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RECLAIMING POLICY SPACE

Domestic Resource Mobilization and Developmental States

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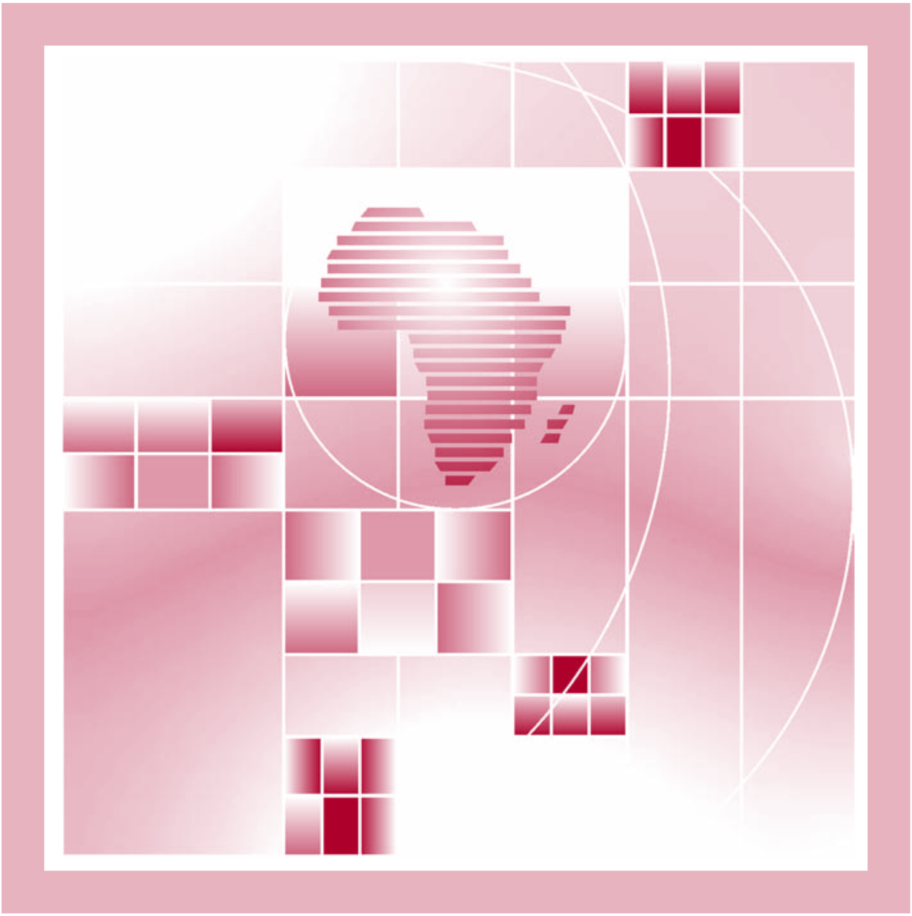

Chapter 4

Reclaiming and utilizing policy space

Africa's economic growth over the last few years has revived the hope that the continent may be emerging from its long period of stagnation. However, the recent rates of growth have not been high enough and sustained for a long enough period in most countries to have made a significant impact on Africa's development. Africa will need to grow by 7 to 8 per cent per annum for up to about 10 years to reach its development targets, particularly that of halving poverty by 2015 as provided for in the MDGs. As mentioned earlier, according to UNCTAD estimates in 2000, investment rates needed to reach 22–25 per cent in order to increase sustainable growth rates to 6 per cent per annum. Investment rates realized by SSA in recent years, 2000 to 2004, averaged only 18.1 per cent of GDP, while the figure for all of Africa was 20.7 per cent. The analysis in this report identifies domestic financial resources as one source that could contribute to closing this resource gap, although these would have to be complemented by ODA and FDI. It also identifies macroeconomic stability, and a stable and predictable policy and political environment, as prerequisites for attracting and sustaining domestic and foreign investments. The role of the State in the support and development of markets and other capitalist institutions is critical. A "strong State" is required for the efficient functioning of these institutions. Indeed, the debate over the direction of development policy in Africa should be underscored by a historical understanding not only of the institutions that underpin the development of markets, but also of the evolution of the State itself in Africa. African countries should choose their development strategies against the background of the available institutional options and their specific historical circumstances (see also Stein, 1994).

The ideas proposed below are some of the elements that could be part of Africa's development strategy with respect to domestic resource mobilization. Some specific measures are proposed with a general but brief discussion of their objectives and modes of implementation. However, the diversity of situations in Africa does not allow for a discussion with finer details. It is expected that UNCTAD's ongoing project on Domestic Resource Mobilization in Africa, which covers seven countries, will provide more details on some of these measures.

A. Mobilizing domestic savings

The discussion in this report shows that there are important resources within African economies which, if properly mobilized and channelled into productive investments, could boost economic performance. Notwithstanding country particularities within Africa, there is a set of common measures that could help countries put in place an institutional setting that is conducive to domestic resource mobilization. In this regard, African countries should implement an arrangement between the Government and the business community, with the objective of identifying the best way to achieve the shared objective of having a financial sector that integrates economic development into its objectives. This would entail the adoption of a financial sector charter that defines the expected contribution of the sector to the national economic development agenda, with clear implementation modalities. Such a charter would provide financial institutions with appropriate incentives to encourage them to maximize their contributions to development, with monitoring guidelines of the performance of the parties involved. The charter could be crafted along the lines of South Africa's "Transformation Charter", agreed between government, business, labour and community representatives in August 2002.[67] The following elements could be part of the new development-oriented financial sector strategy.

Long-term investment fund

Considering the large liquidities in the financial sector of many African economies, countries could consider channelling part of them into a long-term investment fund. It would be funded by voluntary contributions from the most profitable public and private companies, which are often obliged to keep retained profits as short-term bank deposits, due to limited low-risk investments. Pension funds also hold large financial resources that could be partly invested in the long-term investment fund. In resource-rich countries where Governments accumulate rents during periods of high commodity prices, part of the rents could be used to boost the financial base of the fund.

Pooling resources would not only allow for funding large projects, but also minimize the loss incurred by each investor should the investment fail. If necessary, this initiative would benefit from government incentives, in the form of tax breaks, for example, on the amounts contributed to the fund. It could be managed by a board comprising government representatives as well as the major contributors. In the case of Burundi, Nzobonimpa et al. (2006) calculated that if half the profits of the country's eight commercial banks, two development banks, the largest insurance company, a brewery and a sugar factory had been invested in the national economy, they would have increased the country's capital formation from 15 per cent of GDP in 2004 to 23 per cent in 2005. If these resources were spent on productive investment rather than on consumption, their likely effect on inflation would be limited. In the medium term, as development picks up, the development of stock exchanges and bond markets could provide another way of increasing firms' access to long-term investment resources.

Development banks

Development banking has fallen out of favour, owing to past experiences in several countries where they were mismanaged and ended up closing. However, it is important to keep in mind that development banks' past failures were not due to their irrelevance. As discussed in chapter 3, development banks could be an important conduit through which some government development policies are implemented. For example, development banks should refocus their activities on those sectors that are not traditionally attractive to commercial banks. These could include agriculture, non-farm rural activities and small and medium-sized enterprises. The bulk of development banks' financial resources could come from ODA. There are examples in Africa of well-managed development banks that have played a unique role in filling an important financing gap left by commercial banks in some sectors.

Microfinance

African countries could consider creating a microfinance fund dedicated to small credit applicants in urban and rural areas in a way that strengthens the synergies between the formal and informal financial sectors. The fund would use ODA as well as voluntary contributions from the banking sector to constitute its capital. The central bank could also allow commercial banks to contribute a portion of their legal reserves to the fund. In order to encourage commercial banks to contribute to the microfinance fund, interest rates on their contributions could be equal to the rate at which the central bank remunerates their legal reserves plus a risk premium representing some proportion of the difference between the latter and the commercial bank lending rate. This would have the effect of reducing the high interest rates currently paid on micro-credits. Small farmers and small-scale entrepreneurs in need of financial support could be required to open accounts with microfinance institutions with clear repayment mechanisms based on the revenue from the activities of these entrepreneurs. For example, the repayment of these micro-credits could be made contingent on the sale of farmers' crops, with these institutions having a lien on monies from these sales. Requiring the producers to form cooperatives that would be answerable to the microfinance fund could increase enforceability of the repayment mechanism.

Capital repatriation and remittances

Capital flight is the ultimate reflection of a country's failure to mobilize and retain its domestic financial resources. Given the importance of this outflow in a number of African countries, serious consideration should be given to the way these resources could be repatriated and how to limit their flow in the future. Capital flight could be curbed or reversed if African countries generated enough investment opportunities that could interest its diasporas. Countries such as Ethiopia, Rwanda and Ghana have managed to attract diasporas back to invest in their countries of origin. 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. Moreover, the new United Nations Convention Against Corruption, which has already been ratified by more than 40 African countries, offers an international framework that could be used to plead for the return of the proceeds of corruption.

The key policy issue with respect to remittances is not only how to increase them, but also how to encourage the senders to use formal channels and increase the share allocated to investment rather than to consumption. One novel way adopted by a bank in Burundi is to provide remittance-related financial services at competitive cost. The bank has been organizing campaigns in Europe to invite the diasporas to invest in instruments that will be under the direct management of this commercial bank. In addition, this bank offers to act on behalf of the diasporas who are willing but unable to invest in the country due to their absence. These services are expected to be provided at a relatively low cost if many people join the scheme.

Developed countries from which remittances originate could consider, as a measure of development cooperation, granting tax breaks on the amounts sent home through official channels by diasporas as a way of increasing remittance flows. To reduce transfer costs, developed countries could help by proposing transfer mechanisms that limit transaction costs to the minimum. One way could be to encourage local banks to collect remittances into one account per recipient country, with a proper record of senders' and recipients' addresses. The bank would make one transaction per period to send the total amount into a bank account in a recipient country that would in turn redistribute it to the addresses provided by the sending bank. The advantage of this mechanism is that the remittances would use official channels at very low transfer costs.

B. Developing credit markets and boosting productive investments

Credit is the mechanism through which savings are transformed into investment. However, as chapter 2 has discussed, a vibrant investment sector requires more than just credit; it also needs a conducive investment climate. Therefore, investment strategies must combine the requirements of a viable credit market with a good investment environment. In this regard, policies to boost investment could centre on the following.

Low credit transaction costs

High credit transaction costs, particularly outside urban centres, are one of the key reasons why so many businesses or potential entrepreneurs in Africa do not have access to credit. In cases where the limited geographical bank coverage may be due to cost-benefit considerations, encouraging greater density of financial institutions through incentives such as one-off subsidies could help bring more economic agents into the credit market. Obviously, complementary policies such as infrastructure development in rural areas would be needed to introduce banking services. For example, in many countries, the development of mobile telephony has reduced transaction costs by linking up different market segments geographically separated by infrastructure deficiencies.

A different way of addressing the problem of high transaction costs would be to help, rather than hinder, the work of microfinance institutions. As the report discusses, microfinance institutions should be recognized as holding the key for financial development in rural areas, where they could operate down to one-tenth of formal banks. As a result, formal banks and microfinance institutions should each specialize in their segment but allow for proper communication between the two credit sources. In particular, given that many microcredit institutions' activities are limited by resource constraints, they should be able to borrow from commercial banks on preferential terms to expand their lending activities to small borrowers not covered by formal banks.

Credit information and borrowers' database

The poor endowment of African economies in "information capital" has induced a high cost with economic inefficiencies, and prevented the growth of the financial sector. In particular, the lack of reliable information on the risk profile of borrowers is arguably the most important factor constraining bank lending to poorer households and small businesses. The example of Southern African countries, where private bureaus have financial information covering up to 53 per cent of the adult population, is instructive in this regard. Given that the setting up of a comprehensive borrowers' database might not necessarily be in the interest of any individual financial institution, the costs of setting up and maintaining such a database could be at least partly borne by the State. It would be important that whoever manages such a database guarantees confidentiality of information. Also, this agency should be clearly separated from tax authorities, to address the fear that information could be used for tax purposes.

Legal and regulatory framework

Law and order and a credible legal system that enforces property rights are very important instruments of investor protection. Being inter-temporal, credit and investment require an institutional environment where their outcome can be predicted with some degree of certainty. Economic and political stabilization policies that reduce risk and uncertainty should be at the core of the strategy to attract and retain domestic and foreign investment. Obviously, this shows how difficult the task is, particularly in countries recovering from long periods of internal conflict and instability. 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.

Savings and credit cannot boost investment in a climate that is not friendly to investors, so regulatory measures should also focus on the improvement of the investment climate. Since the investment climate has different dimensions, there are several actions that could be taken to improve it. Firstly, investment requires reliable infrastructure such as roads, electricity and telephone communication.

Putting this infrastructure in place, if necessary on a regional basis, should be a development priority in Africa. Investing in basic infrastructure is the basis for other investments to take place, given the positive effect of infrastructure on investment efficiency. Secondly, unnecessary bureaucratic barriers could be reduced dramatically without any serious adverse effects. For example, if one-window shop policies could be generalized and made more effective, they could reduce drastically the costs due to red tape, as well as opportunities for graft. The simplification of procedures could help reduce entry costs and transaction costs involved in paying taxes, and encourage more informal firms to go into the formal sector, thereby widening the tax base. Moreover, the simplification and rationalization of labour market regulations could help remove a number of old regulations that serve no useful purpose and which may deter the entry of new firms into the formal sector. Thirdly, Governments would gain by re-designing their tax systems to make them simpler by adopting fewer but differential tariff lines for imports of capital or intellectual goods and consumption goods and fairer by relying more on direct taxes. This would also make them more effective and more administratively convenient. Such a new tax policy should be accompanied by efficiency improvements in the use of government revenue as part of a broader policy of improving the relations between the State and society.

C. Delivering appropriate financial and investment policies: the need for a “developmental State”

Most of the challenges to domestic resource mobilization and investment discussed in this 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: domestic economic integration, strategic external integration, and effective allocation of resources to achieve clear development goals.

Domestic economic integration

The current discourse over the issue of globalization centres on the way economies are or should be integrated into the world economy, with very little consideration given to “internal integration”. However, it should be clear from the discussion in this report that 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. These efforts require sizable investments that can be provided only by the State. Obviously, infrastructure development, particularly that of roads and telephones, is key to internal integration, as it allows different local entities to communicate with each other, and improves the efficiency of the exchange of goods and services – that is, of markets. The State should prioritize investments in the rural economy, given the high multiplier effect and the level of neglect of the rural sector.[68] After all, the rural economy constitutes the basis of national economic activity and accounts for the largest proportion of the population. State intervention, therefore, should foster the integration of rural agricultural and non-agricultural activities. It has been established that the potential for job creation by rural non-agricultural activities is very high in Africa (UNECA, 2005).

Sectoral integration facilitates product diversification and transformation of the national economy. Even some of the highest-growing economies in the continent have not been able to reduce poverty and skewness in income distribution in any remarkable way, because the source of growth has been limited to one or a few isolated activities (e.g. capital-intensive extractive industries operating as enclaves). Thus, new development 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. The projects with the highest potential for integration should be given more priority. In addition, diversification of economic activity would limit the adverse effects in terms of trade shocks to international markets. As Wade (2005) argues, diversification rather than specialization, as Africa has been led to believe, appears to be 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 grow, thereby addressing the issue of the "missing middle" in the African productive sectors. This could be in the form of duty drawbacks, subsidized finance, technological assistance, training, developing managerial skills, and a system linking the management of "economic rents" to performance targets, in order to prevent misuse or abuse.

Strategic external integration

Policies implemented over the past quarter century have prioritized external integration over internal integration, resulting in disarticulation of the internal structures of most economies. It is now time to address this imbalance by designing policies that emphasize a strategic and phased external integration congruent with the overall development strategy of each country. In part, this will require policies that prioritize technological upgrading linked to a strategic promotion of FDI into those sectors synergistically connected to domestic research and development activities and national training programmes or skills formation within an investment-export nexus. As discussed earlier, the flexibilities in the various WTO Agreements should be exploited to maximize the benefits and minimize the costs from pursuing external integration. Where some specific WTO Agreements may frustrate the implementation of policies in accordance with development priorities or strategies, steps should be taken to have this resolved within the framework of the WTO negotiating process. Africa's entry into the global markets will not be easy, given the current level of competitiveness of countries dominating the labour-intensive exports sector. This underscores the challenges ahead and the need to improve productivity levels.

Effective allocation of resources

The responsibility for Africa's failure to achieve high rates of economic growth over the last three decades has often been blamed on its predatory and rent-seeking officials. While part of the responsibility for Africa's economic failure accrues to its political elites, a more insightful analysis suggests that it might not be right to blame them for all the ills of the continent (see chapter 3). The changes in the international world order and the past experience of keeping the State outside the process of development have undoubtedly shown that Africa needs a "strong State" to carry out the continent's development agenda. The failure of the past development model advocated by the Bretton Woods Institutions has illustrated the need for African States to re-engage in the development business from which they had been marginalized. More particularly, the State must define a clear development vision and translate it into actionable policies.

The widespread market failures and high risk, together with the huge financial resources involved in implementing the earlier stages of development, imply that the private sector cannot be expected to play the lead role. The issue is therefore not "intervention versus non-intervention", but which type of intervention is undertaken, and its objective (Stein, 1994: 1,485). 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 strategy. As was discussed earlier, the State's instruments for intervention include credit allocation policies, official investment and expenditure, and incentives to private sector agents to encourage them to invest in specific sectors.

State intervention does not necessarily imply protectionism, as is often perceived. As practiced in the past by successful developmental States in both developed and developing countries, 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. Overprotection has proved to be counterproductive because it encourages inefficient production systems, as was the case with some import-substitution experiences.

In conclusion, the State needs a number of attributes to play its rightful role in the process of Africa's development. Firstly, in a transparent and competitive political system, the elites should reflect the wishes of their populations in their decisions. The legitimacy of the State 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. Because there is no formula to achieve development objectives, state actors should be allowed to experiment with policies. 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. Those in charge of development policy should be well trained to properly deal with the problems they are confronted with. The discourse on Africa's poor economic performance has not given this factor due importance. In the past, many choices made with the best intentions later proved to be ineffective. 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.