Mobilizing Resources for Structural Transformation

5

CHAPTER

DESPITE THE UPTURN in Africa's economic fortunes in the new millennium, the failure of African economies—resource-rich and resource-poor alike—to diversify commodity-dependent structures has prevented them escaping from persistent fragility. Their growth prospects, and hence, capacity for resource mobilization, remain vulnerable to external shocks.[1]

The commodity boom has not yet succeeded in generating strong positive, economy-wide spill-over effects to other sectors within resource-rich countries or to resource-poor countries on a visible, continent-wide scale. Resource-poor and income-poor countries are heavily constrained by their meagre capacity to mobilize domestic resources as well as attract external resources—apart from official aid flows sustaining a minimum level of investment that prevents the development process from stalling altogether.

Governments face a range of challenges stemming from foreign investment activity. A fair share of the natural resource rents does not go to host countries but rather to the multinational enterprises (MNEs)—as do the benefits of productivity improvements stemming from FDI, instead of to the fragmented producers and farmers. Equally, domestic firms too often miss out on skill and technology transfer and productivity spillovers from FDI. Portfolio capital in resource-rich economies is very volatile, rendering it unsuitable as stable, development finance. Finally, high levels of informality, a shallow tax base and the unbalanced tax mix (often grounded in a heavy reliance on resource or trade taxes, including excessive tax preferences to MNEs), limit a country's domestic resource base.

For the resource-rich countries specifically, the challenge—as long as the commodity boom continues—is not so much how to mobilize external resources, but how to manage the flood of investment. Their windfall should be deployed purposely to help diversify and transform economic structures, including distributing resource rents for ensuring an inclusive growth pattern. Highly competent macroeconomic management over the commodity price cycle is required to avoid Dutch disease and to use resource rents for structural transformation.

The policy challenge shared by all African countries is therefore how to deploy resources for advancing the socio-economic development agenda, mainly because Africa's growth over the last three decades has not translated into meaningful job creation and poverty reduction.

The commodity boom has not yet succeeded in generating strong, positive, economy-wide spillover effects to other sectors.

One strand in meeting this challenge is to take a strategic position with all types of external actors and investors—traditional aid donors, new development partners from emerging economies, MNEs and private stock market investors, even workers abroad sending remittances. It is important to concentrate efforts on deepening financial markets and strengthening institutional capacity so that mobilized funds are effectively intermediated and used for productive investments and socio-economic development. This may entail new financial instruments, as well as substantial changes in public resource management to address at core the structural weaknesses in domestic public resource mobilization.

Policymakers should address these pressing challenges by taking advantage of new opportunities for bringing about structural transformation through improved mechanisms for mobilization, use, and distribution of resources, in order to create a foundation for inclusive growth.

5.1 The need for resources

AFRICA'S RESURGENCE (see chapters 2 and 3) is raising hopes that Africa will finally emerge from its status as a fragile continent, despite its discouraging growth trends. Not only is Africa blessed with rich natural resources, but its demographic trend—a youthful workforce—is favourable. The continent embraces a heterogeneous group of countries in natural resources, per capita income and other socio-political and economic characteristics. This diversity is reflected in the varying capacities across countries for raising financial resources for economic development, including the domestic resource gap—the distance between domestic savings and investment, much of which is met by external funding.

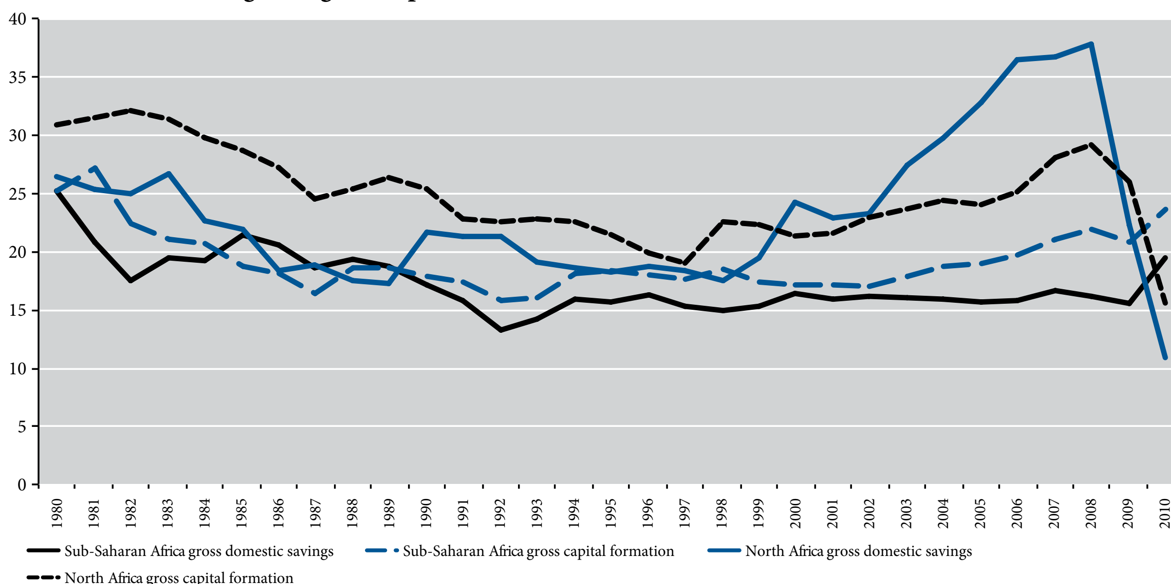
New financial instruments and substantial changes in public resource management are needed to address structural weaknesses in domestic public resource mobilization.

Savings and investment ratios have varied considerably over time (figure 5.1). In sub-Saharan Africa, the gross domestic savings ratio declined sharply from over 25 per cent in 1980 to 13 per cent in 1992 and stayed just above 15–16 per cent until 2009. The gross capital formation ratio followed a similar sharp downward trend from 25 per cent in 1980 to 16 per cent in 1992–1993 and stayed in the 16–18 per cent range for a decade before gradually increasing to 20–21 per cent in 2008–2009. In these early decades, foreign funds, mainly ODA, used to fill the domestic resource gap of about 3 per cent of GDP. The rise in investment after 2002–2003 reflects reviving economic growth, although external flows filled a domestic resource gap that widened from 3 per cent in 2003 to 6 per cent in 2008, as domestic savings did not increase enough.

Both savings and investment climbed markedly in sub-Saharan Africa by 2–3 percentage points in 2010, after experiencing a small reduction in 2009, marking a faster recovery from the global crisis among African economies (and other developing regions) than among developed countries. It is too early though to assume that this trend will continue in 2012 or beyond (see chapter 1).

Figure 5.1

Gross domestic savings and gross capital formation in Africa, 1980–2010 (% of GDP)



Source: *World Bank and UNECA dataset, 2011.*

Mainly because of differences in resource endowments and incomes, wide differences in aggregate savings and investment ratios stand out among country groups and subregions, particularly in low-income countries and in West Africa where savings ratios are around 2–6 per cent and investment ratios 5–9 per cent. These should be compared with the ECA estimate that for Africa to grow at 7 per cent a year—necessary to achieve the MDGs—the continent needs to maintain an investment rate of 33 per cent (UNECA, 1999).

In North Africa, too, these ratios experienced a steady decline through the 1980s to the late 1990s (see figure 5.1). The reduction in investment was particularly sharp, falling from 32 per cent of GDP in 1980 to 19 per cent in 1997. These two decades were indeed "lost" to economic development in Africa as a whole. Domestic savings in North Africa recovered quickly from the late 1990s, climbing to 38 per cent in 2008. This made North Africa a significant net creditor to the rest of the world, as domestic investment rose to only 30 per cent. Both savings and investment declined in 2010, however, reflecting the political upheavals (see chapter 1).

The recent impressive recovery in capacity to mobilize resources and invest is not seen in all African countries. A dichotomy of resource-poor and resource-rich countries, dictated by their natural resource endowments, is a characteristic of the continent. Resource- and income-poor countries have been left out, and are still heavily constrained by their meagre capacity to mobilize domestic resources or attract external resources. ODA fills their wide domestic resource gaps, sustaining the minimum investment required to prevent development from stalling.

Certainly, the acceleration in investment and growth over the past decade has been more characteristic of oil- and mineral-rich countries, and is closely associated with the price hike of their commodities on world markets since 2002, buoyed by strong demand from emerging economies. As long as the boom continues, the task facing these countries is not so much how to mobilize resources as how to deploy newly mobilized resources for the structural transformation and diversification of their economies.[3]

Some countries not necessarily regarded as rich in mineral resources, such as Ethiopia, Kenya and Tanzania, have seen rising investment rates, though their domestic savings rates lag behind. Manufacturing and services have begun to attract private capital flows, which indi-

Africa has a wealth of opportunities rarely available in its post-independence years, but the challenges of turning optimism into reality are daunting.

cates that African optimism is spreading to resource-poor countries and to activities not directly connected with minerals.

Africa is now at a critical juncture. It has a wealth of opportunities rarely available in its post-independence years. The challenges facing policymakers on how to use these opportunities—turning optimism into reality—are daunting.

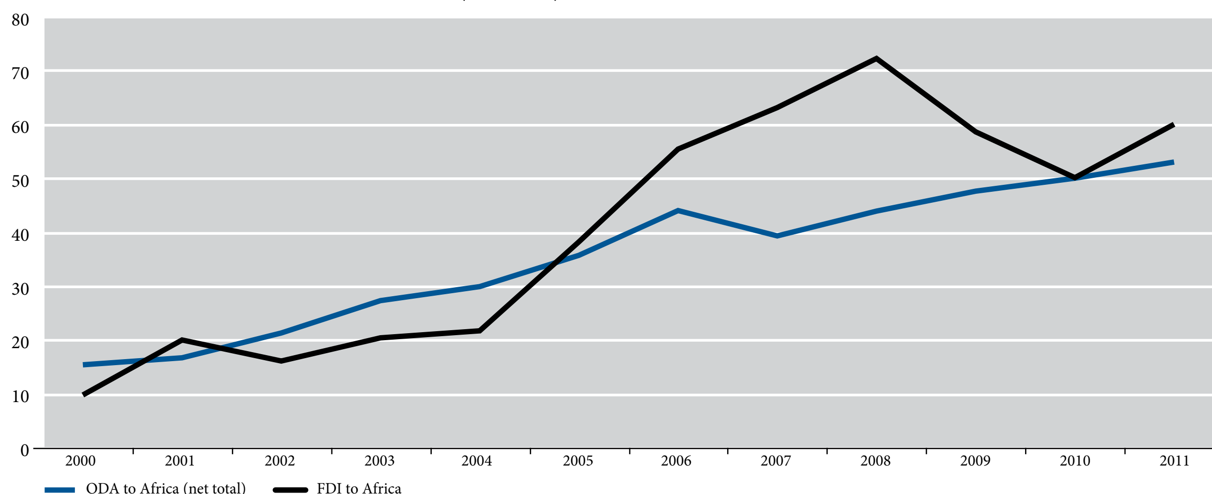
5.2 Meeting the need—external flows

ACCORDING TO AfDB et al., (2011), total external financial flows to Africa increased from $27 billion in 2000 to $126 billion in 2010, and FDI flows for the first time surpassed ODA that decade (figure 5.2).[4]

We now look at the changes in each component of external flows (ODA, FDI, portfolio flows, as well as remittances), largely through the prism of Africa's needs for structural transformation and diversification.

Figure 5.2

FDI and ODA flows to Africa 2000–2011 ($billion)



Source: *AfDB et al. (2011).*

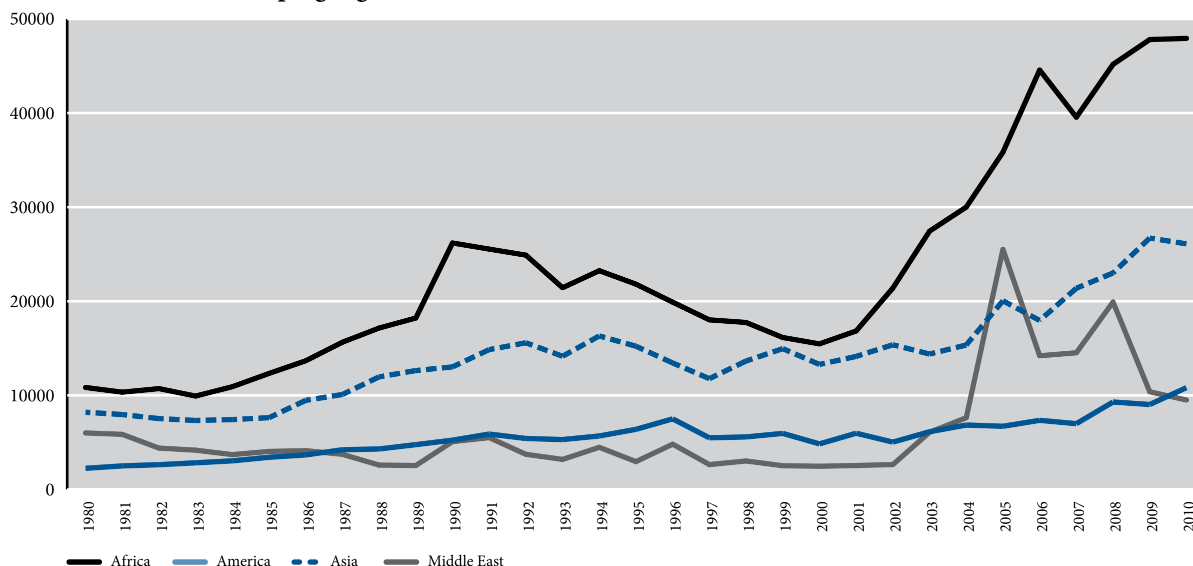
ODA: the shifting ground of aid policy in Africa

Net ODA flows disbursed to all developing countries in 2009 was just more than $127 billion, an increase from around $50 billion in 2000. Africa received net aid flows of more than $45 billion, or 35 per cent (figure 5.3). Sub-Saharan countries received $42.3 billion—the largest share (33 per cent) of total ODA flows—and North African countries received $2.9 billion.[5]

Aid flows to sub-Saharan Africa increased sharply from $12.5 billion in 2000 to $42.3 billion in 2009—over a three-fold increase, though well short of the pledge of "doubling aid to Africa" made at the G-8 Gleneagles conference in the United Kingdom in 2005. Aid to North Africa fluctuated between $2 billion–$3 billion for almost three decades except for 1990–1994 when bilateral dis-

Figure 5.3

Total aid flows to developing regions ($ million)



Source: *OECD Statistics, 2011.*

bursements to Egypt and other countries in North Africa doubled.

Both multilateral institutions and bilateral donors increased official aid to Africa in the past decade, but the sharp spike in aid to Africa in 2005–2006 came mainly from debt cancellation under the Multilateral Debt Reduction Initiative for the HIPCs (figure 5.4).

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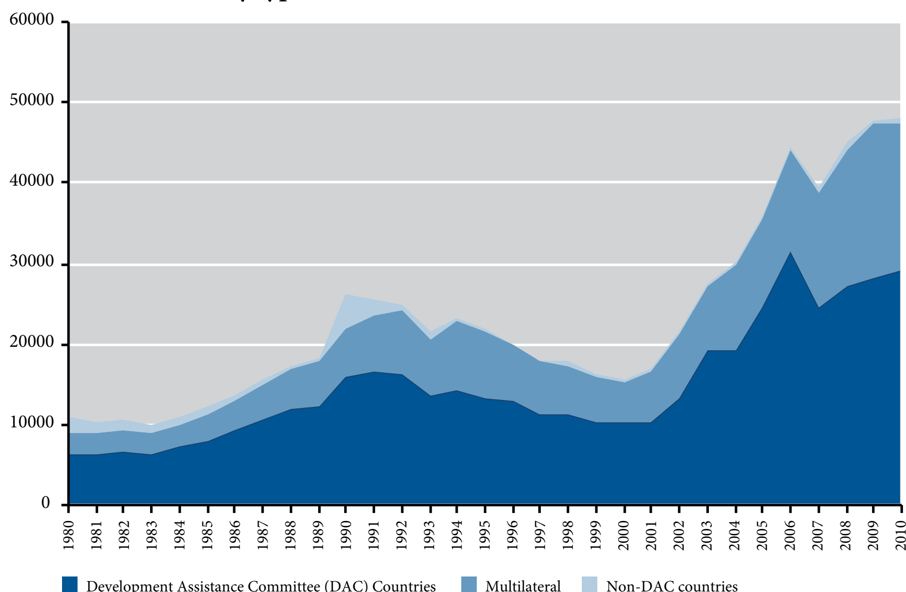
Figure 5.4

Aid flows to Africa by type of donor ($ million)



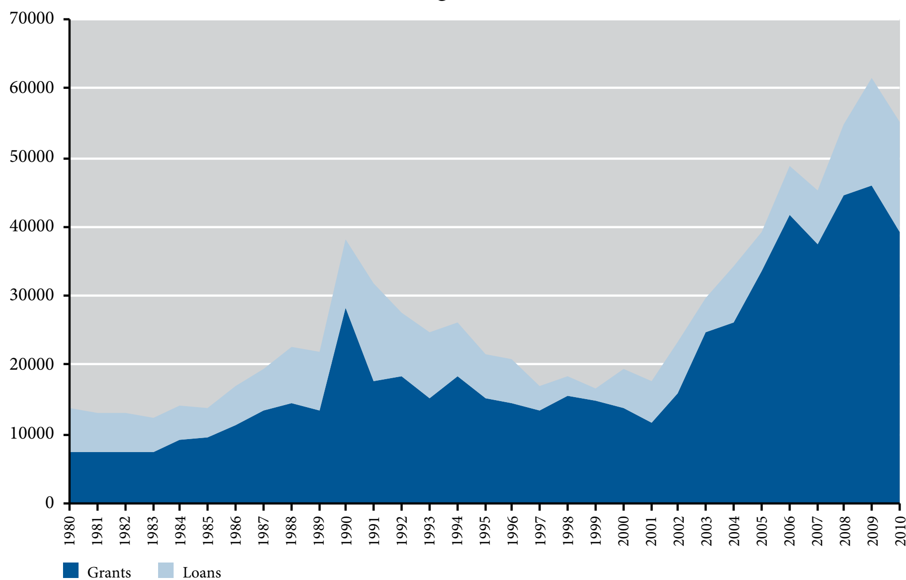
Source: *OECD Statistics, 2011.*

The grant–loan mix

Gross aid flows to sub-Saharan Africa and to North Africa have been dominated by grants in the last three decades (figure 5.5). In 2009, sub-Saharan Africa received $10.9 billion in loans and $36.1 billion in grants, almost 1:3; a larger share of 37 per cent in loans was disbursed to North Africa. This grant–loan mix, heavily in favour of grants, may partly be explained by recipient governments' preference to avoid accumulating debt-service obligations. In sub-Saharan Africa it may also reflect a conscious decision by donors to eschew a repetition of the protracted debt crisis that stalled progress in socio-economic development in heavily indebted countries for 25 years before its resolution through the Multilateral Debt Reduction Initiative adopted in 2005.

Figure 5.5

Gross aid flows to Africa: loans versus grants ($ million)



Source: *OECD Statistics, 2011.*

This section argues that the policy discourse on aid modality between loans and grants is somewhat oversimplistic, if not misguided. In fact, an example of the inappropriateness of such an approach is evident in the practice of the mechanical application of the "traffic light system" for deciding the grant–loan mix in the Debt Sustainability Framework used by the World Bank and IMF in the International Development Association (IDA) aid allocation. The use of properly structured, incentive-compatible loan contracts is technically preferable to outright grants in financing productive investment, with a greater growth dividend recuperated within a reasonable time of debt contracts (Nissanke, 2010b).

We should also consider that, if grants are the only instruments used for aid provision, the size of the overall aid envelope could be limited by the budget constraints that bilateral donor governments and multilateral development agencies face annually. Increasing aid through loans entails lower real costs for donors than providing the same nominal amount of aid as grants (Gunther, 2009). Indeed, the use of concessional loans allows augmentation of the overall aid resource envelope, as governments and agencies can use more funds mobilized through efficient inter-temporal management of their own resources.

An appropriate configuration of the grant–loan mix should thus be decided on, depending on what aid is used for. Many economic infrastructure projects that can alleviate various absorption capacity constraints and other critical supply bottlenecks could, in principle, bring about high growth dividends, faster. Indeed, they can generate high social returns if projects are managed efficiently to create a steady cash flow over a period corresponding to a negotiated debt payment schedule. Hence, for financing these types of projects, concessional loans can be a superior instrument to grants. The real issue for avoiding a protracted debt crisis in future is how to make terms and maturity structures of concessional loan contracts appropriate and generous enough to ensure a steady flow of debt service payment through an efficiently structured, contingent-financing facility that addresses low-income countries' high vulnerability to exogenous shocks.[6]

Investment in social infrastructure, such as health and education, would take longer to generate growth dividends.

Investment in social infrastructure, such as health and education, would take longer to generate growth dividends. Returns to investment in human capital accrue more to individuals, hence widely dispersed, requiring an efficient and progressive tax system to recuperate. The latter takes time for governments to create and administer. Thus, grants can well be a more appropriate instrument of aid for this kind of investment or technical assistance and cooperation. Great care is required in deciding which aid instruments and modalities are appropriate, case by case.

ODA weaknesses in Africa

One might also challenge the basis of some of the key positions taken previously by the donor community in deciding how best ODA should be provided for low-income countries in Africa to overcome developmental bottlenecks. Experience with aid-funded economic infrastructure projects in the 1960s and 1970s was indeed astonishingly dismal in Africa, as many projects were conceived and carried out in an incorrect political-economy context.

For a start, ODA should have never been used for funding many of these politically motivated projects. Also, economic infrastructure projects require strong institutional and political commitment, equipped with dedicated professional management teams and adequate resources for operation and maintenance. Many valuable lessons have been drawn, but these mistakes cannot be used to justify reducing ODA support to economic infrastructure projects altogether. Further, ODA can play a pivotal role in both economic and social infrastructure development in low-income countries, through financial and technical assistance. The need for social infrastructure should not be used as a rationale for drastically curtailing ODA to economic infrastructure development, as happened

in Africa in the 1980s and 1990s. Three reasons are put forward.

The first was the failure of many donor- and government-funded infrastructure projects, often dubbed "white elephants". Some of these projects were manifestly "wrong" from inception, as they were motivated almost exclusively by political considerations rather than carefully justified in economic terms. The others failed because of inadequate provision for recurrent and maintenance costs, unrealistic pricing, or prevalence of regulatory forbearance or gross mismanagement. The second reason was the relentless drive of the World Bank and IMF for public divesture, privatization and deregulation across infrastructure sectors in the 1990s. The third was the powerful advocacy for shifting public spending towards social sectors such as health and education, partly due to the deliberations of the Copenhagen Social Summit in 1995.[7]

In fact, it was the rise of a development paradigm emphasizing the virtues of liberalization, deregulation and privatization during the 1980s that had a profound impact on donor aid policy for infrastructure development. The World Development Report 1994 "Infrastructure for Development" is testimony to the dominant position taken by the donor community at the time. Its main recommendations were to "manage infrastructure like a business", "introduce competition" and "give users and other stakeholders a strong voice and real responsibility" (World Bank, 1994: 2). These policy measures had persuasive power in light of some real problems typically found in infrastructure development and management in Africa, such as inefficient operations, inadequate maintenance, fiscal drain, unresponsiveness to user demands and neglect of the poor and the environment.

Thus, reflecting both the shift in the dominant paradigm in the 1980s and these concerns on the ground, the World Bank then advocated greater private sector involvement and full cost recovery in utility provision, resulting in a major decline in donor-financed infrastructure projects in general. The prevailing view was that, once these sectors were deregulated and privatized, private investors would take over and turn around the coverage and quality of infrastructure services.

Yet, this optimism proved unfounded everywhere, particularly in Africa, which had attracted cumulatively just $28.1 billion of private flows for infrastructure investment in 1990–2002, compared with $199.4 billion in East Asia and $397.4 billion in Latin America and the Caribbean. Further, most of the private infrastructure investment in Africa took place in telecommunications (66 per cent) and electricity (18 per cent). Very little went to transport and water. Only a handful of countries in Africa, including South Africa, attracted private capital for running this infrastructure and these utilities in response to privatization initiatives (AfDB, 2006).

These conditions—especially the low private investment in Africa and in transport and water—partly reflect the well-known fact that there is a big wedge between private and social returns in providing utility services in poor areas. The initial sunk costs of infrastructure investment in poor, inaccessible areas are very high, yet cost recovery through pricing and user charges is impossible without commitments of substantial public financial resources, if the target is to improve the poor's access to infrastructure services. Appropriate pricing of services has often been one of the most difficult issues to address in infrastructure reforms.

The public economics literature has long acknowledged that market failure prevails in the presence of externalities. On account of high positive externalities and spillover effects, the provision of infrastructure development and services should be appropriately seen in the domain of public goods provision. Given that social returns are higher than private returns to infrastructure investment and that high risks are involved in large projects with long gestation periods, the public sector should shoulder a large share of financing infrastructure development and service provision in the early stages of economic development.

Yet, during the 1990s, the public sector throughout developing countries heavily cut its contribution to infrastructure development because of factors such as the unfounded optimism that private finance would be made available, the fiscal austerity required in protracted debt crises, and decentralization (that led to mismatches be-

tween resources and needs). Particularly in Africa, the sharp fall in domestic public financing (section 5.4) was exacerbated by an equally steep reduction in ODA for economic infrastructure in the 1990s. East Asia and the Pacific was an exception to this global trend, however (box 5.1).

Box 5.1: East Asian ODA for infrastructure: bucking global trends

In East Asia and the Pacific, about four fifths of aid in the last two or three decades has come from bilateral donors, with Japan the main source.[1]

Japan's ODA to the region is concentrated in economic infrastructure development, and the share of infrastructure financing in total aid followed an upward trend from the early 1970s. ODA for economic infrastructure and water-related infrastructure accounted for two thirds of infrastructure financing in the 1980s and 1990s. Public goods provision in economic infrastructure has thus been consistently higher in East Asia than in other developing areas. The contrast is sharpest between East Asia and Africa.

The East Asian experience unequivocally points to the central role of infrastructure provision in economic development. Financing infrastructure investment as public goods and strengthening State capacity to deliver infrastructure services sustainably are prerequisites for spurring and sustaining private initiatives and investment.

1. *See Nissanke (2007) for further discussion.*

In Africa, an inevitable correction to the damaging cull of infrastructure financing began by the mid-2000s, once donors identified infrastructure deficiencies as a critical gap in economic development. Given the continent's geographical disadvantages as one of the most binding growth constraints, the need for massive infrastructure investment was officially recognized as crucial for accelerating economic and productivity growth as well as for reducing poverty. This unfortunate delay reflected the unhealthy situation that has evolved since the early 1980s, whereby much of Africa's development agenda is set by donors, in particular IFIs.[8]

This belated official recognition—see, for example, the Commission for Africa Report (2005)—has entailed a heavy cost in forgone economic growth and poverty reduction. Given the enormous infrastructure deficit, in its call for an immediate doubling of ODA to Africa to $50 billion a year, the Commission believed that about half of ODA should be spent on building infrastructure. The most recent estimate suggests that the cost of addressing Africa's needs in physical infrastructure is about $93 billion a year, some 15 per cent of Africa's GDP. About two thirds of this is needed for greenfield and rehabilitation investments, and the other third for maintaining current infrastructure.[9] Will a new development paradigm—South–South cooperation—be any better than the approach of the traditional donors?

Working with new development partners

China and other emerging economies such as Brazil, India, Korea, Turkey, Malaysia and capital-rich countries in the Middle East have increased aid and investment in Africa, offering a new kind of development partnership based on South–South cooperation.[10] Indeed, trade between Africa and its new development partners has increased at a phenomenal pace over the past decade, leading to a marked reduction in the share of the traditional partners from Europe and North America in the continent's trade and foreign investment.[11] In 2009, China's share in Africa's total trade with emerging partners was about 38 per cent, India's 14 per cent, and Brazil, Korea and Turkey each accounted for about 7 per cent (AfDB et al., 2011).

The emergence of China and other economies as new economic partners for Africa has attracted widespread attention and debate, receiving mixed reactions in policy circles around the world. Though the actual amount of aid provided by non-traditional partners to Africa is still small relative to the volumes from the traditional donors (that is, the members of the OECD-DAC), it has been increasing quickly.

The form of engagement among new partners varies (see chapter 4). For example, while Brazil focuses more on agriculture and agro-processing, a large proportion of India's aid, which has expanded alongside FDI and trade, is provided as technical assistance. India is active in learning, skills-intensive areas and services. At the first India–Africa Forum Summit in 2008,[12] India came up with new major initiatives including the Pan-African e-Network Project, the Techno-Economic Approach for the Africa-India Movement as well as Special Commonwealth African Assistance Programmes.

Saudi Arabia is reported to have provided Africa with $5.5 billion in gross ODA in 2008, using the Saudi Fund for Development to finance investment projects through concessional loans for transport and energy infrastructure. It allocated 28 per cent of its loans to countries in sub-Saharan Africa. Arab and Islamic funding institutions in aggregate are reported to have invested $2.4 billion in 2008 and $1.7 billion in 2009, in African infrastructure.[13] As a new member of the OECD-DAC, the Republic of Korea is now aligning its aid policy with those of other DAC members.

Yet, it is the form of China's engagement in Africa as well as its sudden surge in activities and the timing of its "return" to Africa that has attracted perhaps the most commentary worldwide.[14]

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The China card

China's aid is available without any policy conditionality attached, on the basis of a "coalition" engagement (a collaborative State–business approach through aid, trade and investment as a package). Though details of different components in the package are difficult to tease out, China's economic activities in Africa in aggregate have been expanding faster since 2001. In 2001–2008, bilateral trade is reported to have increased 10-fold, while total Chinese investment in Africa is estimated to have reached $26 billion by the end of 2008, according to a Chinese source.[15] China's pledge to double aid within three years (2007–2009), made at the summit meeting of the third Forum for China–Africa Cooperation in Beijing in 2006 was fulfilled, despite the global crisis. China has also agreed debt relief or cancellation with 31 African countries. At the last forum in November 2009, it made a new pledge to double its concessional loans to Africa to $10 billion in the next three years, while setting aside $1 billion for loans to SMEs in Africa.

So far, one of the main focuses of China's aid has been on building economic infrastructure, now universally seen as critical to Africa's future, and that contribution is also highly visible. Even with issues encountered in implementation, the country is rapidly expanding its areas of cooperation, going beyond natural resources and infrastructure through the "Angola Mode" to agriculture and sectors such as telecommunications and water, as well as to soft infrastructure projects such as building hospitals and schools. A raft of new financial institutions and facilities has also been created, including the China Development Bank. More than 90 per cent of China's infrastructure projects are still financed by preferential loans from the EX-IM Bank, but some, such as road activities in Botswana and Ethiopia, are now funded by the Ministry of Commerce, which has begun providing investment and trade credit financing.[16]

Large State companies from China may dominate big infrastructure projects and resource extraction sectors, but some private companies have become active in various sectors. With official financial support initially avail-

able through the China–Africa Fund, an ever-increasing number of small, privately run firms have been setting up in manufacturing and services across the continent, especially in Nigeria and South Africa.[17] These private firms operate mainly outside the close circle of Chinese Government supervision and monitoring. Private firms, initially assisted by concessional loans, have also been told to wean themselves financially off State help.

Private commercial banks, such as the China Merchant Bank and the Industrial and Commercial Bank of China, which acquired a 20 per cent stake in South Africa's Standard Bank in 2007, have started playing a pivotal role in providing commercial loans to a growing number of Chinese private entrepreneurs in Africa. China's State credit insurance agency—Sinosure—has become active in offering cover for country and credit risks.

Chinese–African economic relationships are, in short, complicated, spanning numerous activities and actors, evolving constantly as a critical part of China's overall going-out strategy.

In agriculture, China has targeted its aid at increasing productivity by sending large numbers of experts and setting up extension centres for sharing and transferring technology. African farmers are reported to prefer farming machinery from China to that from the West as it offers technology that is simple and easy to operate. Yet, China's domestic considerations and imperatives sometimes appear to impose themselves also on engagement with Africa in agriculture. For example, there has been a big push for Chinese farmers to focus on opening new lands for plantations in Africa. What lies behind this initiative is reported to be China's own need to relocate the farmers displaced through the dual pressures of WTO trade liberalization and its rapid urbanization, as well as its eyeing Africa as a source of future supply for its own food security. This move has inevitably produced a backlash against large Chinese investments in agriculture. African smallholders see such initiatives as a threat to traditional farming, dubbing them land grabs.

Overall, aid in a package deal with expanded investment and trade from China (and other new partners), without policy conditionality and cumbersome negotiations, has added impetus to African development against the chequered history of aid relationships with traditional bilateral donor countries and multilateral institutions. The emerging partners' stance offers African countries an opportunity to gain the policy space that is desperately needed for exploring their own path of economic development. It could, potentially, even help to bring to maturity Africa's nascent democracy if it makes African policymakers accountable for policy reforms to their citizens, not just to donors.

Finally, because aid and investment flows from new development partners have targeted not only critical bottlenecks in African economic development—infrastructure and agriculture—but also new activities and sectors—services and manufacturing—there is hope that such engagement could alleviate these bottlenecks, realize the structural transformation of economies and share benefits from economic globalization, in a sustainable manner. For this to become reality, African policymakers have to take proactive, strategic positions in their economic relationships with emerging partners as these partners are engaging in Africa undoubtedly driven by their own business and economic interests.

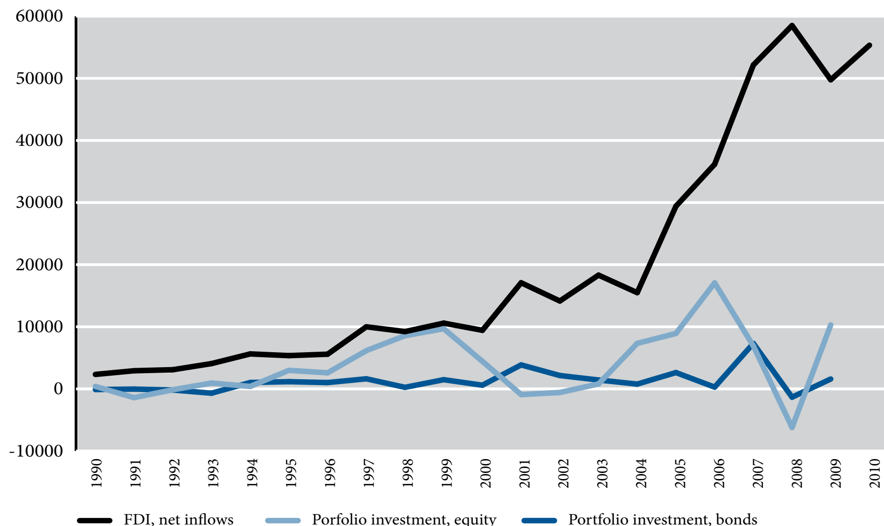
African policymakers have to take proactive strategic positions with emerging partners in their economic relationships.

Private capital flows

The surge in interest in resource-rich Africa from new partners and creditors has had other tangible "leverage-in effects" from international investors, unseen before in Africa. For the first time, private investors are increasingly taking Africa seriously as one of their key destinations. Net flows of FDI and portfolio investment (equity and bonds) to Africa for 1990–2010 are given in figure 5.6.

Figure 5.6

Net private capital flows to Africa, 1990–2010 ($ million)



Source: *World Bank (2011a).*

Foreign Direct investment

FDI to African countries peaked in 2008 at $72 billion—a five-fold increase from 2000 and from just $2 billion in 1990—falling to $59 billion in 2009 and to $50–$52 billion in 2010, owing to the global financial crisis (figure 5.6). FDI now accounts for 20 per cent of gross capital formation in Africa, much higher than in other developing regions (AfDB et al., 2011).

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Africa still attracts largely natural resource–based FDI or FDI geared towards the lower end of the global value chains of MNEs, such as simple assembly-line operations. FDI in the garment industry in Africa is an example of "foot-loose" FDI, attracted by temporary conditions such as preferential market access granted through the African Growth and Opportunity Act (AGOA) or protections accorded under the Multifibre Arrangement before it expired in 2005. These sectors and activities are characterized by fewer dynamic externalities and knowledge spillovers than in other developing regions. Only some of the very recent FDI in new knowledge- and technology-intensive sectors—such as telecommunications, ICT and solar-panel production, or biotechnology-based agricultural products—have raised hopes for a new generation of FDI activities that are local market–based and can therefore be locked firmly with commitments to Africa's future.

In considering the strategic position that the host countries should take to derive maximum developmental benefits from FDI, one should recognize wide asymmetries in market power and access to information, technology and other intangible knowledge assets between MNEs on the one hand, and local entrepreneurs, farmers and traders in developing countries on the other. Indeed, contemporary "corporate-led" globalization has eroded the capacity of governments to raise revenues for redistributional purposes or to enact regulations to protect and enhance labour rights or protect the local environment, for fear of driving away MNEs or capital. This is reflected in the MNE dominance in commodity and value chains of traded goods, as well as in observed conditions such as the sharp decline in real wages in export processing zones.

In such global conditions, the benefits of productivity improvements, instead of going to the fragmented producers and farmers, are largely appropriated by MNEs and global supermarket chains. This has resulted in a hugely skewed distribution of gains from global trade and direct investment, pointing to the need to improve the negotiating positions of governments in developing countries vis-à-vis MNEs—in a strategic, targeted approach to FDI—so that FDI can facilitate skills and technology transfer and generate strong productivity spillovers that also benefit domestic firms.[18]

More specifically, given that most FDI is attracted to Africa by its rich deposits of oil, minerals and other metals, we cannot expect dynamic externalities (through market-based channels) such as the generation of significant forward and backward linkages between upstream and downstream industries, as is the case in manufacturing or services. Hence, the issue of how to manage and distribute resource rents through macroeconomic policy configuration and fiscal mechanisms should take a central place in policy discussions in natural resource-based economies.

There is a need to ensure that a fair share of the resource rents accrues to host countries in the first place—thus, the question of how to conduct negotiations on resource rents with MNEs, becomes critical. In Africa, the position of governments weakened sharply after mineral concerns were privatized in the 1990s, and in an ownership structure dominated by MNEs policy space for autonomous fiscal and monetary management—in bringing about short-run stabilization as well as long-run economic development through fiscal mechanisms—is heavily curtailed. Owing to differences in privatization programmes negotiated with MNE conglomerates, Zambia, for example, found itself in a much less favourable position than Chile in distributing and using mineral rents.[19] Given the public outcry over unfair tax regimes for mineral rents negotiated under earlier secret deals, the Zambian Government was in the end forced in 2008 to renegotiate the initial fiscal concessions accorded to MNEs.

Negotiations between MNEs and host countries on fiscal and tax regimes conducted in secret tend to produce outcomes strongly favouring MNEs, because host countries, too fearful of losing the MNE interested in their location, offer unnecessarily generous fiscal concessions such as tax holidays or lower taxes and royalty payments. Indeed, asymmetric access to information on MNE global strategy and little transparency in negotiations have often prompted competing host governments to "race to the bottom".

Yet, fiscal concessions may not be one of the top criteria for MNE investment-location decisions, compared with other fundamental issues such as the size of the potential national and regional markets or the skills level of workers (with horizontal and vertical integration), the quality or other technical properties of natural resource deposits (with resource-based FDI) or general political and economic stability. For this reason, policymakers need to focus on improving these fundamental conditions in order to influence MNE decisions on where to invest. As chapters 3 and 4 showed, there are numerous other factors as well, including the institutional environment, economic and social infrastructure, and technological capabilities. All these need to be upgraded not only for investment promotion, but also for laying a solid, wider foundation for socio-economic development.

Over the past decade, African governments have taken many investment promotion and liberalization measures to attract foreign investors, with an emphasis on creating "an enabling environment for doing business" in policy

The quality of governance over the domestic distribution of resource rents makes a huge difference to the development of resource-based economies.

discussions led by the IFIs. These measures include reducing transaction costs by cutting unnecessarily cumbersome bureaucratic paper work and strengthening regulatory systems. These measures are naturally important for facilitating private investment generally, by foreign or domestic investors.

However, there is a question mark over the "additionality" in investment flows entailed in various attempts at luring foreign investors by granting too generous fiscal incentives. Aarsnes and Pöyry (2010) argue for more transparency and for host countries to move away from agreements with individual MNEs signed behind closed doors. They stress the merits of establishing open, general, transparent non-negotiable fiscal terms enacted directly in tax law, as in most developed countries. In particular, they recommend that host countries have tax systems and rates that are neutral relative to the MNE home countries or have clear benchmarks for comparable countries in the case of capturing resource rents. Their proposal is specifically intended to avoid unnecessary fiscal competition and to reduce incentives for MNEs to use illicit transfer-pricing mechanisms for repatriating profits.[20]

Finally, there is no doubt that the quality of governance over the domestic distribution of resource rents makes huge a difference to the development of resource-based economies. In fact, the use of resource rents for sustainable economic development is likely to require the formation of a developmental State through a real public–private sector alliance in the name of broad–based, inclusive, socio-economic development.[21]

Portfolio flows

Private portfolio flows to Africa are much smaller than FDI flows (see figure 5.6). South Africa is the dominant destination, taking about 80 per cent of Africa's total, and Egypt comes next. Mauritius is known to be the most active portfolio investor in intra-African portfolio investments (AfDB et al., 2011). With increased private capital flows over recent years, Africa's asset–liability positions with the rest of the world and its debt profile and dynamics may change greatly. In particular, if these flows are properly deployed in productive investment with substantial growth dividends, the absorptive capacity of capital flows and the debt-carrying capacity of African economies could be enhanced.

However, portfolio flows are characterized by very high volatility and are pro-cyclical (see figure 5.6). These charts show net portfolio flows, which already cancel out the extreme volatility exhibited in gross flows. Further, portfolio flows in contemporary financial globalization are more diversification finance (conducted through asset swapping for risk hedging and shedding by financial investors to achieve maximum risk-adjusted returns to asset holders) than development finance, the case under the early phase of globalization in the late nineteenth and start of the twentieth centuries. Mediated through very high-frequency trading activities, portfolio flows are viewed rightly as "hot money".

The pro-cyclicality of portfolio flows is driven by fast changes in investor liquidity preferences and risk appetites or aversion. Hence, the potentially detrimental effects of sudden cross-border movements on the stability of macroeconomic conditions and on domestic asset prices raise serious policy concerns. It is by now well acknowledged that financial globalization proceeded without a proper global governance structure, including an internationally coordinated system of regulation and supervision of the activities of financial institutions. Furthermore, cross-border capital flows are the main culprit for developing unsustainable global macro imbalances and periodical financial crises.

As newcomers to international capital markets, policymakers in Africa can draw many valuable lessons on how to manage cross-border portfolio flows from the expe-

riences of emerging economies in other regions which adopted a regime of full capital-account convertibility earlier. In fact, the best approach for African countries may well be to concentrate efforts on deepening financial markets and strengthening the capacity of financial institutions, rather than on courting international investors excessively out of eagerness to mobilize additional resources.

The size of African capital flight is huge. More than $700 billion fled the region during 1970-2008.

Remittance flows, and flights of financial and human capital

Given the growing size of workers' remittances to Africa, how can they be used better (UNECA and AUC, 2011) note that remittances represented the most important source of capital flows to Africa after FDI in 2010, equivalent to about 7 per cent of African GDP. Cape Verde, Gambia, Morocco, Nigeria, Senegal and Togo receive some of the larger flows as a share of GDP.

Workers' remittances accrue to private citizens, and are used for various purposes, including: keeping current consumption over subsistence levels among poor households; attending to medical conditions of household members; investing in children's education, nutrition and health; building private housing; and starting and expanding businesses. These uses contribute to socio-economic development, but are not centrally mobilized and are intermediated through informal channels and financial systems to the hands and accounts of the recipients.

Developmental benefits would stem from increased income and enhanced savings from remittances, preferably mobilized through financial institutions or a broadened tax base with an enhanced system of collection of direct and indirect taxes.

Policymakers could also aim to repatriate the huge wealth that has built up in foreign bank accounts or in real assets abroad as a result of capital flight (capital that has left the continent through non-transparent transactions or illicit channels used by high-profile politicians or other government officials with access to public money).

The size of African capital flight is huge, according to Ndikumana and Boyce (2011). On the basis of data reconstructed from balance-of-payments statistics of 33 sub-Saharan countries, they estimate that more than $700 billion fled the region during 1970–2008. If one includes earned interest at market rates on the accumulated wealth, the value of capital flight amounts to $944 billion—close to sub-Saharan Africa's GDP in 2008 of $997 billion.[22] These statistics reveal a major development challenge stemming from unacceptable levels of mismanagement of public resources in Africa.

To this capital flight, we should add the loss of public resources incurred through the brain drain of skilled human resources because of the lack of suitable jobs at home. Many African countries are in effect paying to train medical professionals for developed countries. By one recent estimate, "sub-Saharan African countries that invest in training doctors have ended up losing $2 billion as the expert clinicians leave home to find work in more prosperous developed nations".[23]

Governments could usefully revisit the "the brain drain tax" proposal made in the mid-1970s by Professor Bhagwati. For example, at least some proportion of income tax on skilled and professional emigrants levied in destination economies could be used as a source of development financing for specific projects in education and health or for schemes designed to create job opportunities for skilled and educated youth in home countries.[24]

Such financial haemorrhaging and massive human capital loss from the continent illustrate how much hardship the people of Africa have had to endure unnecessarily because of the "institutional development trap" that has characterized the African continent throughout the post-independence era, despite its immeasurable developmental potential in human and natural resources (box 5.1).[25]

Box 5.2: The institutional development trap

Diagnosing the development trap in Africa as resulting from large-scale pervasive government failure, in the wake of the early 1980s' debt crisis, the IFIs recommended economic liberalization and deregulation, and keeping the size of governments to a minimum, in exchange for aid and debt restructuring. Africa's debt crisis was, however, closely linked to the severe commodity crisis at the time (Maizels, 1992).

The collapse of commodity prices amounted to a loss of real purchasing power of 40–60 per cent for many commodity-dependent economies in sub-Saharan Africa—a deeper crisis than that faced during the Great Depression in the 1930s. For macroeconomic stabilization, the demand management of commodity-dependent economies hit by external shocks should have been countercyclical to commodity price movements. Yet, at that time of an externally induced balance-of-payments crisis, accompanied by a sharp drop in domestic demand, these countries were forced—lacking alternative financial facilities—to adopt the IMF-sponsored pro-cyclical stabilization programme that brought about further contraction in aggregate domestic demand.

In practice therefore, with the debt crisis, as well as severe and deep fiscal retrenchment imposed on them in the reform process, governments were generally left with little capacity and few resources to undertake sustained public investment and little ability to crowd in private investment.[1] In the absence of reliable public goods provisions, transaction costs to engage in productive activities remained prohibitively high. Economic transactions were conducted in highly uncertain and risky environments, which engendered eminently volatile returns to investment.

High uncertainty and instability are powerful deterrents not only to private investment and economic growth, but also to the composition of investment in favour of reversible and safe investments that have a self-insurance character. In such circumstances, African investors systematically chose safe and liquid assets over less liquid but high-yielding assets. While wealthy segments of the population often invested abroad—capital flight—other private investors put their capital in short-term assets in sectors with lower sunk costs and shorter turnover periods, such as trading, rather than in long-term physical investments (Aryeetey, 1994). The resulting low public and private investment together harmed economic growth and development in Africa.

In particular, the political and economic environment in the 1980s and 1990s kept the economic activities of a significant proportion of private agents away from the "official" economy. Since then, the informal economy has become an important source of employment and income for the majority of urban and rural households, and economic activities tend to be restricted to small-scale production and local trade. The majority of the poor, particularly the rural poor, have been left behind. At the same time, a largely informal economy leading to a weak and narrow tax base reinforces fiscal fragility.

The slow but gradual transition from systems of personal or authoritarian rule—characterized by infrequent but often violent turnover of incumbents—to democratic regimes with a multi-party system since the turn of the 1990s was naturally a welcome change. This could potentially lay the basis for creating governments committed to broad-based, equitable and inclusive development.

Yet, in practice continued poor public-goods provision and fragile fiscal conditions developed its own vicious cycle for condemning an economy to low equilibrium, leading to a fragile State with reduced institutional capability to function. Indeed, the scope and quality of public social and infrastructure services progressively deteriorated in many countries in the 1990s.

Thus, without resolving the institutional trap, States could make little progress in mobilizing the energy and resources of their people for commonly shared development objectives. Rather, more often than not, fiscal fragility and retrenchment aggravated distributional tensions and conflicts in ethno-linguistically fractured societies. These factors have acted as serious impediments to structural transformation in Africa's economies.

***1.** See Nissanke (2011b) for a further analysis of how international and institutional traps are closely interrelated through feedback mechanisms that have created both a low-equilibrium trap of debt-induced growth and an institutional configuration that is detrimental to shared growth and inclusive development through a loop of negative private–public interfaces for economic development.*

5.3 Meeting the need—new approaches

SEVERAL INNOVATIVE FINANCIAL instruments have attracted attention as mechanisms for closing Africa's vast infrastructure gap by mobilizing private savings through financial markets. Among them are instruments targeted at global investors who can bear high currency and country risks in their quest for high returns, including debt instruments issued in hard currencies, and private funds or vehicles (Brixiova et al., 2011; Beck et al., 2011).

Ghana's sovereign external 10-year bond issue of $750 million in late 2007, for example, to finance energy and infrastructure projects attracted heavy publicity at the time, as it was the first sovereign bond issued by a sub-Saharan country (apart from South Africa). It was hailed as a success, achieving a B+ rating and four times oversubscribed at the time of issue, with strong demand from asset managers and hedge funds in particular. In the wake of the global financial crisis, however, it was sold heavily at 48 cents to the dollar in the fourth quarter of 2008. It recovered to 80–85 cents to the dollar in summer 2009 but with a yield of about 12 per cent.

This episode, as well as the sovereign debt crisis in the euro area, shows the high volatility in sovereign bond markets and that debt sustainability could be at risk when investor risk appetite shifts rapidly. Indeed, a series of sovereign bonds issues planned in 2009 and 2010 by African countries had to be deferred owing to adverse conditions on global financial markets.[26]

Attention has recently been paid to tapping excess savings in public bodies on the continent or globally for accelerating investment in Africa. Many resource-rich countries in Africa have become net creditors to the rest of the world, as the rapid increase of commodity prices since 2002 and many new discoveries of mineral and oil deposits in Africa have led them to accumulate reserves. Windfalls from these resource rents are often far in excess of a country's absorptive capacity to deploy them effectively for development over a short period. In any case, commodity prices are inherently volatile, so policymakers in these countries require attractive savings instruments to smooth their expenditures and absorption over commodity boom-bust cycles.[27]

In response to these conditions, several governments with large excess reserves have established sovereign wealth funds (SWFs) to manage these savings. SWFs are increasingly seen as one of the potential sources for financing development, in particular infrastructure projects in Africa.

In contrast to private equity funds, which are mostly managed by private investors, or bond issues on international capital markets, SWFs are managed by governments with excess public savings. A number of resource rich countries in Africa, such as Libya and Nigeria, have already used this approach to fund development projects in their own countries or elsewhere in Africa.

African policymakers need to take a strategic position on exploiting all these new opportunities, and negotiate and secure best deals, so that resources in minerals, oil, and precious metals are used in the best interests of the future generations of the African people.

Mitigating risks

A common thorny issue in all these sources potentially available to bring in foreign funds, private or public, is how to mitigate risks associated with long-term investment. Brixiova et al. (2011) propose various risk-mitigating instruments, including:

- Debt and equity insurance and guarantee instruments for mitigating commercial and political risks, in addition to partial risk guarantees offered by multilateral institutions.
- Viability-gap financing (leveraging in public funds for infrastructure investment by providing public subsidies through partial capital cost financing upfront) for reducing risks to private investors.
- First-loss guarantees for portfolios such as the First Loss Investment Portfolio Guarantees developed by AfDB to mitigate country risk premiums.
- Currency hedging, government exchange guarantees and devaluation liquidity schemes against currency risks.

These are useful when supporting institutions and when other preconditions are in place. However, residual risks always remain in any inter-temporal financial transactions, and often the excessive application of sophisticated financial instruments and securitization increase systemic macro risks, as seen in many financial crises over the past two decades.[28]

Further, efficient trading of international financial instruments requires deep, highly liquid, markets and developed forward markets for domestic currencies in the first place; such preconditions cannot be developed overnight. Over the past decade, many emerging economies in Asia have focused efforts on deepening bond markets by issuing debt instruments in domestic currencies to attract both domestic and global investors on an experimental basis and by gradually deepening the market with more issues. They have also boosted the capacity of domestic financial institutions and regulatory systems.

African countries require a long learning period before operating in international capital markets with confidence on an equal footing.

In considering the use of risk mitigating instruments, therefore, associated costs and benefits should be carefully weighed. On the one hand, the cost of accessing sophisticated risk-hedging instruments is often prohibitive for low-income countries without subsidies from multilateral public institutions. On the other hand, as the global financial crisis suggests, the effectiveness of the risk-mitigating capacity of some instruments is not guaranteed. These considerations raise the question of whether public resources should encourage use of these instruments, rather than focus on deepening markets and boosting domestic capacity.

Policymakers should be also much more vigilant against accumulating unsustainable private external debt, by carefully monitoring debt through an appropriate debt sustainability analysis framework (under different assumptions and scenarios). In a crisis, it is the government that has to take on private debt obligations and turn them into sovereign debt obligations.

African countries require a long learning period before operating in international capital markets with confidence, on an equal footing. They may consider experimenting with issuing debt instruments in local currencies and aiming primarily at domestic (or diaspora) investors and financial institutions (or those with ties to, or expertise in, countries in Africa).

Since investors in these investment vehicles are more likely to have firm commitments and interests closely aligned with the economic development of African countries, they are probably willing to take currency or other country risks associated with these local currency–de-

nominated instruments issued in domestic capital markets, by positioning themselves with a longer perspective. Hence, these instruments are by nature more geared towards financing long-gestation infrastructure projects.

Recent examples of instruments launched in Africa in this category include four types of bonds (Brixiova et al., 2011):

Local currency infrastructure bonds. The Kenyan Government issued three infrastructure bonds for roads, energy and water, sewerage and irrigation with a total value of $1 billion in 2009/2010. This paved the way for issuance of corporate bonds by private and State companies, including Safaricom (a mobile phone company) and KenGen (an electricity utility). Additional incentive schemes instituted with infrastructure bonds in Kenya: allow bond holders to use infrastructure bonds as collateral for bank loans, and banks can pledge them as collateral for their operations; exempt bondholders from tax on interest payments; and incorporate the practice of Islamic banking, so that banking institutions such as the Gulf African Bank can participate.

Commodity-linked bonds. The Standard Bank Group in South Africa offered rand-denominated, commodity-linked, exchange-traded notes in August 2010, which are listed on the Johannesburg Stock Exchange, with a specific redemption date and returns linked to the performance of precious metals.

Infrastructure and municipal bonds. These seek the participation of domestic pension and other funds, as well as international investors.

Diaspora bonds. Such bonds could raise $5 billion–$10 billion annually by tapping the wealth of 16 million Africans living abroad (Beck et al., 2011). The people of the diaspora are viewed as less risk-averse towards bonds issued in domestic currencies as they know more about their country of origin than other investors. They also have liabilities in their home country and often have a desire to help develop it. Ethiopia, for example, issued Millennium Corporate Bonds targeting Ethiopians at home and abroad.

Realistically, however—for the time being at least—only a handful of "frontier" markets such as Egypt, Kenya, Nigeria and South Africa may issue bonds, because bond markets have to be highly liquid, with appropriate term structures. Many smaller countries would require regional capital markets in subregional hub countries, which are important in accessing finance for cross-border infrastructure projects, as their economies are often too small to justify projects on their own. One way forward, benefiting from economies of scale, can be done through subregional banks, funds and associated instruments, as discussed at recent meetings of the AU and various RECs.

5.4 Meeting the need—taxation

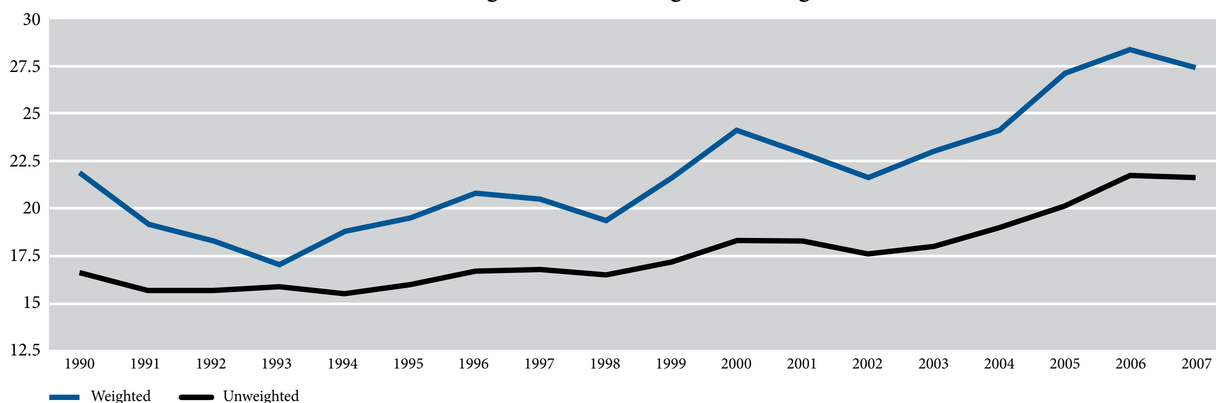
Recent trends in tax revenues

THE AVERAGE TAX to GDP ratio has been increasing since the early 1990s in Africa (figure 5.7). The weighted average of the tax ratio declined from 22 per cent in 1990 to 17 per cent in 1993, but from then it climbed to 27 per cent of GDP in 2007, a 10 percentage point increase in 15 years. Africa's average tax ratio is quite high relative to developing countries in East Asia and the Pacific and Latin America and the Caribbean, whose ratios were 10–17 per cent in 2007–2009.

The tax ratio differs hugely among African countries depending on the country's natural resource endowments and income. The recent increase in Africa's average tax ratio is largely driven by windfalls to governments in oil-producing countries. Classified by income (figure 5.9), the tax ratio in upper middle-income countries in Africa in 2007 was 30 per cent, nearly achieving the average of 35 per cent in OECD countries. Lower middle-income countries had a ratio of 20 per cent and low-income countries only around 15 per cent (AfDB, OECD and UNECA, 2010).

Figure 5.7

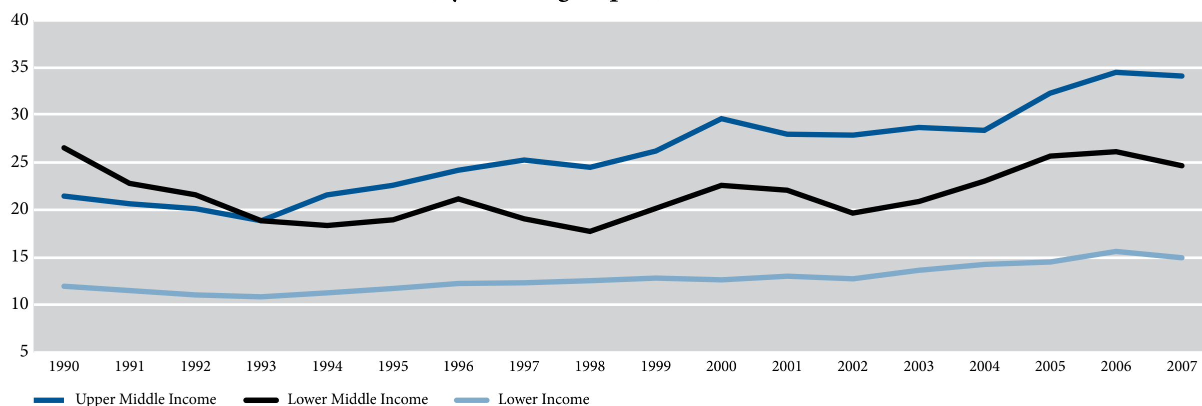
Tax share of GDP in Africa, 1990–2007 (weighted and unweighted averages, %)



Source: *AfDB, OECD and UNECA (2010).*

Figure 5.8

Tax share of GDP in Africa, 1990–2007 (by income group, %)



Source: *AfDB, OECD and UNECA (2010).*

As expected, there are clear overlaps in groupings between resource-rich countries and upper middle-income countries.

What makes tax systems in Africa different from those in other developing regions are a heavy reliance on resource-based taxes in resource-rich countries, particularly among oil-producing countries; a small share of direct taxes (personal income and corporate income taxes combined) in most African countries; and a high share of trade taxes in poorer countries.[29]

Trends in 1996–2007 were as follows: the increase in the weighted average tax ratio for Africa (see figure 5.7) was driven almost entirely by the rise in resource-based taxes in resource-rich countries, in particular in oil-producing countries.[30] The share of resource-based tax revenues as a share of GDP tripled from 3 per cent in 1998 to 15 per cent in the late 2000s. In Libya and Angola, this share was 66 per cent and 39 per cent, respectively, in 2007.

The share of corporate income tax remained stable but low relative to potential revenues because of too many tax concessions and exemptions granted to corporations. In indirect taxation, lower-income countries showed a marked increase despite its regressive nature. The share of trade taxes declined in the period, but the rate of the decline decelerated. In the earlier years, the effects of trade liberalization strongly affected government revenues.[31]

Structural tax issues

The critical structural issues in domestic public resource mobilization may be summarized under three headings (AfDB, OECD and UNECA, 2010):

- Unresolved cross-cutting structural bottlenecks: high levels of informality, a lack of fiscal legitimacy and huge administrative capacity constraints.
- Further erosion of the already shallow tax base by excessive granting of tax preferences, inefficient taxation of extractive activities and inability to fight abuses of transfer pricing by MNEs.
- Unbalanced tax mix: excessive reliance on a narrow set of taxes to generate revenues, disproportionate representation of some stakeholders in the tax base, and emergence of a critical gap in public resources due to declining trade taxes.

The two key features of most African countries—the shallow tax base and unbalanced tax mix—are largely outcomes of the unresolved cross-cutting structural bottlenecks.

The informal economy, which remains stubbornly high in Africa, is less productive than the formal sector, and people in it have no labour or social protection schemes. Many informal economic activities are very fragile, and by the nature of their activities, they function outside the tax net, although they may pay indirect taxes, such as value-added tax.

Many informal operators may not feel much benefit from paying taxes—direct or indirect—gaining little tangible payback in high-quality public services or provision of public goods. Thus, as AfDB, OECD and UNECA (2010) note, informality often arises where the costs of legal employment outweigh the benefits for producers, employers or employees. Further, if entry costs in a regulated economy are unaffordable, people and businesses are forced to remain outside the system (Jütting and de Laiglesia, 2009).

The institutional changes required to move out of this type of behavioural impasse are usually slow to come. Concerted efforts on all fronts would, however, make a difference and would lead to lifting institutional constraints and freeing the traps discussed above (box 5.1). In particular, enhanced and sustainable provision of public goods is essential for domestic stakeholders to feel tangible returns from their tax contributions.

Another outcome of the structural bottlenecks is that public resource mobilization cannot be improved by just increasing tax rates from the existing narrow base. Yet, policymakers in Africa tend to take an easy short cut by adjusting the tax rate at margin to increase revenues. For example, UNECA and AUC (2011) point to tax-related problems, citing several assessments such as "African countries tend to enforce easy taxes, particularly trade taxes, and impose high taxes on the formal sector or both" (Aryeetey, 2009). The finding by Gauthier and Reinikka (2006) suggested that "a high tax burden is imposed on a limited number of taxpayers, and on medium-size firms, which already bear a disproportionately high share of taxes". Indeed, UNECA and AUC (2011) argue that "A fundamental tax difficulty in Africa is the trilemma between the demand for higher tax revenue to finance development; the unwillingness of those with political power and economic ability to pay additional tax; and the rest who have no assets to be taxed and who resist paying taxes."

AfDB, OECD and UNECA (2010), among other studies on tax in Africa, discuss detailed policy measures for overcoming the weaknesses in the tax system such as establishing an independent revenue collection body

Many informal operators may not feel much benefit from paying taxes—direct or indirect—gaining little tangible payback in high quality public service or provision of public goods.

and enhancing the administrative and technical capacity of tax-collecting institutions. Beyond such proposals, tax issues should be considered as deeper structural concerns that require fundamental changes in public resource management. The unbalanced and shallow tax base in African countries today, in particular, their strikingly heavy reliance on resource-based tax revenues is not only a testimony to the continuous susceptibility of fiscal revenues to commodity boom-bust price cycles but is also a result of the historically evolved weak incentives for governments to engage in forging a meaningful partnership with domestic stakeholders for advancing the socio-economic agenda.[32]

Mobilizing and managing domestic resources better

A distributional fiscal mechanism should therefore be used so that a genuinely functional partnership between the State and domestic stakeholders can be forged. Policy discussions should go well beyond the technical issues looked at above. Mobilizing domestic public resources should be discussed in the context of a broader debate on how to mainstream the informal economy into the country's development agenda as part of the strategy of improving public resource management at large. Broadening the tax base through improved fiscal distribution mechanisms is the best way forward in the long run.

Further, to avoid past experiences with forced fiscal retrenchment in crisis, resource-rich countries should strengthen their macroeconomic management over commodity cycles—now, while their economies enjoy the commodity boom. Countercyclical macroeconomic management through commodity stabilization funds, as practised in Chile and Norway, is undoubtedly a critical tool for managing resource rents for economic development.[33]

But the practicality and efficacy of implementing such policies depend heavily on how mineral rents are distributed between domestic stakeholders and MNEs, and how they are used and managed. Many low-income countries find it hard to conduct successful countercyclical macroeconomic policy, not just because it requires high technical knowledge, but because they regard the opportunity cost of holding savings abroad as too high in the light of immediate pressing needs to accelerate economic development and to reduce poverty.

5.5 Conclusions and policy recommendations

SEVERAL POLICY IMPLICATIONS can be drawn from the analysis and discussions in this chapter, summarized as follows:

- Windfalls from commodity booms and newly available resources should be deployed purposely to help diversify and transform economic structures, while resource rents should be distributed to ensure that an inclusive growth pattern emerges.

- African policymakers should take a strategic position with all the categories of external actors and investors. They should seize on their newly acquired, stronger position by presenting their home-grown development visions and strategies as a basis of negotiations.

- To mobilize private domestic and foreign savings through financial systems, it is important to concentrate efforts on deepening financial markets and strengthening the capacity of financial institutions so that mobilized funds are effectively intermediated and used for productive investments and socio-economic development.

- It is critical to forge a truly productive partnership between the State and domestic stakeholders. This requires making substantial changes in the political economy of public resource management, to address at core the structural weaknesses in domestic public resource mobilization.

- Policymakers should broaden the tax base by improving fiscal distribution, such as better provision of public goods, and by mainstreaming the informal economy into development processes.

- Mechanisms of regional cooperation for countercyclical macroeconomic management should be explored and deepened.

With changes in external economic conditions and the geopolitical landscape for Africa, the aspirations of domestic stakeholders have been rising. Young generations of Africans in particular are eager for a better future and are rightfully demanding inclusive development, politically and economically. Policymakers should take up this challenge and turn emerging opportunities into reality by accelerating the process of structural transformation, as well as by facilitating wider engagement of domestic stakeholders in economic policymaking, so as to build an inclusive society.

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Notes

1 See Nissanke (2012) for detailed discussion on factors behind recent commodity price dynamics.

2 These groupings have a few overlapping countries such as Mauritania and Sudan, owing to the differences in the way the World Development Indicators and UNECA classify countries.

3 The portfolio element in capital inflows is very volatile, and exaggerates commodity price cycles. It can disappear quickly as market sentiment shifts, making it unreliable as development finance.

4 There are some discrepancies in the volume of each of the flows reported in AfDB et al., (2011) and the discussions in this section depend on the source of data used for analysis. However, all the data, irrespective of source, reveal common trends.

5 Our analysis on ODA is based on OECD-DAC data, which report total aid flows to Africa and for countries “South of Sahara” and “North of Sahara” separately as well as to individual countries. Under its classification, Sudan and Mauritania are grouped into North Africa, as in the UN classification. In this chapter, we use countries in sub-Saharan Africa (Africa excluding North Africa) for countries “South of Sahara”.

6 See Nissanke (2010b) for detailed arguments and the cases for incentive-compatible loan contracts and an efficiently structured contingent financing facility along the lines originally proposed by Krugman (1988), but specifically adapted for use as a mechanism to avoid recurrence of debt-overhang conditions in low-income countries prone to exogenous shocks (such as commodity prices shocks). The objective of such a facility is to provide low-income countries with an automatic debt-relief mechanism incorporated in the original contracts. See also Cohen et al. (2008) for an alternative contingency scheme—the countercyclical loan facility.

7 See Ndulu (2006) for a discussion on this effect.

8 The diagnoses offered by the donor community for development failures in Africa have in fact evolved from “capital shortage” in the 1960s and 1970s to “policy failures” in the 1980s to the “institutional failures” in the 1990s (Adam and O'Connell, 1997). Only in the 2000s has the “infrastructure” failure in Africa received due attention.

9 See Beck et al. (2011).

10 Africa's top emerging partners are China, India, Brazil, Republic of Korea and Turkey (AfDB et al., 2011).

11 Traditional partners' share in Africa's overall trade totalling $673 billion in 2009 was 64 per cent (AfDB et al., 2011).

12 India at the first India-Africa Forum Summit promised to provide $5.4 billion in loans and $500 million in grants over the following five or six years.

13 Brixiova et al. (2011).

14 See Nissanke and Soderberg (2010) for more detailed discussions of China's drive in Africa. It looks at such areas as China's domestic imperatives for its drive in Africa, its adoption of the economic cooperation model practised by the Japanese Government in Asia as its chosen aid modality (with some notable variations), and its impacts on African development, which have raised both hopes and fears in the region.

15 Detailed statistics and information on Chinese aid and cooperation are hard to obtain. Indeed, the paucity of information and the unfamiliarity or non-transparency of the Chinese engagement have led to some misunderstanding, confusion, and occasionally unfounded accusations against Chinese aid in Africa. Offered as a package together with trade and investment, aid cannot be disentangled from other economic deals and relations, and hence it is difficult to analyse on a par with bilateral aid from other DAC countries. This must be one of the

reasons why aid flows from non-traditional partners are not properly captured in the OECD-DAC data, on which figure 5.4 draws.

16 See Wang (2007) for further discussion of financial facilities.

17 The China–Africa Fund, China's State-owned private equity fund, was set up in 2006 with an initial $5 billion. The fund was given a promise of further expansion at the FOCAC meeting in 2009. Alden and Hughes (2009) suggest that much more than three quarters of a million Chinese have migrated to Africa in recent years, following the lure of African riches.

18 See Nissanke and Thorbecke (2010) for detailed discussions of recent trends in MNEs' activities and changes in their relative positions versus host countries.

19 See Nissanke (2010a and 2011a) for more detailed discussion on recent developments in governance of commodity markets and production, and their effects on economic development in low-income commodity-dependent countries.

20 See Aarsnes and Pöyry (2010) for discussions of various components of tax systems for resource rents.

21 See UNECA and AUC (2011) for detailed analysis of the developmental State.

22 Similarly, it has emerged that former Presidents Ben Ali of Tunisia and Mubarak of Egypt (and their families and associates) have embezzled billions of dollars over many decades, much in capital flight. Former President Ben Ali and his entourage are reported to have expropriated over $5 billion, while wealth totalling $10 billion–$11 billion has been amassed by former President Mubarak (and his associates). Al-Alami (2011) compares these figures with an education budget of $2.5 billion and capital spending of $1 billion for 2007 in Tunisia and an education budget of $5.8 billion for 2007 in Egypt.

23 Kelland (2011). South Africa and Zimbabwe suffer the worst brain drain of medical staff.

24 See Bhagwati (1976) for a rationale for the brain drain tax, and Brauner (2010) for designing the tax to make it administratively and legally feasible in the current international tax regime.

25 See Nissanke (2011b) for conditions characterized by the two traps that have impeded African development over five decades.

26 Similarly, private equity funds, in their quest for high, private returns, may not be the appropriate vehicle for development financing. If African policymakers do use them, they should put in place necessary measures to safeguard the interests of projects and people in Africa against instability originating from these destabilizing cross-border movements of funds.

27 Some emerging countries in Asia and Latin America now hold large international reserves resulting from their desire to have liquid assets for self-insurance purposes against currency attacks or financial crises. A large part of these excess savings are held in safe assets with low returns such as US Treasury bills, entailing substantial opportunity costs.

28 In the global financial crisis, for example, sophisticated derivatives and instruments such as collaterized debt obligations or special-purpose vehicles to securitize original credit transactions gave an illusion that risks had been removed from their portfolio. If anything these instruments amplified aggregate systemic risks. See Brunnermeier (2009).

29 AfDB, OECD and UNECA (2010).

30 AfDB, OECD and UNECA (2010).

31 See Keen and Monsour (2009) for detailed discussion of the sharply declining share of trade taxes in tax structures in sub-Saharan Africa for 1980–1982 to 2003–2005.

32 See UNECA and AUC (2011) for discussion on institutional deficits in the early post-independent years which made it difficult to advance developmental agenda collectively.

33 See Nissanke (2011a) for a critical assessment of the proposal for using macro-hedging with derivative instruments as an effective substitute for countercyclical macroeconomic management through commodity stabilization funds. For such a proposal see Borensztein et al. (2009).

Economic Commission for Africa

African Union

Although Africa's growth has, since independence, been driven mainly by primary production and export, its growth resurgence since 2000 has benefited from improvements in macroeconomic management, good governance, institutional reforms and reduction in armed conflicts such that, apart from primary commodities, manufacturing, modern financial and telecommunications services and tourism are beginning to make significant contributions to growth.

While the negative effects of the triple crises in 2007–2009 still linger in food, energy and finance, the euro area sovereign debt crisis has further aggravated the structural imbalances in the world economy. Africa's swift and robust recovery in the aftermath of the global crises slowed to 2.7 per cent in 2011, with the political turmoil in North Africa. But even with the uncertainties in the world economy, the continent's growth rate is projected to rise to 5.1 per cent in 2012 and remain strong in the medium term.

The growth resurgence has transformed Africa from the world's lowest growing region in the past to one of the fastest growing regions, raising its potential as a new pole of global growth. For Africa to be a bona fide global growth pole, it must sustain the present growth momentum for at least another two decades. This requires innovative and bold long-term actions on seven fronts. First, improve political and economic governance. Second, invest in human capital and critical physical infrastructure. Third, promote innovation and technology transfer for increased value addition, industrialization and structural transformation. Fourth, address the daunting challenge of climate change. Fifth, catalyse a green revolution in agriculture. Sixth, mobilize increased development financing from internal and external sources. And seventh, accelerate regional integration and intra-Africa trade and harness new partnerships with the emerging southern economic powers.

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