures do, however, provide an idea of the importance of remittance flows and of their evolution over time.

Officially recorded remittance flows to developing countries have increased from \$15 billion in 1980 to \$80 billion in 2002, an annual growth rate of 7.7 per cent (Solimano, 2003). Africa as a whole receives around 15 per cent of global remittance flows, with around two thirds of them going to North Africa (UNECA, 2006). Sub-Saharan Africa receives the lowest level of remittances of any region (\$4 billion) and records the slowest growth rate of remittances over the 1980–2002 period, with 5.2 per cent (Solimano, 2003). There is, however, reason to believe that official figures for remittances in the region are particularly subject to underestimation as there is a high proportion of remittances flowing through informal channels due to lack of access to formal transfer institutions in many areas.

The fact that much of the migration in the region is intraregional and short to medium term also increases the use of informal channels (Sander and Maimbo, 2003). Additionally, informal transfer agents offer such appealing features as anonymity, speed and minimal paperwork (Gupta et al., 2007). It is therefore estimated that the actual level of remittances in the region is at least twice as high as the reported level (UNECA, 2006).

Figure 4
Capital flows to Africa, 1985–2005
(in US\$ millions)



Source: UNCTAD 2006b, OECD 2007 and IMF 2007.

Even the supposedly underestimated figures indicate that remittances form a significant capital flow to African countries. Indeed, at 2.5 per cent of gross national income for Africa, remittances represent a more important capital inflow than FDI (UNECA, 2006). However, the importance of remittances varies hugely from country to country. Egypt, Gambia, Lesotho and Morocco all receive remittances worth over 5 per cent of their gross national income, but remittances are negligible in many other countries.

The level of remittance flows to or from a country is essentially driven by the prevailing patterns of migration. More emigrants with higher levels of education and commanding higher wages in their countries of residence will generate higher remittance inflows. Obviously, the benefit of remittances, while important, can at best mitigate only a small part of the cost to the country of people emigrating in the first place. This cost is especially high in sub-Saharan Africa, as skilled emigration is particularly high. Some countries, such as Burundi or Mozambique, have lost over a third of their educated workforce to emigration (Gupta et al., 2007).

With regard to the motivations of migrants sending remittances, the distinction is generally made between altruistic motives and self-interested motives. The altruistic motive relates to migrants sending remittances back home in order to improve the well-being of relatives in their home countries. In contrast, the self-interested motive relates to a portfolio choice on the part of the migrant to invest in assets in his home country. If the altruistic motive predominates, remittance inflows could be expected to be counter-cyclical. Conversely, if the selfish motive is stronger, remittance inflows would likely be pro-cyclical. In fact, empirical evidence is unclear and it would seem that remittance inflows reflect both types of motivation, with remittances to sub-Saharan Africa showing remarkable stability throughout the growth cycle (Gupta et al., 2007).

Remittances can have a positive impact on receiving countries in a number of ways. Firstly, as inflows of foreign capital, remittances improve the balance of payments situation of receiving countries. Secondly, remittances directly reduce poverty and help households smooth their consumption patterns, thereby indirectly contributing to stabilizing the country's economic activity (UNDP, 2005). It is estimated that around 80 per cent of remittances in Africa are used for consumption and schooling (UNECA, 2006). Consumption increases demand for local products and through indirect multiplier effects can promote employment and investment. Spending on schooling or health meanwhile improves the human capital of the country, thereby influencing its productivity. Investment in land, livestock or real estate is also common, though secondary to daily needs and human capital expenses (Sander and Maimbo, 2003). Finally, there is some evidence of remittances being increasingly used for investment purposes, mainly in financing small and medium-sized enterprises or small infrastructure projects (Sander and Maimbo, 2003; UNDP, 2005).

In sum, remittances are an important and steadily growing resource for development, and help offset the costs of emigration, increase households' incomes and ameliorate receiving countries' external balance. With the appropriate policies and institutions in place, they could be better harnessed as a development resource and channelled into productive investment, thereby contributing to employment and growth.

H. Capital flight

Capital flight reduces the amount of resources available for domestic investment, both private and public. Understanding the determinants of capital flight in order to reduce its magnitude can therefore contribute to increasing the level of domestic savings and investment.

Capital flight is not a clearly defined concept, and different definitions and measurements exist. The essential conceptual difference between various measures for capital flight lies in the coverage of outflows of capital, particularly whether the distinction is made between capital flight caused by political and economic uncertainty, and “normal” capital outflows that would happen regardless of such uncertainties. Thus, while one set of measures looks at the total amount of resources leaving the country, the other looks more specifically at episodic surges of capital “fleeing” unfavourable conditions. Understandably, these different sets of measures produce conflicting estimations of the magnitude of capital flight in African countries. Indeed, there are not many empirical studies of capital flight in African countries and differences in capital flight definitions, calculation methods, sample countries and years covered make comparisons between these studies almost impossible.

Highly conservative estimates of capital flight from Africa suggest that it averaged nearly \$3 billion per year between 1976 and 1997, an annual loss of 2.6 per cent of GDP (Lensink et al., 2000). Other estimates report capital flight levels of above \$13 billion per year between 1991 and 2004, a staggering 7.6 per cent of annual GDP (Salisu, 2005). It has been estimated that the cumulative stock of flight capital for sub-Saharan Africa from 1970 to 1996 was approximately \$285 billion. Considering that the combined external debt of the region was \$178 billion as of 1996, this arguably makes sub-Saharan Africa a “net creditor” vis-à-vis the rest of the world (Boyce and Ndikumana, 2001).

Just as there are important differences between estimates of the magnitude of capital flight from African countries, there is no consensus on their evolution over time. Indeed, while Collier, Hoeffler and Patillo (2004) suggest that capital flight peaked at 35 per cent of private sector wealth in 1988 and has since been declining, Salisu (2005) estimates that capital flight doubled from \$15 billion in 1991 to \$30 billion in 2003.

What emerges from all these studies is that capital flight is currently diverting a large amount of resources from countries that are in urgent need of financing for development. In effect, whether the magnitude of capital flight is 5 per cent of GDP (Ajayi, 1997) or more than 7 per cent (Salisu, 2005), it is clear that reversing a large part of the flight could greatly reduce the resource gap in African countries.

Capital flight is the result of a decision to hold assets abroad rather than within the domestic economy. As such, it is responsive to factors such as macroeconomic and political instability, as well as financial market depth, all of which influence the risk-adjusted returns of domestic assets.

Empirical studies that have sought to determine more precisely which factors most affect the level of capital flight yield different results according to the definition of capital flight and the sample choice. However, some factors appear to be more influential than others. Among indicators of financial instability, the level of external debt appears to be the most clearly correlated to capital flight. It seems that debt serves as a signal both of economic mismanagement and of future increases in taxation, therefore instigating capital flight. There is also evidence that in some cases debt has provided the funds for capital flight (Ajayi, 1997). Other indicators of economic mismanagement also seem to influence capital flight. These include currency overvaluation, fiscal imbalances and high inflation rates. The empirical evidence regarding their influence over capital flight rates in Africa is, however, more ambiguous.

Political stability has a strong influence on capital flight. It directly induces greater capital flight and often leads to macroeconomic instability, thus reducing investment opportunities and increasing the risk associated with holding domestic assets. Indicators of political stability and good governance are therefore negatively related to rates of capital flight (Collier et al., 2004; Lensink et al., 2000).

Differences in the rate of growth between two economies also promote capital flight from the slower growing economy to the faster growing one, reflecting increased opportunities and better returns. Levels of financial deepening are also expected to reduce the incentive for capital flight by increasing the quantity and quality of domestic investment opportunities as well as the returns on such investments (UNECA, 2006). The effect of capital account liberalization, which has been a component of financial sector reforms in many African countries,

on capital flight is contested. While liberalization makes it easier to transfer assets abroad, whether legally or illegally, it has also been argued that it creates investment opportunities domestically. The empirical evidence on the subject is mixed (Collier et al., 2001).

Capital flight, however defined, currently denies African countries a considerable amount of resources. Its reversal could contribute to filling the resource gap in African countries.

I. Conclusion

Domestic financial resources in Africa are mainly drawn from private savings and government revenue. Gross domestic saving rates are low and unstable in Africa, and they have fallen considerably over the past four decades. Paradoxically, research suggests that African households do save a considerable proportion of their income. However, in large part due to the weakness of the formal financial sector, these savings take place in non-financial form or in the informal sector, where they are not intermediated towards productive investment. Firms also generate savings, but the ill-functioning credit market forces them to retain their earnings principally for self-investment.

Tax revenues are relatively low in most of sub-Saharan Africa, partly reflecting administrative and technical difficulties in tax collection. In many countries in Africa, raising additional tax revenue is further constrained by weak State legitimacy, as taxes have often not translated into improvements in public service delivery. Thus, there is a danger of depressing economic activity if taxes are pushed higher without a corresponding increase in State legitimacy. Much can be done, however, in terms of improving the quality of public expenditure and investment, as is discussed in chapter 2.

The financial system has an essential role to play both in terms of improving domestic resource mobilization and in channelling those resources towards productive investments. At present, however, its performance in both these aspects is poor. The formal financial sector caters almost exclusively to the needs of a small, urban-based elite of formal firms, wealthy individuals and Governments. The informal financial sector meanwhile provides financial services to poor households, but the resources thus mobilized are not intermediated towards productive investments. There are nonetheless some encouraging signs

of an emerging semi-formal sector that may be able to respond to the financial needs of small and medium-sized enterprises in some countries. Advances in technology may also help to improve the provision of financial services. Mobile phone banking, for example, allows banks to offer their services to a broad base of customers at reduced cost.

Workers' remittances are an important capital flow which has been steadily increasing in volume over the years. Their exact magnitude is not known, as a large portion of remittances in Africa is thought to be transmitted through informal channels. Remittances contribute to the receiving households' finances and are mainly used for basic needs and education.

Capital flight reduces the amount of domestic resources available for productive investment within a country. Though definitions and estimations differ, it is clear that capital flight remains a severe drain on domestic resources in several African countries, and that a reversal of this flight would likely have a great impact on the availability of domestic resources for development.

The low productivity of investment and high level of liquidity in banks in Africa suggest that the availability of domestic resources is only one side of the equation. Maximizing the development impact of such resources will require much greater attention to increasing both their volume and their use. Improving the mobilization and use of domestic resources should have a strong positive impact on development in African countries. Increased levels of domestic resources and the corresponding decrease in dependence on aid should enable them to increase their "ownership" of the development process, and identify priority sectors for investment that generate sustained growth within the context of a developmental State.