Raising Growth and Investment in Sub-Saharan Africa.(research)

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Sub-Saharan Africa must increase economic growth to reduce poverty and improve living standards. This article discusses some obstacles to growth in the region, as well as some policy actions that would improve its prospects.

SUB-SAHARAN Africa's long-term growth performance will need to improve significantly for the region to visibly reduce poverty and raise the standard of living to an acceptable level. Appropriate actions will also be needed to ensure that an adequate share of the growing income is devoted to reducing poverty--for example, by improving the delivery of social services. In view of the low level of per capita income in many sub-Saharan African countries, it is difficult to see how redistribution alone could provide a lasting solution to the problem of poverty unless the size of the pie increases markedly. The evidence from empirical studies suggests, in fact, that the income of the poor increases one for one with overall growth and that economic growth is one of the best ways to reduce poverty.

The key policy question for these countries and their development partners is how to spur economic growth. Empirical studies suggest that the contributions to growth of physical investment and total factor productivity (defined as the rate of growth of GDP that cannot be explained by capital formation or labor force growth) in sub-Saharan Africa have been low in comparison with other regions and have declined over time. These trends have reflected inefficiencies in resource allocation; poor delivery of public goods, notably health care and education; and the high risk of doing business in many parts of the region. Moreover, although the labor force has expanded rapidly, its productivity has remained relatively low because of generally poor standards of health and education.

Improving the environment for investment

In the 1990s, the ratio of investment to GDP in sub-Saharan Africa hovered around 17 percent of GDP, well below the ratios attained in the developing countries of Latin America (20-22 percent) and Asia (27-29 percent). The empirical evidence and international comparisons also suggest that the ratio of private investment to GDP is low in sub-Saharan Africa. This is worrisome for two reasons. First, private investment has been found to have a significantly stronger effect on growth than government investment--probably because it is more efficient and, in some countries, less closely associated with corruption. Second, official development assistance, which provides the financing for a large share of public investment in Africa, is declining.

Perhaps the primary reason for the low level of private investment in sub-Saharan Africa is the perception, held by both domestic and foreign investors, that the risk-adjusted rate of return on capital is low. Three major sources of risk appear to be particularly relevant: macroeconomic instability; inadequate legal systems--in particular, the difficulty of enforcing contracts; and political risk, especially armed conflicts. Reducing risk should greatly improve the attractiveness of holding assets in sub-Saharan Africa and, therefore, raise domestic investment and saving rates while reducing capital flight--a major problem in many countries in the region.

First, with respect to macroeconomic instability, the countries of sub-Saharan Africa have recently succeeded in cutting their budget deficits and reducing the rate of increase of the money supply and inflation. But arrears, both domestic and external, remain a serious problem in many of them. In recent years, events in Gabon and Zimbabwe, in particular, have shown how quickly monetary and fiscal control can be lost. These countries and their development partners must therefore continue to focus on macroeconomic stability as a key feature in the design of programs.

Second, inadequate legal systems are a major problem. Private investment will not take off in a country where investors and lenders lose their capital because a dysfunctional court system fails to enforce contracts and property rights. Some progress is being made at the regional level--for example, through the work of the Organization for the Harmonization of Business Law in Africa--but much remains to be done.

Third, armed conflicts threaten the viability of growthoriented programs. This is a difficult problem, but the international community and African institutions like the Economic Community of West African States are now finding ways to support countries involved in peacekeeping operations (for example, Nigeria in Sierra Leone) and those that have had to cope with large numbers of refugees (such as Guinea). Organizations like the World Bank and the IMF are also helping those countries emerging from armed conflicts to rebuild their physical infrastructures and restore their ability to collect taxes and deliver essential public services.

High tax rates are another reason for the low level of private investment in sub-Saharan Africa. High tax and import duty rates combined with pressures from special interest groups have resulted in a vicious circle in which rising exemptions erode the tax base and, ultimately, lead policymakers to further increase tax rates to avoid mounting budget deficits. For this reason, and also because they create microeconomic distortions and provide fertile ground for corruption, tax exemptions should be sharply reduced as part of a strategy to boost growth and investment.

The debt overhang that many African countries have accumulated discourages private investment by reducing the expected after-tax rate of return on capital. The World Bank and the IMF's enhanced Heavily Indebted Poor Countries (HIPC) Initiative aims to provide faster, deeper, and broader debt relief to as many as 30 countries, mostly in sub-Saharan Africa, while establishing a close link between debt relief and poverty reduction.

Raising productivity and growth

The rates of return on both capital and labor and the overall productivity of the sub-Saharan African economies remain low because of a variety of distortions and institutional deficiencies. The list of problems is familiar: obstacles to international trade; overvalued exchange rates; poor infrastructure; bad governance and corruption; and insufficient competition and monopolistic structures in many sectors, notably agriculture. These problems can be corrected if public policies are set on the right course, but change will be politically difficult and will take time.

On the first issue, sub-Saharan Africa is less open to international trade than other developing regions. Several studies conclude that trade liberalization should improve the region's trade performance significantly and thus spur the growth of productivity and output. Some African countries have made progress in liberalizing trade over the past several years. For example, the implementation of the common external tariff in the West African Economic and Monetary Union will contribute not only to intraregional trade liberalization but also to a considerable reduction and simplification of the region's external tariff structure. Such progress must now be strengthened and extended to other parts of sub-Saharan Africa.

Although trade liberalization in the region is crucial, it is equally important that African producers be granted better access to the markets of the advanced economies. In particular, the advanced economies should reduce tariffs at all stages of production, with a view to lowering the effective protection on goods of actual or potential interest to sub-Saharan African countries, such as clothing, fish, processed foods, and leather products.

While selected industries in sub-Saharan Africa may have benefited from a protectionist trade policy, overall production and exports in the region have often been hurt by overvalued exchange rates. One motivation for such a policy is the desire to provide cheap imported goods to the urban elite. But the resulting bias against the tradable goods sector has been very costly in terms of lost output and employment. Fortunately, policy in this area evolved in the right direction during the 1990s. The most spectacular example was the devaluation of the CFA franc in 1994, which, following a lengthy period of stagnation in the CFA franc zone, provided a strong boost to growth, investment, and exports in that region.

Another factor that inhibits private investment and growth in sub-Saharan Africa--by increasing the cost of investing in physical capital--is the poor quality of infrastructure, particularly in sectors like communications (ports, roads, and railroads) and electric power generation. The poor quality of the infrastructure imposes heavy costs on producers of tradable goods, on top of the costs stemming from the low population density and the fact that many African countries are landlocked. The reasons for the inadequate investment in, and maintenance of, infrastructure are related to policy: insufficient budgetary resources, fraudulent diversion of public funds, and inefficiencies caused by corrupt management (for example, of ports) and cartels.

Many of the structural and budgetary difficulties confronting the continent are associated with bad governance. Corruption, in particular, hinders growth and investment by raising transaction costs, thereby reducing profitability, and by diverting public resources from their intended uses. Moreover, corruption and fraud feed on government policies that generate rents and allow a few members of society to acquire undeserved profits by bribing government officials. For this reason--as well as for reasons of efficiency--the IMF has consistently asked for the removal of import and export quotas, tax exemptions, subsidies, and other policies that grant privileges to special interest groups. The IMF has also sought to liberalize agricultural sectors throughout the region--notably the cocoa sectors in Cote d'Ivoire and Ghana and the cotton sector in many West African countries--with a view to raising efficiency and improving the distribution of income in favor of poor farmers. In addition, the IMF will continue to call for the end of agricultural subsidies and protection in industrial countries, in some cases to the detriment of African producers.

Corruption also can lead to the misappropriation of public funds in violation of the law and budget procedures, sometimes in connivance with officials in the spending ministries or with potential taxpayers. In several African countries, the IMF has required that instances of fraud be investigated and, together with the World Bank, has asked for external audits of major public sector entities in countries where fraud, financial improprieties, or a lack of transparency was suspected. In a few countries, the IMF has had to delay, interrupt, or refrain from extending a program because a major episode of corruption or fraud was unresolved.

Raising labor productivity

The labor force has grown quickly in sub-Saharan Africa because of the rapidly increasing population. In parts of the region, however (in southern Africa, in particular), employment growth has been hindered by labor market rigidities, including the excessively high wages obtained by powerful labor unions for unskilled workers. Moreover, the growth of employment and the labor force is likely to be seriously affected by the sharp increase in the number of deaths from HIV/AIDS.

Recognizing that human capital formation is an important determinant of growth, the IMF and the World Bank have stressed that the sub-Saharan African countries need to increase the share of government spending devoted to education and health infrastructure (including improved sanitation and supplies of drinking water). Spending is not the whole story, however. There is statistical and anecdotal evidence of a large gap between budgetary appropriations and effective improvements in health care and education in sub-Saharan Africa. The difficult task ahead is to ensure that outlays earmarked for health care and education are not diverted to other uses and that schools and hospitals in rural areas get their fair share of public funds.

Major risks

Policies aimed at removing the obstacles to private investment and raising productivity, along the lines suggested in this article, should allow sub-Saharan Africa to make the most of its resources. However, for several reasons, the extent to which these policies will succeed in raising per capita income growth may be limited. First, there is the risk that the spread of armed conflicts might jeopardize the ongoing economic restructuring and poverty alleviation efforts in a number of countries. The continuation or escalation of conflicts will damage investor confidence and trigger capital flight and thus pose a major risk to the achievement of rapid and sustained growth.

Second, the spread of HIV and AIDS, particularly in southern Africa, could have a devastating impact on income and welfare. It is clear from several case studies that there will be considerable demographic, macroeconomic, and health care repercussions, including a significant deterioration in per capita income growth over the medium term.

What can be done?

In recognition of the limited progress achieved so far in reducing poverty, particularly in sub-Saharan Africa, the IMF has recently modified its concessional lending programs. The new Poverty Reduction and Growth Facility will continue to address the fundamental constraints on economic growth, but programs under this facility will place greater emphasis on poverty reduction and, hence, on adequate financing and delivery of social services, as well as on governance issues. Moreover, governments are increasingly taking the lead in developing ideas and plans for poverty reduction in the framework of a broad dialogue with civil society.

Raising growth and reducing poverty will be a difficult task, but one that can be accomplished, provided that policymakers in Africa and the international community are ready to do their part. As part of that effort, the IMF will continue to encourage countries to

* pursue strong macroeconomic policies: no one benefits from high inflation, particularly not the poor; large budget deficits crowd out private investment and discourage exports; and arrears deter investors;

* improve economic efficiency by liberalizing trade and maintaining competitive exchange rates, removing the state from direct involvement in the production of marketable goods and services, and enhancing domestic competition in all sectors, especially agriculture;

* support regional integration efforts that contribute to trade liberalization, strong macroeconomic policies, and the building of institutions that promote good policies;

* improve infrastructure, particularly ports and communications, to encourage trade and investment;

* increase the share of government spending directed to education and health and improve the delivery of services in these areas;

* intensify efforts to root out corruption; and

* reduce investors' risks by improving the quality and the integrity of the legal system.

In many of these areas, the World Bank will have a larger role to play. But the IMF can help through its financial programs, policy advice, and technical assistance. It can also contribute by helping countries that have been ravaged by armed conflicts, taking an active part in extending and deepening debt reduction, and pressing the advanced countries to open their borders to the exports of sub-Saharan Africa.

This paper is based on the author's "Raising Growth and Investment in Sub-Saharan Africa: What Can Be Done?" (IMF Policy Discussion Paper 00/4), which contains extensive references to the empirical literature.