Private Sector Development as an Engine of Africa's Economic Development

African Development Report 2011

The African Development Bank

African Development Report 2011

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FOREWORD

Africa's private sector is coming of age: It is poised to become the main engine of growth for the African continent.

Over the past decade, African countries have made great strides in improving their economic management and creating a better business climate. Countries such as Mauritius are leading performers on the global competitiveness index. These achievements are demonstrated by the remarkable growth in construction, retail, telecommunications and financial services of recent years. This in turn contributed to Africa's relative resilience in the face of the global financial crisis. We are also witnessing the emergence of a new African middle class with money to spend on consumer items, creating exciting new opportunities for business.

Today, however, Africa's private sector still faces a daunting array of challenges, including inadequate infrastructure, unfair tax regimes, a mismatch of skills, and limited access to finance. It is not yet generating the jobs needed to make major inroads into African poverty. Moreover, four out of every five private sector jobs in Africa are informal, many of them unpaid.

The African Development Bank is addressing the constraints on private sector development. We believe developing the private sector —and the jobs they provide— is fundamental for creating inclusive growth. The private sector also provides essential goods and services to the public, and a key source of the revenues that African countries need to meet their development challenges.

We have therefore made private sector development one of the four priorities of our Medium Term Strategy 2008–2012, together with infrastructure, governance and higher education. Our goals include improving the business environment, promoting inclusion through local enterprise development, and promoting social and environmental responsibility. Private sector development is the 2011 theme of the African Development Report, to highlight its potential in Africa. We want to send a clear signal to the world that Africa is open for business. The Report also notes our analysis of the challenges ahead, and how we at the Bank are working with our partners to address them.

Donald Kaberuka,
President
African Development Bank Group

Most African countries recognize the critical role that the private sector can play to help the continent reach its full economic and social potential. The private sector reduces poverty and drives economic growth and job creation, while empowering poor people by increasing their incomes and providing a broad range of products and services at lower prices. This requires an environment that supports small, medium and large companies alike. It also requires the creation of a favorable business climate (including the legal and regulatory environment), addressing the continent's infrastructure deficit, improving access to finance, strengthening human capital and skills development, fostering entrepreneurship, and improving corporate governance. All too often, however, Africa lags behind other developing regions in addressing these challenges, and ongoing efforts need to be intensified.

The private sector —which accounts for over four-fifths of Africa's total production, two-thirds of investment and three-fourths of credit to the economy— holds the key to the inclusive economic growth and high levels of employment that the continent needs to successfully tackle poverty. Decades of difficult political, economic, and social conditions, together with burdensome government policies, have constrained private sector development in Africa. Thanks to macroeconomic and structural reforms, the continent's economy has made significant strides over the past 10 years, and its resilience to the global economic downturn highlights how much has been achieved. Yet, fast growing gross domestic product has failed to translate into equal gains for all Africans: The number of poor people and indicators of inequality and unemployment, particularly amongst youth, have increased.

The 2011 African Development Report focuses on private sector development as the engine of Africa's economic development. It examines the challenges facing private sector development, and highlights ways to address these challenges, taking country differences into account. It concludes by discussing the Bank's role in support of private sector development.

The African Development Bank has been promoting private sector development for over 40 years and is committed to working with its development partners to support it. To generate greater developmental impact, the Bank is integrating private sector development across all its operations. Its objectives are threefold: (i) supporting regional member countries in improving business-enabling environments, and strengthening their international competitiveness; (ii) broadening participation and inclusion in the private sector and supporting local enterprise development for spurring robust employment creation and improving social well-being; and (iii) encouraging social and environmental responsibility, sustainability, and good corporate citizenship in private sector development.

Insights from this report are targeted towards existing and potential African and global private sector operators looking to enter or expand in the continent, and to policymakers and development partners that can shape the business climate. This report also promotes increased collaboration and

partnership among stakeholders to significantly enhance the ability of the private sector to advance the development process in Africa.

The elements to achieve unprecedented private sector growth all exist. We hope that this report will help bring them to reality.

Professor Mthuli Ncube
Chief Economist and Vice-President,
African Development Bank Group

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ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
ADF	African Development Fund
ADOA	Additionality and Development Outcome Assessment
AEO	African Economic Outlook
AfDB	African Development Bank
AICD	Africa Infrastructure Country Diagnostic
APRM	African Peer Review Mechanism
CAI	Capital Access Index
CASE	Cairo and Alexandria Stock Exchange
CEO	Chief Executive Officer
CIMA	Inter-African Conference on Insurance Movements
DRC	Democratic Republic of the Congo
DFI	Development Finance Institution
DIP	Directors Induction Program
ECA	Export Credit Agency
ECOWAS	Economic Community of West African States
ESB	External Sovereign Bonds
FAPA	Fund for African Private Sector Assistance
FDI	Foreign Direct Investment
GEM	Global Economic Monitor
GDP	Gross Domestic Product
GNI	Gross National Income
GOWE	Growth Oriented Women Entrepreneurs
HEST	Higher Education Science and Technology
ICT	Internet and Communication Technology
IDA	International Development Agency
IFC	International Finance Corporation
ILO	International Labor Office
IOD	Institute of Directors
IPPF	Infrastructure Project Preparation Facility
ISP	Institutional Support Program
IT	Information Technology
JSE	Johannesburg Stock Exchange
MDB	Multilateral Development Bank
MDGs	Millennium Development Goals
MIGA	Multilateral Investment Guaranty Agency
MNC	Multinational Corporation
MSME	Micro, Small, and Medium Size Enterprise
MTS	Medium-Term Strategy
NBER	National Bureau of Economic Research
NEPAD	New Partnership for Africa’s Development
NILEX	Nile Stock Exchange
ODA	Official Development Assistance
OECD	Organization of Economic and Commercial Development
OPEV	Operations Evaluation Department

OPSM	Private Sector Operations Department
OSGE	Governance, Economic and Financial Management Department
OSHD	Human and Social Development Department
OSS	One Stop Shot
PBO	Policy Based Operation
PCG	Partial Credit Guarantee
PEF	Private Equity Fund
PIDA	Programme for Infrastructure Development in Africa
PPP	Public Private Partnership
PRG	Partial Risk Guarantee
PSD	Private Sector Development
PSP	Private Sector Policy
PSS	Private Sector Strategy
RMCs	Regional Member Countries
SME	Small and Medium Size Enterprise
SMIEIS	Small and Medium Industries Equity Investment Scheme
STEM	Science, Technology, Engineering and Mathematics
STI	Science, Technology, and Innovation
TCX	Currency Exchange Fund
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
VOTEC	Vocational and Technical Training Institute
WAEMU	West African Economic and Monetary Union
WAMZ	West Africa Monetary Zone
WBES	World Bank Enterprise Surveys

OVERVIEW

Introduction

Africa's private sector is coming of age. Held back for decades by burdensome government policies, it is now poised to assume its critical role as the engine of economic growth and poverty reduction on the continent.

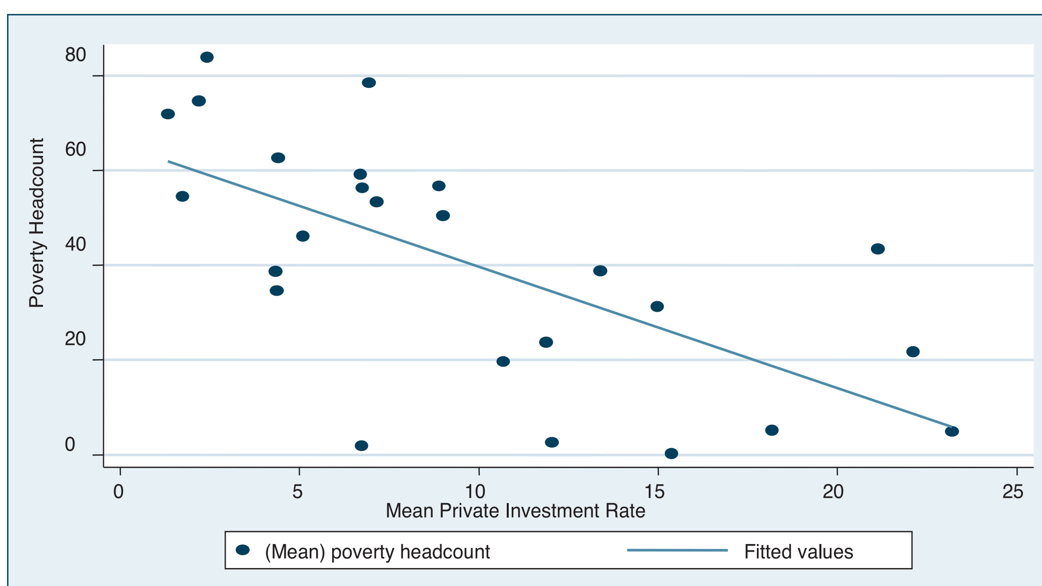
The private sector helps reduce poverty: It's a fact. The higher the share of private investment is of gross domestic product (GDP), the lower the incidence of poverty. A healthy private sector creates jobs and generates income, provides essential consumer goods and services, and through investments in infrastructure, it frees up public sector funds for other uses.

With poverty reduction in mind, private sector development has to become more of a priority in Africa. Although the region's per capita GDP has grown rapidly over the past decade and the number of people living in extreme poverty has declined, inequality remains stubbornly high and unemployment, particularly amongst youth, increased. To achieve economic outcomes that lift greater numbers out of poverty and soften inequality requires a vibrant private sector in which micro, small, and medium-size enterprises thrive alongside large firms, and both labor-intensive and higher value-added economic activities can flourish. This in turn requires improving the legal and regulatory environment for doing business, addressing the continent's infrastructure deficit, promoting access to finance, improving corporate governance, strengthening human capital, and fostering entrepreneurship.

Key Findings in Private Sector Development

This report looks at six often inter-related areas that pose challenges to Africa's private sector development. The legal and regulatory environment, infrastructure development, access to finance, human capital and skills development, corporate governance, and cultivating entrepreneurs are analyzed from several perspectives including country economic development level (African Development Fund (ADF), African Development Bank (ADB), Fragile Countries) and company type (formal, informal) and size (Micro, Small and Medium-sized Enterprises (MSME), large). The

Figure 1: Private Investment and Incidence of Poverty, 1996-2008



Source: AfDB calculations based on PovcalNet database and African Economic Outlook (AEO) data for 41 countries.

African Development Bank's role in each area is also highlighted.

The main findings of the *African Development Report 2011: Private Sector as an Engine of Africa's Economic Development* are:

- Most private sector activities are informal and carried out by MSMEs. Small enterprises account for an estimated two-thirds of Africa's total number of firms. Informal activities constitute a large share of Africa's production and employment. See Chapter 1.

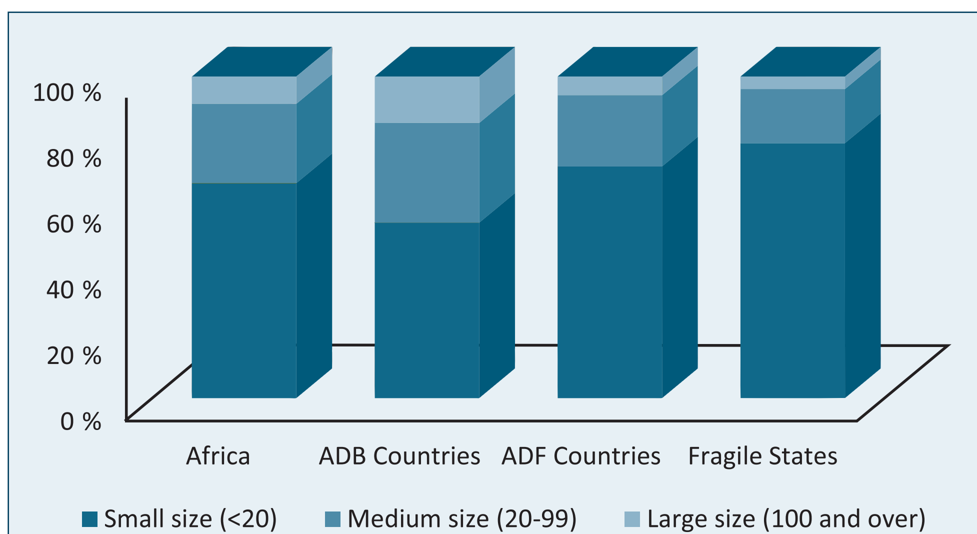
- From formal firms' perspective, constraints to private sector development vary according to levels of economic development. Fundamental constraints such as insufficient transport and access to power and finance are most critical in Fragile States and lower-income African Development Fund (ADF) countries; administrative constraints such as high tax rates and poor tax administration are more salient in higher-income ADF countries. Labor market-related constraints such as labor regulations and skill shortages are more serious in African Development Bank (ADB) countries than in ADF countries. See Chapters 2 and 3.

- Developing Africa's infrastructure at the pace necessary to unleash its economic potential requires a concerted effort to improve planning, preparation, and procurement capacities in line ministries and relevant sector units. Financial resources must be mobilized and leveraged for regional infrastructure development. See Chapter 3.

- Although laws and regulations critical for private sector development and corporate governance have been strengthened, they are undermined by poor monitoring and enforcement. See Chapters 2 and 7.

- Both bank and non-bank finance for African businesses is scarce, and long-term finance is even scarcer. Firms in countries with more advanced financial systems are increasingly able to tap stock markets to meet their financing needs. Access to finance for firms in countries with less developed financial systems could be enhanced through the creation of public registries and private credit bureaus and by tapping into private equity funds. See Chapter 4.

Figure 2: Size of Enterprises in Selected African Countries (By number of employees)



Source: AfDB calculations and World Bank Enterprise Surveys database for 41 African countries.

- There is a skills mismatch between Africa's tertiary and vocational schools' graduates and market needs. In the short run, this can be addressed by improving training programs and facilitating linkages between educational/ vocational institutions and the private sector. In the long run, sciences and technical skills, as well as learning through problem solving and critical thinking, should be prioritized throughout the education system. See Chapter 5.

- Becoming an entrepreneur in Africa is difficult. In addition to the general constraints to doing business, there are few apprenticeship/ training programs. Providing financial support for the creation of specialized business training programs would help encourage entrepreneurism. See Chapter 6.

Overview on the Challenges and Opportunities Facing the Private Sector in Africa

To begin with, reliable statistics on private sector activities in African countries are scarce. The informal sector is not systematically captured in national accounts, information on small and medium enterprises has to be extrapolated from surveys, and even private output in the formal sector has to be inferred from private consumption and investment. A concerted effort to systematically gather data on private sector activities, particularly on production and employment in both the formal and informal sectors, is urgently needed.

What Private Firms Look Like and Need to Develop Further.

Small firms dominate the private sector in Africa (Figure 2). The proportion of medium-size firms in Africa is low relative to other developing regions, implying that there is a "missing middle". Few African firms appear to transition from small- to large-size businesses. In contrast, more dynamic economies are characterized by a persistent high inflow of new entrants, an ongoing consolidation into medium-size firms, and the exit of weaker competitors. This competitive pressure drives productivity and employment in the micro, small and medium enterprises sector, which in turn feeds economic growth. Most of Africa's largest corporations are based in a handful of ADB countries and are primarily in the extractive industry.

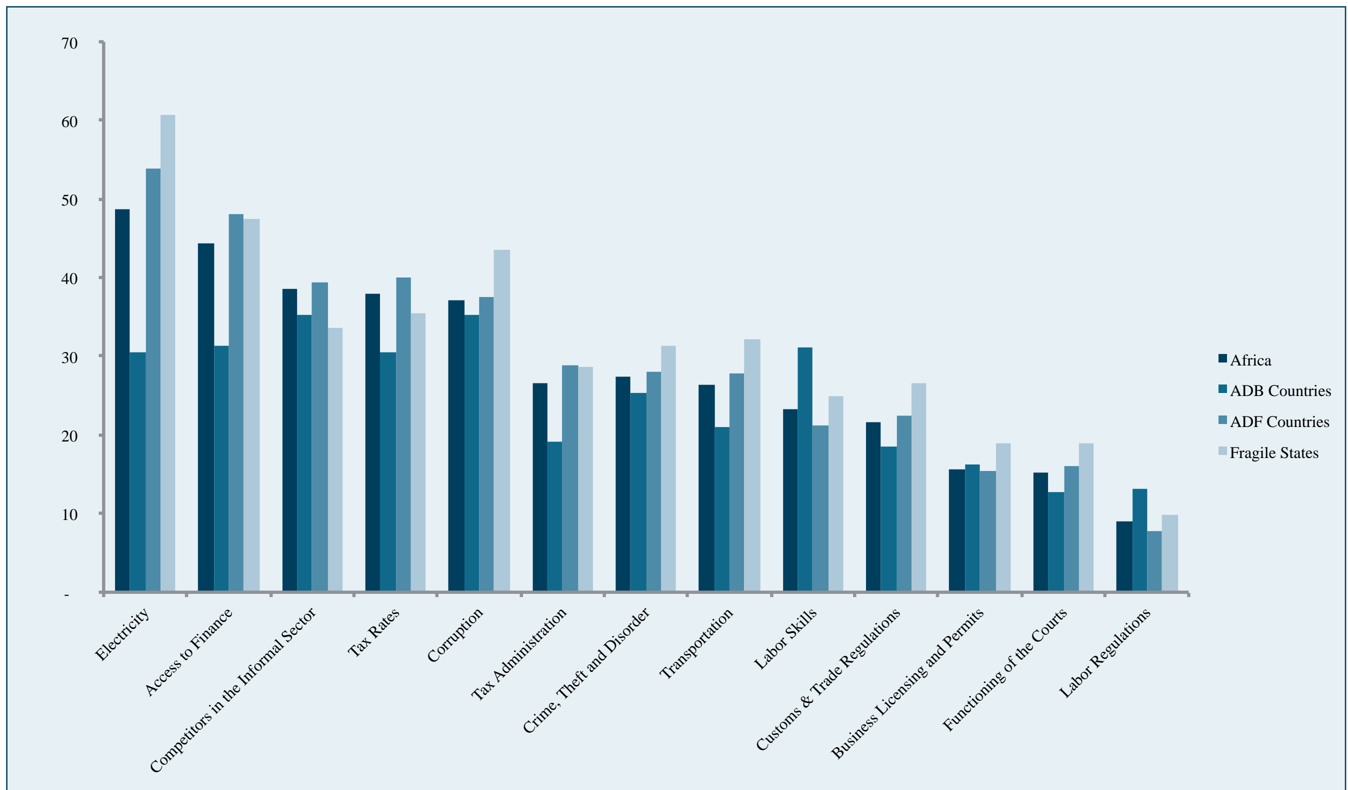
Challenges also differ by type of firm. Large companies are more concerned about corruption, skill shortages and labor regulations, while export-oriented businesses place tax administration at the top of their list. These systemic factors are of less importance for small firms, which find the lack of access to (and high cost of) finance, insufficient collateral, and the business owner's limited technical, management, and accounting skills to be more binding. The most severe challenge for microenterprises is access to finance.

Location Matters.

Although the private sector in African countries faces common challenges, the impact of these constraints varies according to the stage of economic development (Figure 3). From the perspectives of firms, fundamental constraints such as insufficient transport networks and lack of access to power and finance are most critical in Fragile States and lower income ADF countries, while administrative constraints such as high tax rates and poor tax administration are relatively more binding in higher-income ADF countries. In ADB countries, labor market-related constraints such as skills shortages and labor regulations are more important than in ADF countries.

The relative importance of individual constraints to gross domestic product (GDP) also varies according to African countries' level of competitiveness per their global competiveness index ranking. The results are similar to those based on rankings by income level. The results using the more disaggregated alternative classification scheme noted earlier are also broadly in line with those depicted in the income-based classification.

Figure 3: Ranking of Business Environment Constraints in Selected African Countries (Percentage of firms ranking a problem as major or severe)



Source: AfDB calculations and World Bank Enterprise Surveys data for 41 African countries.

Legal and Regulatory Environment

Private sector development requires predictable and transparent rules and procedures that foster business, backed by effective monitoring and enforcement. A poor regulatory environment hurts business competitiveness. Yet African countries rank low in terms of business environment, with a few exceptions (Figure 4). Twenty of the bottom 25 countries in the World Bank's *Doing Business* rankings are in sub-Saharan Africa.

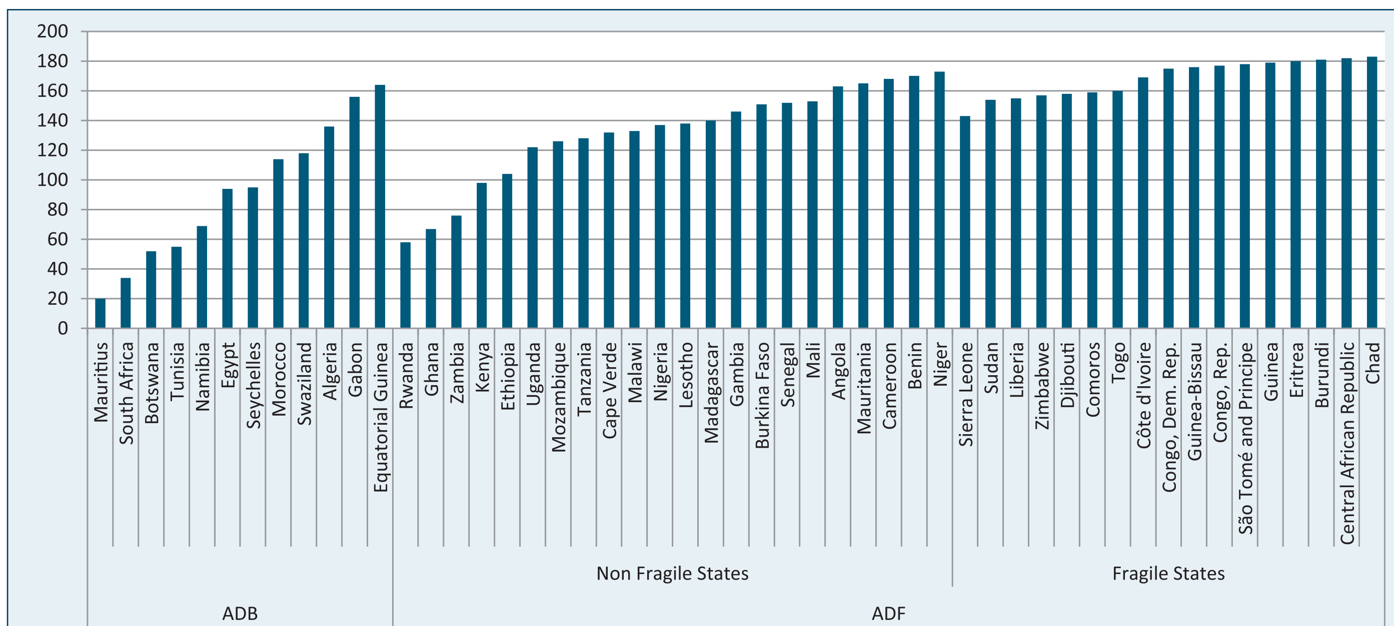
Starting up and operating a formal business could be greatly eased, and competitiveness improved, by introducing of one-stop shops for business registration, reducing the minimum capital required to start a business, simplifying tax systems, introducing and enforcing insolvency laws, protecting property rights, enforcing of contracts, and developing and enforcing clear competition policies. Clear and transparent regulations creating incentives for innovation while safeguarding property rights would facilitate investment.

Prioritizing areas where each country lags the most would result in the greatest impact, therefore maximizing the use of scarce human and financial resources. Unwavering commitment from, and cooperation amongst, policy makers, the private sector and civil society are essential for reforms to succeed.

Developing and Financing Infrastructure

Developing Africa's infrastructure at the pace necessary to meet its growth needs of about US$ 93 billion per year will require improved planning, preparation, and procurement capabilities in line ministries and relevant sector units. Coordination and planning also need to be at the regional level as some infrastructure projects are large scale and cross borders.

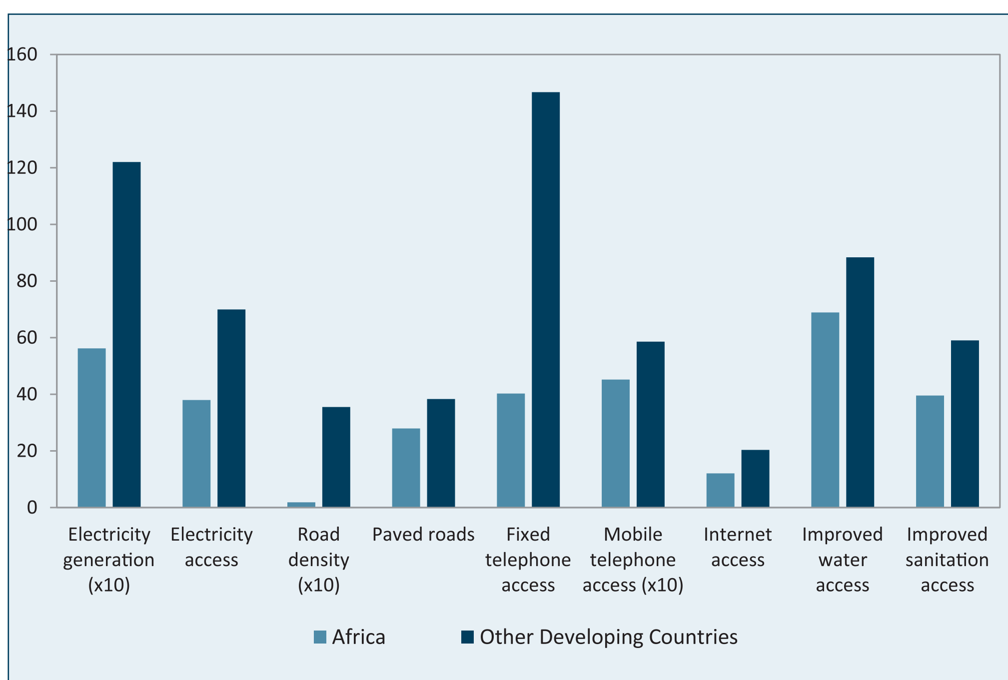
Figure 4: Ranking of African Countries' Business Environments in 2011 out of 183 countries



Source: World Bank Doing Business database.

The main constraints to infrastructure development and maintenance include deficiencies in planning, preparation and procurement due to vague sector policies and plans, prioritization of projects based on social rather than economic considerations, skill shortages, and a lack of transparency in procurement.

Figure 5: Africa's Infrastructure Stock



Note: Electricity generation is measured in kilo watt hours per capita; road density in kilometers per 100 square kilometers of land; paved roads in percentage of total roads; internet, electricity, improved water and improved sanitation access in population percentage; fixed telephone, and mobile telephone access in users per 1000 people

Source: Foster and Briceño-Garmendia 2010; and AfDB 2011.

Box 1: Innovative Government and Private Instruments for Infrastructure Financing

Innovative Government Financing Instruments	
Government infrastructure bonds: Sovereign bonds issued on the domestic market to finance public infrastructure projects. ***Diaspora bonds:*** Government bonds targeted at a country's diaspora, which can also be offered to the local population. ***Remittance securitization:*** An instrument where a government provides a local bank with the local currency counterpart of foreign currency-denominated remittances. This has yet to be tested in Africa.	***Resource-backed infrastructure financing:*** Loans for infrastructure projects that are repaid through natural resource exports. ***External sovereign bonds:*** Foreign-exchange denominated government bonds issued in international capital markets. ***Sovereign wealth funds***: Government investment funds capitalized from resource export proceeds.
Innovative Private Financing Instruments	
Specialized infrastructure funds: Funds created by established infrastructure contractors to finance projects in which they are involved. ***Commodity-linked debt instruments:*** Domestic notes linked to specific commodities that can be traded on local exchanges.	***Private equity funds:*** Funds mobilized primarily from international and local institutional investors and traditional financiers and invested in unlisted enterprises. ***Corporate bonds:*** Domestic bonds issued by private firms.

Source: Brixiova and others 2011.

In addition there is poor management of existing infrastructure assets, even though the costs of not maintaining infrastructure far exceed the costs of doing so.

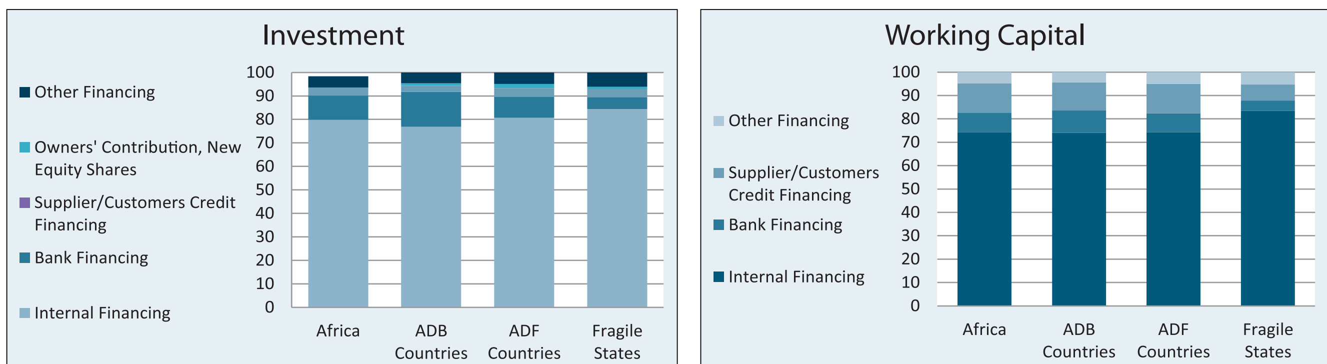
Additional resources need to be raised through financial innovation such as those described in Box 1.

Access to Finance

Finance is scarce in Africa, and long-term finance is even scarcer. Challenges are most pronounced for small businesses compared to large ones, and in Fragile States (Figure 6). Less than a quarter of African businesses hold a loan or line of credit from a financial institution, by far the lowest proportion among developing regions. In addition, almost 60% of the loans extended by African banks have a maturity of less than one year, and less than 2% have a maturity greater than 10 years. Banks remain the main source of external financing, and stock or bond markets, private equity funds, factoring, or leasing remain embryonic in most of the region.

Access to finance in Africa is hindered by four areas: (1) underdeveloped financial systems dominated by banks; (2) difficulties to assess creditworthiness

Figure 6: Sources of Financing of Working Capital and Investment in Selected African Countries



Source: AfDB calculations and World Bank Enterprise Surveys database.

due to a lack of credit information systems, as well as poor internal reporting and auditing standards; (3) capacity constraints that impede entrepreneurs from translating their ideas into bankable projects and submitting applications in a professional manner; and (4) the broader environment, including economic or political conditions perceived as risky, crowding out by governments bonds, regulations that discourage lending to the private sector, and poor contract enforcement and asset repossession systems.

These challenges result into excessive collateral requirements by financial institutions, which can be as high as 155%.

The priority in ADF countries is to put in place the foundations for a well-functioning financial system by building an adequate financial infrastructure, shoring up institutions, organizing capacity building programs for both finance providers and regulatory authorities, and adopting well-defined regulatory frameworks that foster competition and innovation within the financial sector.

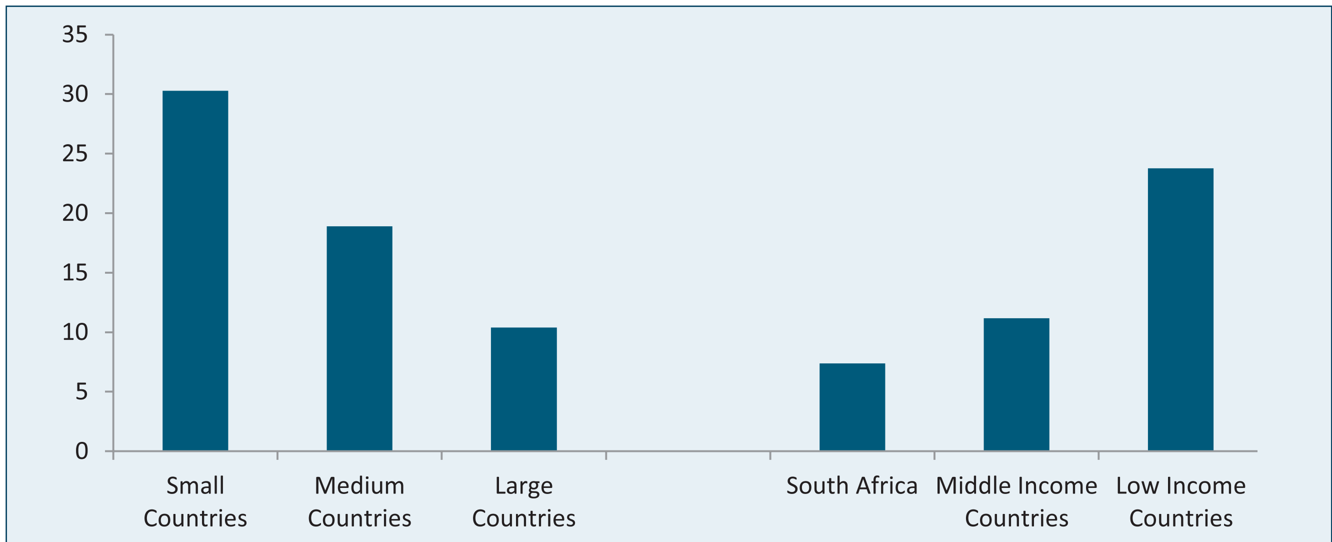
Developing financial products for small and medium enterprises would help address the specific financing challenges that smaller businesses face across the continent. Supporting a well-functioning microfinance sector would also support small businesses, especially in Fragile States and in some ADF countries where the banking sector is not sufficiently developed. Non-bank financial institutions, such as leasing and factoring companies, also need to be supported through clear regulatory frameworks, programs to familiarize companies with the functioning and value added of these sources of finance, and improving asset repossession systems. Fostering the development of the contractual savings industry and private equity activities through concerted efforts to stabilize the macroeconomic environment, appropriate regulatory frameworks, fiscal incentives and capacity building for regulators would help ease the scarcity of long-term finance.

The problem of information asymmetry and collateral requirements could best be addressed through the creation of public registries and private credit bureaus. The development of corporate bond and stock markets would provide an alternative source of long-term financing, particularly in ADB countries. This requires diversifying the investor base and addressing inefficiencies in bankruptcy and listing procedures that plague most African systems. Efforts should be made to develop financial infrastructure, reduce listing fees, offer financial literacy programs and enhance the capacity of regulatory authorities.

Human Capital and Skills Development

Although tertiary education enrollment rates in Africa are up, they remain the lowest in the world. In addition, only 20% or so of tertiary education students in the region are enrolled in science, engineering, technology or business, compared to at least 50% in countries such as South Korea, China, and Taiwan. This forces African firms to rely on imported skilled labor or live with skills shortages. At the same time, large proportions of

Figure 7: High-Skill Migration Rates in Africa in 2010



Source: AfDB and World Bank 2011.

graduates remain unemployed and have to work in the informal sector or emigrate (Figure 7).

Addressing the skill mismatch in Africa's private sector would, in the short run, require improved training programs and closer links between tertiary and vocational educational institutions and the private sector. Training programs should include on-the-job initiatives targeting those already working, as well as graduates with a general education who lack specific work skills. Stronger university-industry connections can be created by including private sector representatives in national education and training policy bodies and on academic boards involved in curriculum development. This could also facilitate private sector funding for research, scholarships, internships and apprenticeships.

In the long run, increasing the supply of human capital and skills will involve changing the way students are trained-a process that will require changes in the education system, labor markets, government policies, and the interaction among all three.

Corporate Governance

Addressing deficiencies in corporate governance requires a concerted effort from both national authorities and the private sector. Governments can contribute by customizing existing international guidelines to the domestic context and adopting the recommendations of the African Peer Reviews on corporate governance. Corporations should be encouraged to adopt corporate governance principles into their company codes, have their financial statements externally audited and published in a timely manner, and appoint a diversified Board of Directors who is properly trained about their roles and the protection of minority shareholders' rights.

The enforcement of the principles embedded in national laws and corporate codes are, however, sorely lacking. Strong institutions and appropriate sanctions are needed to ensure rules and procedures are followed. Development partners, including the African Development Bank, can play a critical role by insisting that private companies that receive their support meet basic corporate governance standards, and by providing incentives for good governance, such as preferential rates and better terms. They can also provide resources to train regulators, directors, and managers on best practices. They should also ensure that companies in which they invest provide shareholders, particularly minority shareholders, with critical information and recourse regarding the decisions and actions of managers.

Entrepreneurship Development

African entrepreneurs would benefit from specialized training programs and financial support. Encouraging risk taking, critical thinking and problem solving at all levels of education

and vocational training would help ensure that Africa's entrepreneurs have the requisite skills to succeed. For example, universities in Botswana, Ethiopia, Kenya, South Africa, and Tunisia offer entrepreneurial courses at the undergraduate, masters, and doctorate levels. In addition, development partners can help increase and deepen technical assistance/capacity building to African entrepreneurs who lead micro, small and medium enterprises. The African Development Bank and others have been offering business development assistance to entrepreneurs for many years through programs like Growth Oriented Women Entrepreneurs (African Development Bank), Business Edge and Small and Medium Enterprises Toolkit (International Finance Corporation), and Small Enterprise Programme (International Labour Organization).

Promoting "clustering", encouraging Diaspora involvement, and facilitating foreign direct investment would further support African entrepreneurs. Industrial clusters facilitate technological spillovers, access to specialized intermediate inputs and services, and labor market pooling. Government efforts promoting foreign direct investment can also translate into much-needed knowledge transfer, provided the recipient company already has the necessary human capital to absorb new technologies and a supportive business environment is in place. Finally, the African Diaspora's financial resources and skills can be further harnessed to support entrepreneurs at home. For example, the African Diaspora Marketplace, a business plan competition created by the United States Agency for International Development, Western Union, and the Global Development Alliance, encourages the U.S.-based African Diaspora to invest in micro, small and medium enterprises at home.

The African Development Bank and Private Sector Development

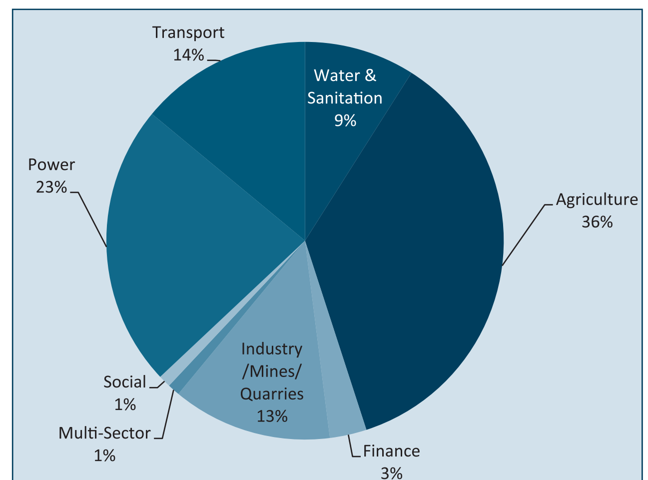
Bank Operations for Private Sector Development

The African Development Bank (AfDB, Bank) recognizes the importance of a flourishing private sector for inclusive, sustainable economic growth. It has been supporting private sector development across Africa through interventions in infrastructure, governance, and higher education and vocational training. Interventions include sovereign lending, private sector operations, budget and policy support, capacity building, technical assistance and advisory services.

The Bank finances infrastructure directly and indirectly through traditional and innovative methods. Over the past five years, the Bank has:

- "Increased both the volume of financing for infrastructure projects and the proportion of financing that supports regional projects. Power, transport, and water and sanitation sectors together account for almost half the Bank's portfolio (Figure 8).

Figure 8: Cumulative Active Projects in African Development Bank Portfolio by Sector



Source: AfDB 2011.

- Catalyzed private financial sources by blending debt and equity, as well as risk management instruments. For instance, AfDB developed a Currency Exchange Fund (TCX) to ease the impact of foreign exchange volatility by hedging foreign exchange risks associated with infrastructure financing in local currencies. The Bank has also been providing partial risk guarantees, and participating in currency and interest rate swap markets. Subordinated loans are now used to raise investment returns or enhance credit structures to acceptable risk levels as well.

- Built capacity to support efficient and sustainable institutions and regulatory frameworks, and brokered complex regional projects. The Bank is working closely with the African Union through the Programme for Infrastructure Development in Africa, which is creating a road map for priority regional integration infrastructure projects.

The Bank has been at the forefront of promoting financial sector development and private sector access to finance in Africa, in particular micro, small and medium enterprises (MSMEs). Initial interventions focused mainly on lines of credit to financial institutions, which remain the Bank's main instrument to channel financing to the private sector. AfDB has also been promoting microfinance institutions. Over time, it has been placing greater emphasis on policies, institutions and financial infrastructure by supporting reforms of payment systems, funding capacity building programs to strengthen institutions and financial supervision, and offering policy-based loans and budget support to foster financial sector reforms. Examples include the reform of the banking system in Egypt and of the payment systems in the West African Economic and Monetary Union (WAEMU). In 2005, the Bank also launched the Fund for African Private Sector Assistance (FAPA) to build capacity in financial institutions. More recently, the Bank has been developing innovative solutions to improve MSME's access to finance, including the creation of the Microfinance Capacity Building Trust Fund in 2009 and the African Guarantee Fund for small and medium enterprises.

The Way Forward

For nearly 40 years, the Bank has provided support and continually seeks to improve its impact. In its 1997–2005 internal review of private sector operations, AfDB concluded that almost 80% of its projects had positive development outcomes and the key to good performance was to support sound business environments. At the same time, AfDB recognized that its previous approach of fostering private sector development through separate departmental interventions lost valuable opportunities for synergies and cross learning.

Drawing on lessons learned, AfDB prepared a new Private Sector Policy and an updated Private Sector Strategy in 2011. The Private Sector Policy—the first ever developed by an international development finance institution—seeks to:

- Help regional member countries improve their business environments and international competitiveness through policy reform, regional integration, infrastructure development and delivery, and financial markets.
- Promote private sector-led economic growth by fostering entrepreneurship, providing direct and indirect support to MSMEs, assisting women to become entrepreneurs, and encouraging economic integration and diversification.
- Encourage social and environmental responsibility, sustainability, and good corporate governance.

AfDB's efforts are guided by four principles: (i) Ownership of gross domestic product (GDP) begins first and foremost with regional member countries; (ii) Use of Bank resources must be leveraged to channel additional resources into projects; (iii) Bank operations should promote a private sector that is sustainable, inclusive, socially equitable, open, and competitive; and (iv) Risk taking must be properly paired with financial prudence.

GDP growth is central to every dimension of the Bank's work. Country Strategy Papers and Regional Integration Strategy Papers will provide the framework for multi-stakeholder reviews and identify priority areas for policy dialogue, policy-based operations, investment financing and economic and sector analysis. Operations focusing on business environments will include knowledge products, policy-based operations, and sovereign projects. Non-sovereign interventions will include private sector and sub-sovereign operations, as well as technical assistance and advisory services. Risk management, outcomes assessment, and monitoring and evaluation will be used to ensure additionality, effectiveness, financial sustainability, and catalytic effects. All these will be couched in the single optic of GDP.

Going forward, AfDB and other development partners should scale up their financial support for infrastructure, finance, human capital (especially

higher education and skills development), and regional networks. The Bank should also scale up its engagement with the private sector through public private partnerships and support for improvement of the investment climate in regional member countries.

To that end, the Bank has identified private sector development as a priority area of intervention, and is integrating it into all its operations under its "One Bank" approach which is described in Chapter 8 of this report.

Conclusion

The last decade has marked what could be a turning point for Africa's economy. Macroeconomic and structural reforms have transformed what was once labeled as a "hopeless continent" into a fast-growing region able to withstand severe global downturns. This stronger Africa appears to have laid out the foundations for a more sustained development, away from the booms and busts that used to cripple the continent.

Yet the business environment in many African countries remains amongst the least favorable in the world. While the debate over the respective roles of the private and public sectors has evolved since the 1990s, the private sector remains central to generating the jobs and economic growth that the continent badly needs to lift greater numbers out of poverty and build a more equal society. Governments, in cooperation with the private sector and civil society, must spearhead the efforts to create the conditions for business to thrive and contribute to a better life for all.

The African Development Bank is committed to helping governments on the continent realize the full economic potential and nurture private sector throughout Africa.

Chapter 1 :

THE ROLE OF THE PRIVATE SECTOR IN AFRICA'S ECONOMIC DEVELOPMENT

Africa's private sector is coming of age. Hamstrung by a crippling environment and burdensome government policies for decades, it is now poised to assume its critical role as the engine of economic growth and poverty reduction on the continent. This chapter examines Africa's private sector, which accounts for over four-fifths of total production, two-thirds of total investment, and three-fourths of total credit to the economy, and employs 90 % of the employed working age population.

Historical Evolution

After independence, most African governments pursued state-led economic development strategies based on import substitution, which was considered to be the key to rapid industrialization and modernization in low-income countries. Governments created large state-owned enterprises in sectors considered strategic and erected trade barriers to protect nascent domestic production. They also created agricultural marketing boards that set prices. These policies diverted resources and credit away from agriculture towards manufacturing. To manage this process, governments created large public administrations, while the private sector was marginalized.

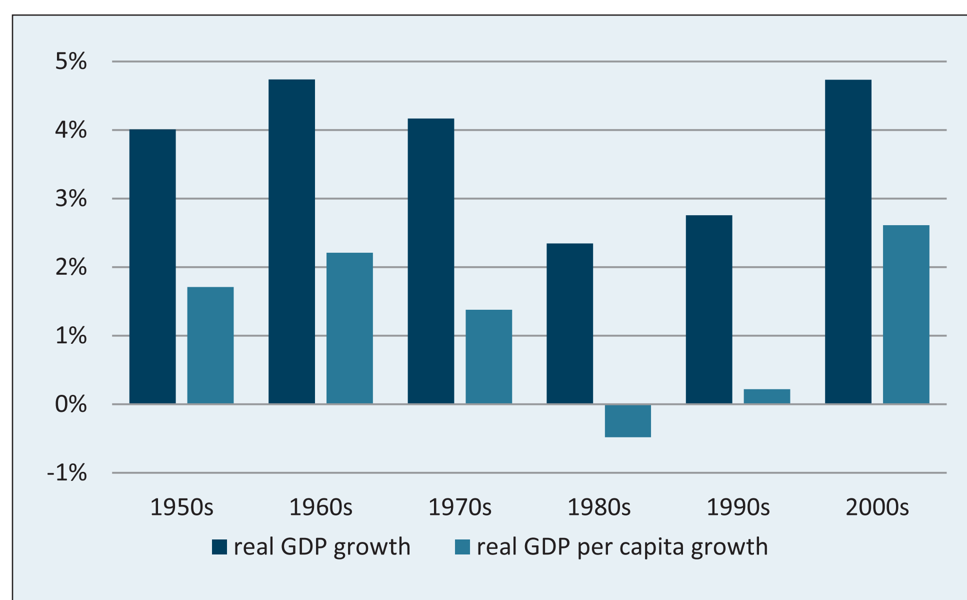
State-led economic development proved to be unsustainable. Agricultural output and productivity stagnated, as price controls diverted resources to industrial sectors.[1] Protected from competitive pressures, state-owned enterprises failed to innovate, relied on inappropriate capital-intensive technologies, and became dependent on imported inputs. As a result, exports were never competitive, and instead contributed to fiscal and trade deficits, with severe and prolonged economic implications. This was exacerbated by the several commodity shocks in the 1970s[2] and resulted in economic stagnation. The continent's real GDP growth averaged only 4.5 % per annum over 1960–1980, with real per capita income growing on average by only 1.7 % over the same period (Figure 1.1).

In the 1980s, several African countries made economic and structural reforms that began their unprecedented period of sustained growth from the 1990s onward. Tanzania, Kenya, and Zambia, for instance, dismantled their state-led development institutions and began turning the state into a regulator and facilitator, with the private sector driving economic growth. The governments divested from state-owned enterprises, restructured public utilities, reformed commodity marketing boards, and introduced private-sector partnerships. These governments also reformed their public financial management systems and re-focused public expenditure on infrastructure, education and health. Moreover, they dismantled administrative controls over prices, imports, and foreign exchange, and lifted prohibitions on private sector and foreign participation in commercial activities. These difficult reforms paid off: economic growth, income per capita and productivity picked up in the 1990s and further accelerated during the past decade, despite the international financial crisis in 2008-09.

1 Agricultural output per worker in sub-Saharan Africa grew at a rate of 0.45 % per year between 1960 and 1980.

2 These included the oil shocks of the early 1970s, which affected all countries, and other commodity shocks affecting specific countries, such as the collapse in the prices of coffee (Kenya), cocoa (Ghana), and copper (Zambia).

Figure 1.1: GDP and GDP per Capita by Decade (Percentage change)



Source: OECD database and AfDB Data Platform.

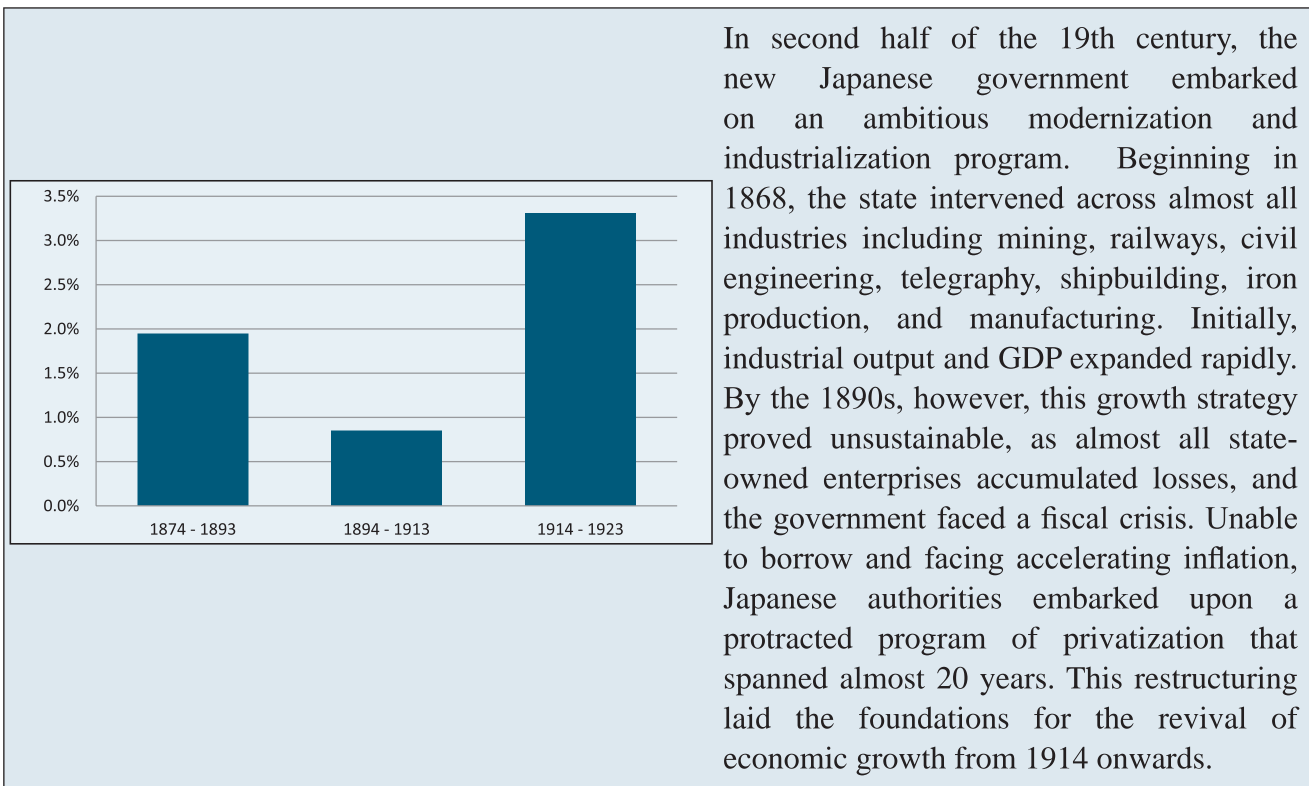
Africa's initial growth following independence, its protracted decline up until the mid-1990s and its subsequent revival indicate that the structural reforms undertaken were transformative and had their intended effect. Countries in other regions going through similar transitions were rewarded with comparable outcomes. Canada and Japan in the 19th century, for instance, adopted a similar path of state-led growth, which resulted in economic stagnation (Box 1.1). Following economic liberalization, economic growth in both countries recovered and accelerated at the beginning of the 20th century. Several Latin American countries and the Soviet Union also adopted a state-led capital accumulation until their economies stagnated in the 1970s[3], following which economic liberalization helped revive their economic fortunes. Finally, both India and China undertook structural reforms in the 1990s that removed restrictions against private sector participation in a number of sectors, which eventually contributed to the acceleration of growth rates to almost 10 % per annum[4]. While the recent commodities boom contributed to Africa's economic performance in the 2000s, prudent macroeconomic management and private sector liberalization accounted for over two-thirds of the continent's economic expansion[5]. Moreover, these policies underpinned a GDP growth that proved sustainable in the face of the international economic crisis and the collapse of commodity prices in 2008 and 2009. While most African countries experienced rising real GDP per capita during the 1970s commodity boom (1.4 % on average), their performance during the recent boom was not only better (2.6 %) (Figure 1.2), but also less volatile (Figure 1.4). Although the commodity boom was more pronounced in the 1970s than in the 2000s (Figures 1.2 and 1.3), many African economies subsequently contracted, while real GDP per capita still expanded by 3.8 % in 2008 and 3 % in 2009.

3 The Soviet Union's total factor productivity growth rate averaged 1.3 % a year in the 1950s, decelerated to -0.1 % during the 1960s, before falling to -0.8 % and -1.2 % in the 1970s and 1980s, respectively. In the 1970s, high rates of investment and capital accumulation could not compensate for falling productivity, and GDP per capita began to stagnate (Easterly and Fischer, 1994).

4 Indian firms entering the market since 1985 increased their share of total output from 1.6 % in 1990 to 15.3 % in 2005 (Alfaro and Chari, 2009), driving down the market share of inefficient state-owned enterprises. State-owned enterprises have been found to be 29 % and 42 % less productive in India and China than their private sector counterparts (Hsieh and Klenow, 2009).

5 Recent reports (McKinsey, 2010) and peer reviewed studies (Beny and Cook, 2009) also reached the same conclusion.

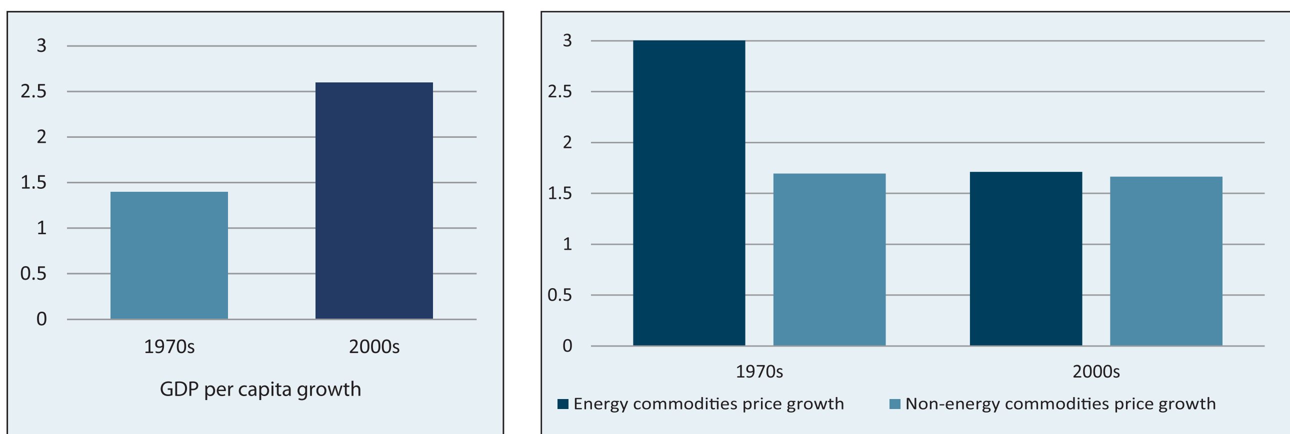
Box 1.1: Japan's Real GDP per Capita by Decade (Percent change)



In second half of the 19th century, the new Japanese government embarked on an ambitious modernization and industrialization program. Beginning in 1868, the state intervened across almost all industries including mining, railways, civil engineering, telegraphy, shipbuilding, iron production, and manufacturing. Initially, industrial output and GDP expanded rapidly. By the 1890s, however, this growth strategy proved unsustainable, as almost all state-owned enterprises accumulated losses, and the government faced a fiscal crisis. Unable to borrow and facing accelerating inflation, Japanese authorities embarked upon a protracted program of privatization that spanned almost 20 years. This restructuring laid the foundations for the revival of economic growth from 1914 onwards.

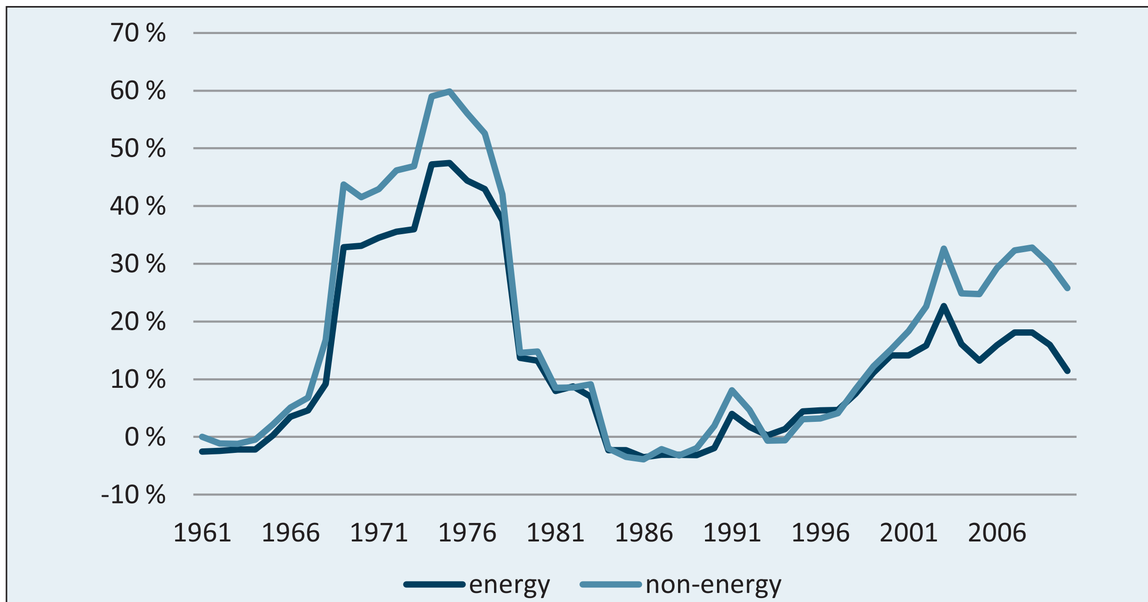
Source: League of Nations, Annual Statistics (various years).

Figure 1.2: Commodities Prices and Real GDP per Capita in the 1970s and 2000s (Percentage change)



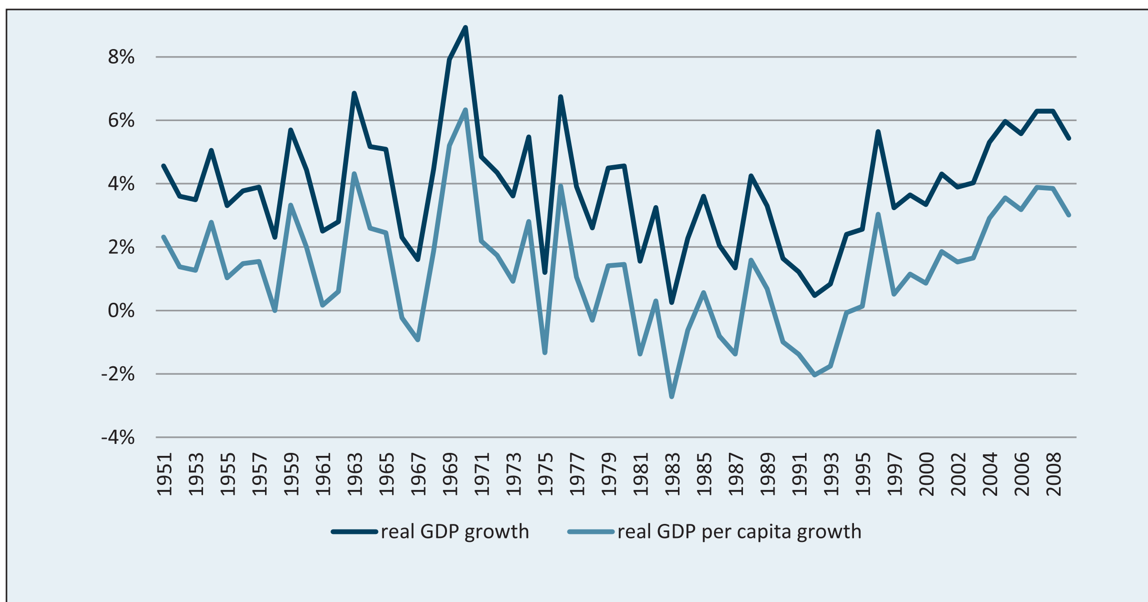
Source: GDP from OECD and AfDB data platform; commodities prices from World Bank.

Figure 1.3: Commodities Prices, 1961-2010 (Changes in percentage, 10 year moving average)



Source: World Bank Commodities Price Data.

Figure 1.4: Real GDP and Real GDP per Capita Growth, 1951-2009



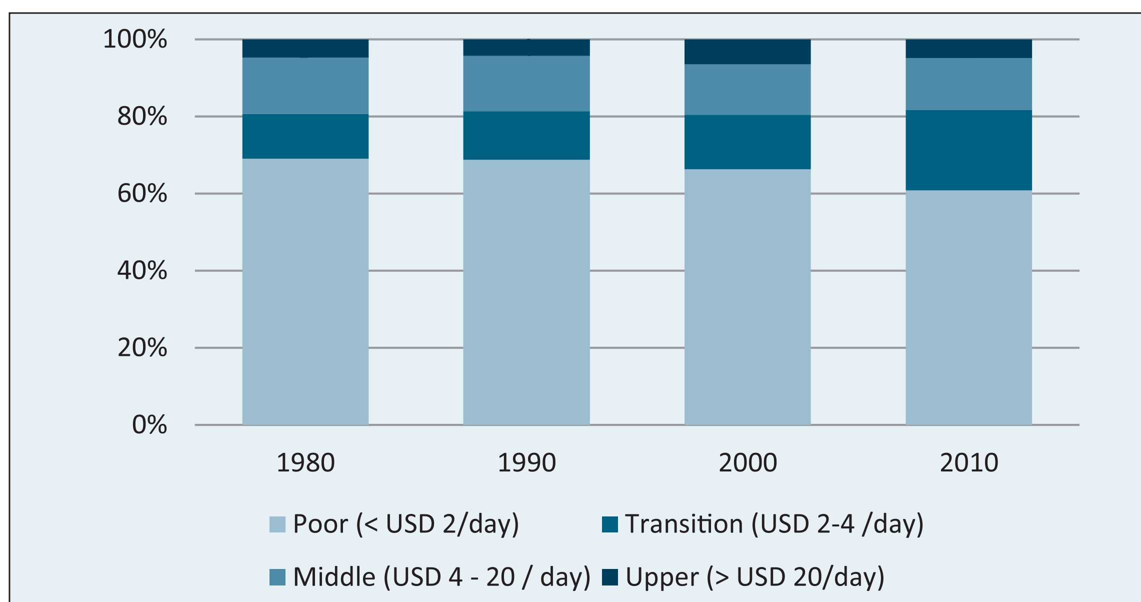
Source: OECD and AfDB data platform.

Africa's economic expansion over the past decade has been accompanied by a significant reduction in poverty across the continent that reached even the poorest segment of the population[6]. Following two decades (1980-2000) of economic stagnation during which 70 % of the population was poor[7], the poverty rate declined from 66 % to 61 % over the past decade. Over the same period, the transition

6 Sala-i-Martin and Pinkovskiy (2010) reach a similar conclusion.
7 The poor are defined as those earning less than US$2 a day.

class—defined as those earning between US$2 and US$4 per day—grew from 14 % to 21 % of the population (Figure 1.5 and Table 1.1)[8]. While the impact of the past decade's economic expansion on poverty has been somewhat disappointing, it has nevertheless resulted in the growth in the number of non-poor (an additional 117 million people) outpacing that of the poor (73 million) for the first time in 30 years.

Figure 1.5: Distribution of Income Classes



Source: AfDB Statistics Department; and World Bank data.

Table 1.1: Size of Income Classes in Africa

	Percentage share of population	
Year	Poor Class	Transition* and Middle Class**
1980	69,0	26,2
1990	68,7	27,0
2000	66,3	27,2
2010	60,8	34,3

Source: AfDB Statistics Department and World Bank data.

*Transition (US$ 2–4 per day); **Middle (US$ 10–20 per day).

8 The transition class increased from 101.7 million people in 2000 to 190.6 million in 2010. While individuals in this group could eventually transition into the middle class, they are also at risk of sliding back into poverty.

Profile of Africa's Private Sector

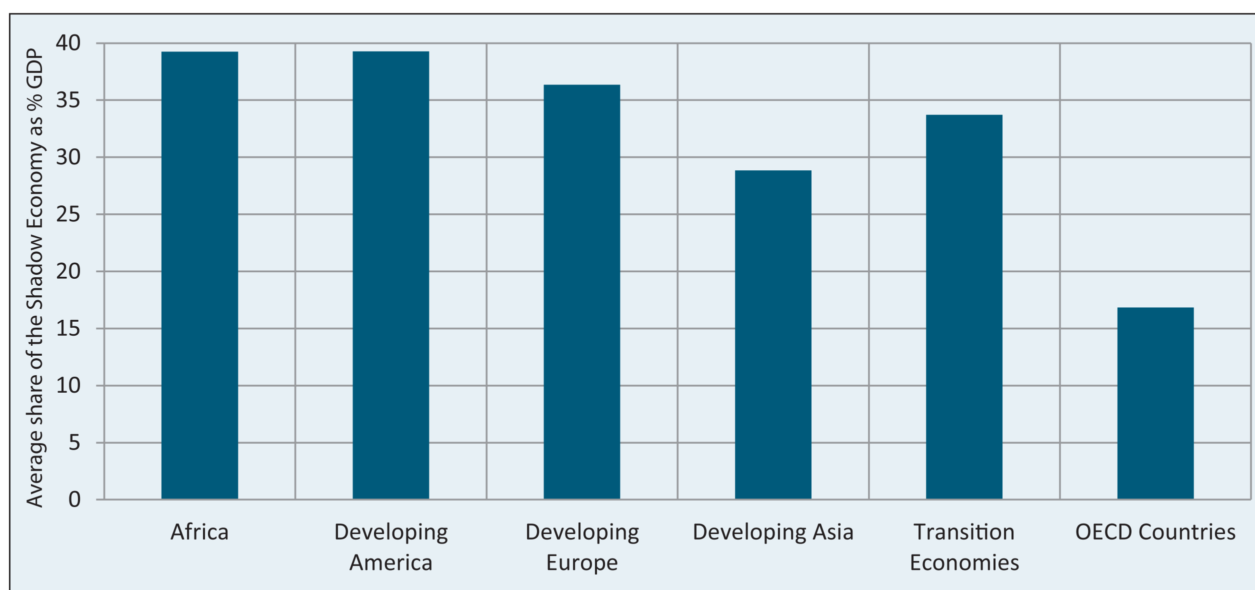
Statistics on Africa's private sector are limited. National accounts statistics do not include data on private sector production in the formal sector, which must instead be derived indirectly from private consumption and investment[9]. Similarly, informal private sector data have to be inferred. This is also the case for data on small- and medium-size enterprises, which can only be estimated from surveys often based on different country classifications and methodologies.

Subject to these limitations, this report analyzes Africa's private sector using an income-based classification separating low-income or ADF countries, including Fragile States, from middle-income or ADB countries, with additional breakdowns by sub-regions (North, Southern, East, West, and Central) and by oil status (importers vs. exporters). An alternative country classification scheme recently developed by Bank staff but not yet officially adopted ranks countries based on their level of development and/or attraction of their financial markets to foreign investors. It broadly covers the above-mentioned income categories, but disaggregates low-income countries into three sub-categories (pre-transition, transition, and frontier markets as indicated in the Methodology Note[10]).

Informal Sector

The informal sector accounts for a whopping 40 % of Africa's economy—more than in any other region except Latin America (Figure 1.6).

Figure 1.6: Size of Informal Sector across Countries, 2006



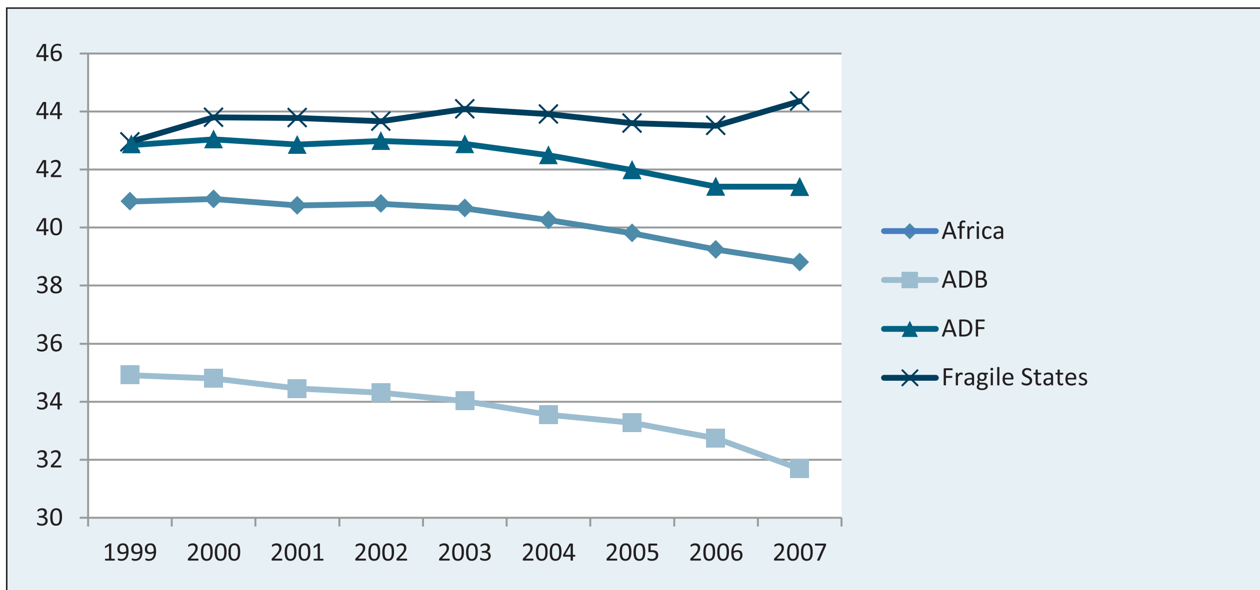
Source: AfDB calculations based on the data presented in Schneider and others (2010).

Within Africa, Fragile States and low-income countries have the largest informal sectors, averaging 44 % and 42 % of GDP, respectively, over the past decade. Moreover, the informal sector increased slightly over the past decade in the Fragile States, while it contracted in the rest of the region (Figure 1.7).

9 Staff estimates for private production are derived from the expenditure side of national accounts. Since private consumption and investment include purchases of domestic goods and services as well as imports, this estimate overstates the size of private output. On the other hand, as net exports/imports are relatively small as a share of GDP, staff estimates are likely to be broadly in line with the actual size of private production.

10 The alternative classification scheme was developed by Brixiova and Ndikumana (2011).

Figure 1.7: Evolution of the Informal Sector in African Countries, 1999-2007



Source: AfDB calculations based on the data presented in Schneider and others, (2010).

Although there is no single definition, informality is understood as all economic activities that are not registered, covered by formal arrangements and captured by the tax net (Box 1.2). There are generally four steps that a firm needs to take to operate in the formal economy: (i) getting the company name approved; (ii) registering with the government institution responsible for commercial activities; (iii) obtaining a trade license and/or registering for a general business license; and (iv) obtaining a tax number. There is a continuum of informality, as firms may complete one or more of these steps, but not all (Figure 1.8). The main reasons for informality in Africa are in Figure 1.9.

Box 1.2: Informality and the Entrepreneur

Two main theories attempt to account for the existence and the extent of the informal sector. The first theory considers the "opportunity entrepreneur" who has the ideas, technical skills, and market access to innovate and operate in the formal sector and chooses to work in the informal arena because of the complexity and cost of formal registration.

The second theory focuses on the "necessity entrepreneur" and assumes that businesspersons in informal enterprises do not have the means to develop and operate formally. They lack the necessary education, technical and management skills, and access to markets and finance, which relegates them to carrying out marginal and low-productivity activities in the informal sector. In this theory, businesspersons and workers operating in the informal sector have very limited employability and, as a consequence, seek informal activities as a safety net and supplementary source of income for their subsistence.

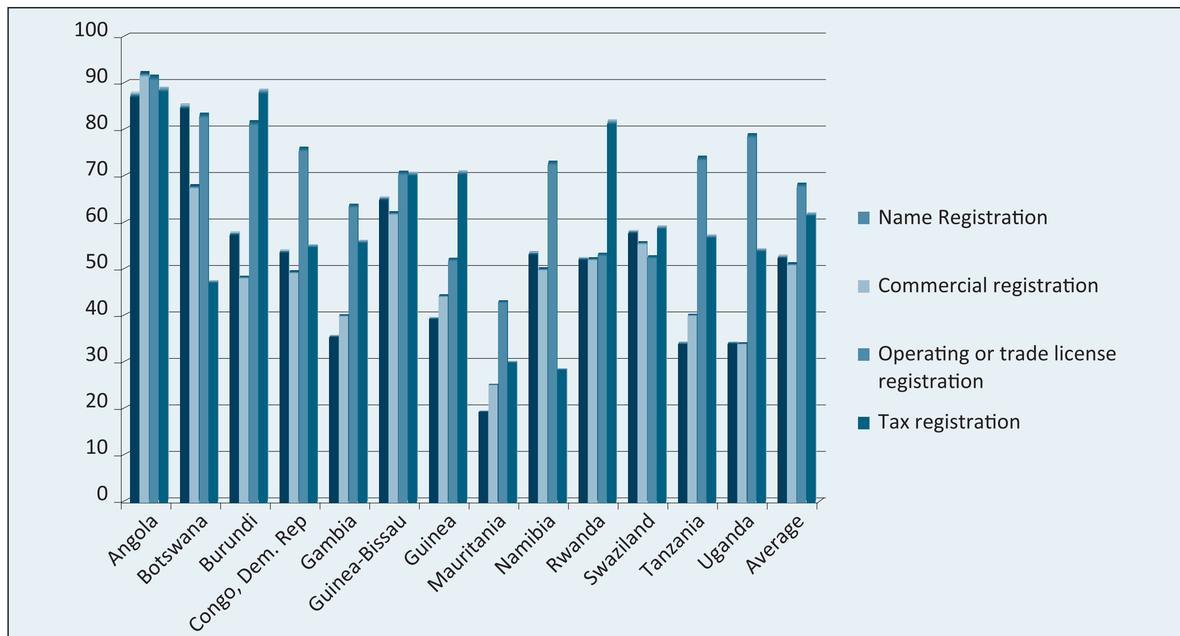
According to the World Bank's Informal Enterprise Survey[11], the main reasons why informal firms in Africa chose not to register was fear of having to pay taxes, lack of information on how to register, the cost of registration procedures, and the general perception that there was nothing to be gained from being registered.

11 As part of its annual Enterprise Surveys, the World Bank conducted Informal Enterprise Surveys that included 12 African countries (i.e., Angola, Botswana, Burkina Faso, Cameroon, Cape Verde, Cote d'Ivoire, Democratic Republic of the Congo, Egypt, Madagascar, Mali, Mauritius, and Niger) between 2005 and 2010. These surveys collected data on non-registered business activities in the manufacturing and services sector.

Despite their reluctance or inability to register, over three quarters of the operators surveyed believed that there are tangible benefits to operating formally: almost two thirds thought that they would secure better access to markets, and over half believed they would likely do more business with formal firms and gain better access to finance. These respondents would therefore most likely choose to operate in the formal sector if registration procedures were streamlined, registration costs and minimum capital requirements revised downwards, and tax obligations minimized.

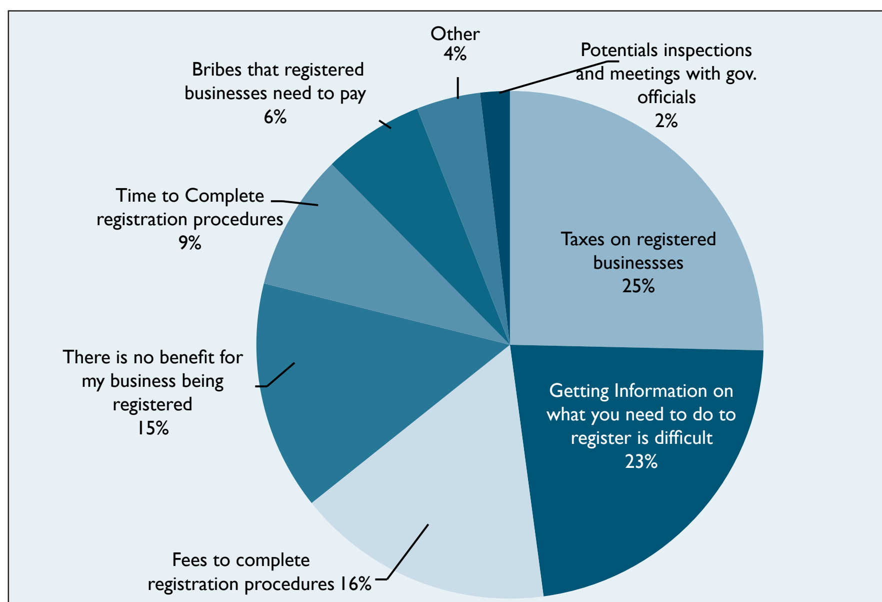
Source*:* UNIDO and GIZ 2008.

Figure 1.8: Completion of Steps towards Formalization by Microenterprises in Selected African Countries



Source: AfDB calculations based on World Bank Microenterprises Surveys.

Figure 1.9: Main Reasons for Informality

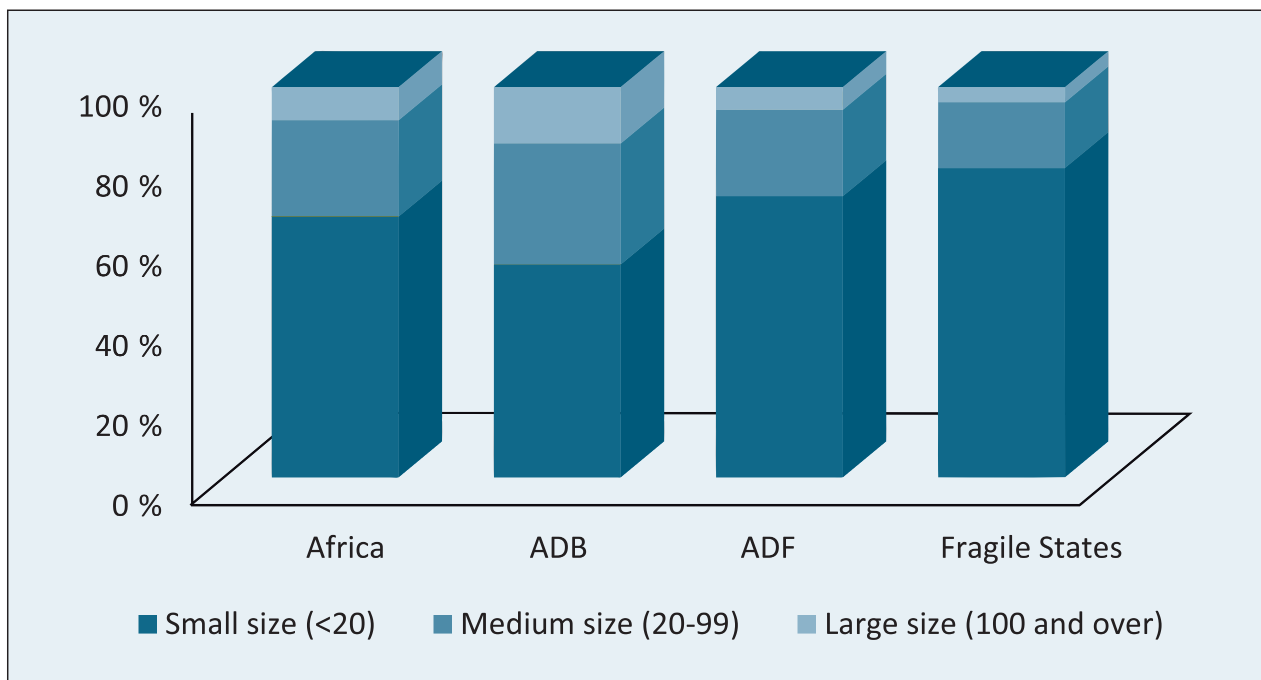


Source: AfDB calculations based on World Bank Informal Enterprise Surveys data.

Formal Sector

Small firms dominate the formal sector in Africa, particularly in Fragile States and low-income countries (Figure 1.10). Although more prevalent in middle-income countries, Africa's medium and large firms account for only a third of all businesses, and by comparison, much less than in other parts of the world.

Figure 1.10: Size of Enterprises in Selected Countries



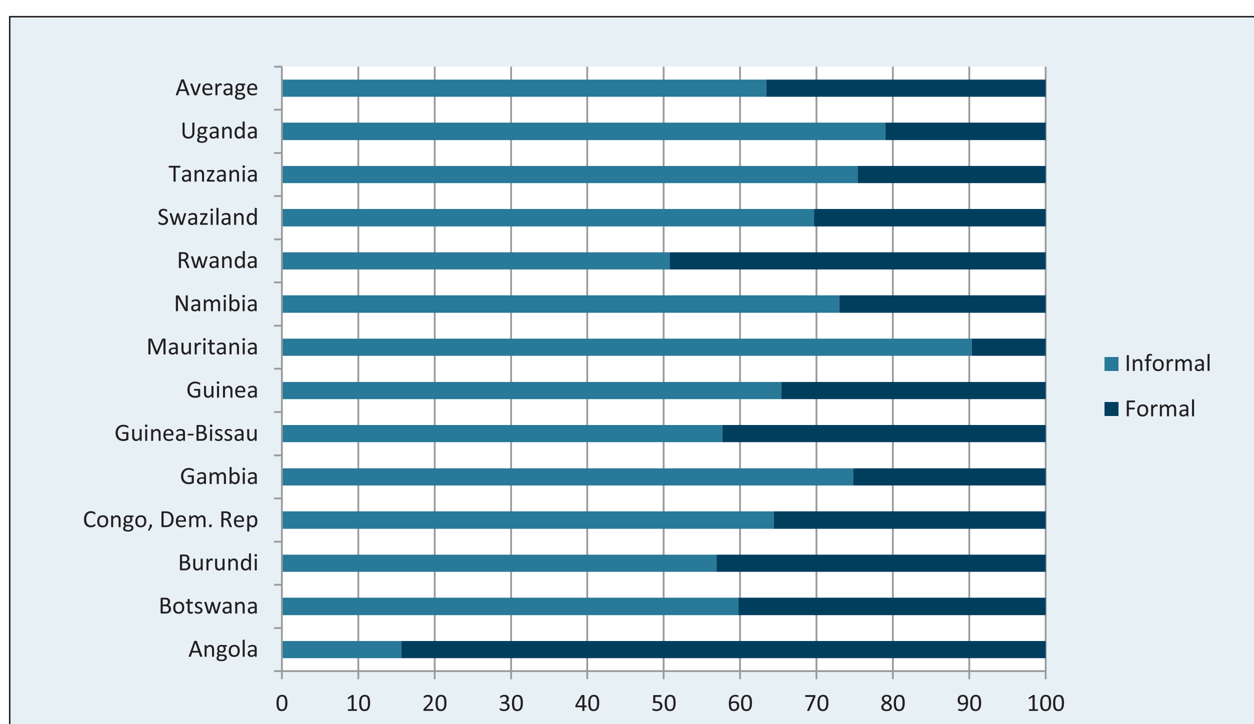
Source: AfDB calculations based on World Bank Enterprise Surveys for 41 African countries.

Although their contribution to total production is marginal, micro and small enterprises (MSEs) constitute the largest number of businesses in Africa and are also the main source of employment and income for the poor. While the majority of micro and small size enterprises are located in the informal sector (see Figure 1.11), they play a greater role in countries with more developed private sectors and positive business environments. In Nigeria, for example, MSEs account for 95 % and 70 % of employment in the formal manufacturing and industrial sectors, respectively.

Medium-size firms are underrepresented in Africa relative to other regions. The ratio of medium-size firms to large-size firms is 2 to 1 for Africa's middle-income countries and 4 to 1 in its low-income economies and Fragile States. This implies that there is a "missing middle" regarding the size distribution of businesses across Africa. The apparent difficulty to transition from small- to medium-size businesses is most likely due to barriers to exit/entry throughout the transition from small to medium to large firms regarding costs associated with taxation and administrative compliance. More dynamic economies are characterized by a persistent high inflow of new entrants, an ongoing consolidation into medium-size firms, and the exit of weaker competitors. This competitive pressure drives productivity and employment in the MSME sector, which in turn feed economic growth.

Most of Africa's largest corporations are based in a handful of middle-income countries and are primarily in the extractive industry. South African firms account for over three-fourths of the total market capitalization of Africa's top 250 corporations, and North African companies make up another 15 %. Besides being large economies, both sub regions have relatively well-developed financial sectors, good infrastructure, and supportive business environments. West African and East African firms, on the other hand, capture relatively

Figure 1.11: Distribution of Microenterprises in the Formal and Informal Sectors in Selected African Countries (Percentage of total)



Source: AfDB calculations based on World Bank Microenterprise Surveys for 13 African countries.

small shares of total market capitalization. Their weight is expected to grow over the next decade, however, as reforms in banking, power, and hydrocarbons in Nigeria and economic integration in the East African Community gain momentum. Although the hydrocarbon and solid mineral sectors continue to dominate the operations of Africa's largest companies, telecommunication, banking, construction, and retail firms are gaining ground. The total market capitalization of Africa's largest 250 companies stood at US$848 billion in March 2010, 33 % higher than in 2009[12].

The Private Sector, Engine of African Economies

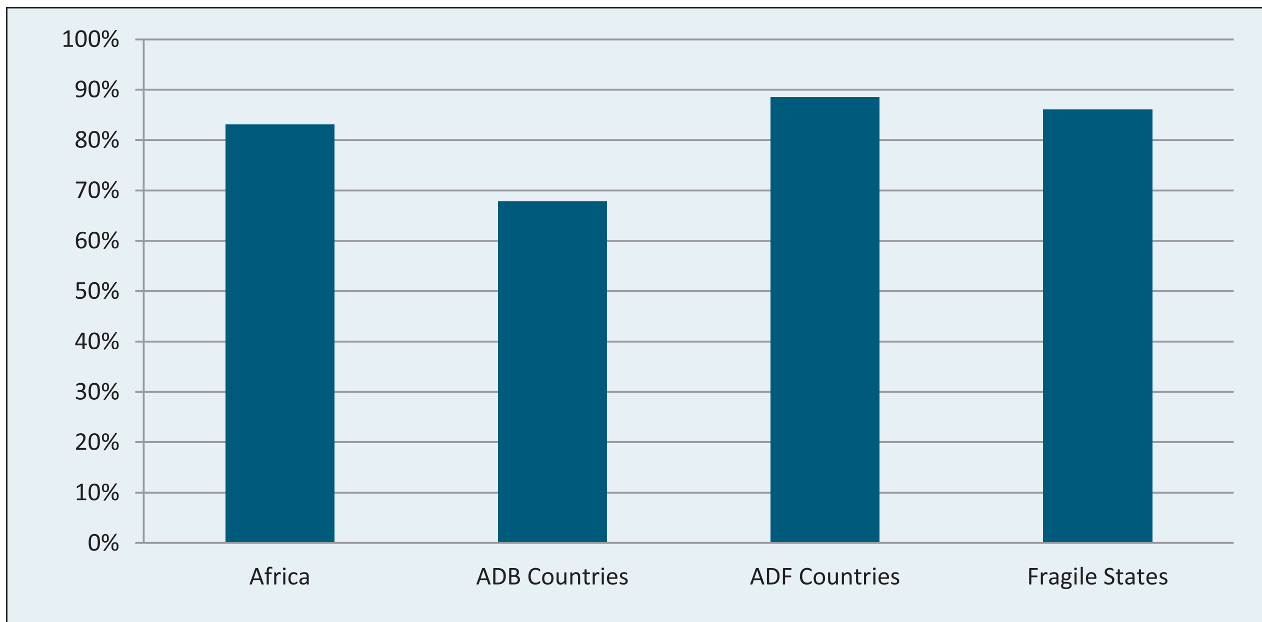
The private sector dominates Africa's economy. It accounted for over 80 % of total production, two-thirds of total investment, and three-fourths of total credit to the economy over the period 1996-2008 (Figures 1.12, 1.13)[13]. It also gave jobs to about 90 % of the employed working age population (Figure 1.14). Domestic credit to the private sector as a share of GDP was 59 % of GDP in Sub-Saharan Africa compared to 30 % in Latin America and Caribbean, 32 % in South Asia, 42 % in Middle East and North Africa and 145 % in OECD member countries.

In middle-income countries, private companies operate principally in the formal sector, with both large enterprises and MSMEs each generating sizeable shares of value added and employment. Yet the private sector in these countries makes up only two-thirds or so of total production overall, which is substantially lower than in low-income countries (85 %), due to the relatively larger role of state-owned enterprises in the production and export of oil in North Africa. Similarly, even though the private sector generates three-fourths of jobs in middle-income countries, state-owned enterprises accounts for a much greater share of employment than elsewhere in Africa. The share of permanent and formal jobs is also higher in middle-income countries than in other African countries, reflecting

12 African Business Magazine 2011.

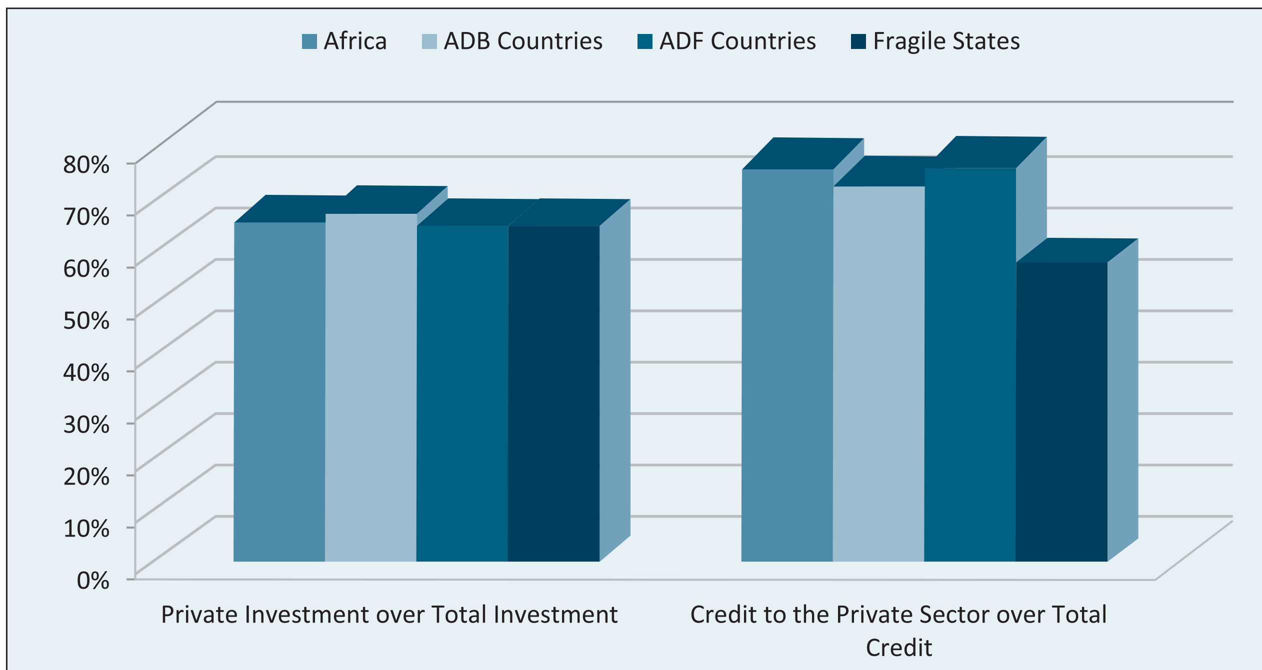
13 See Stampini and others (2011) who present detailed evidence on the size of the private sector.

Figure 1.12: Private Production in Selected African Countries, 1996-2008 (Percentage of total production)



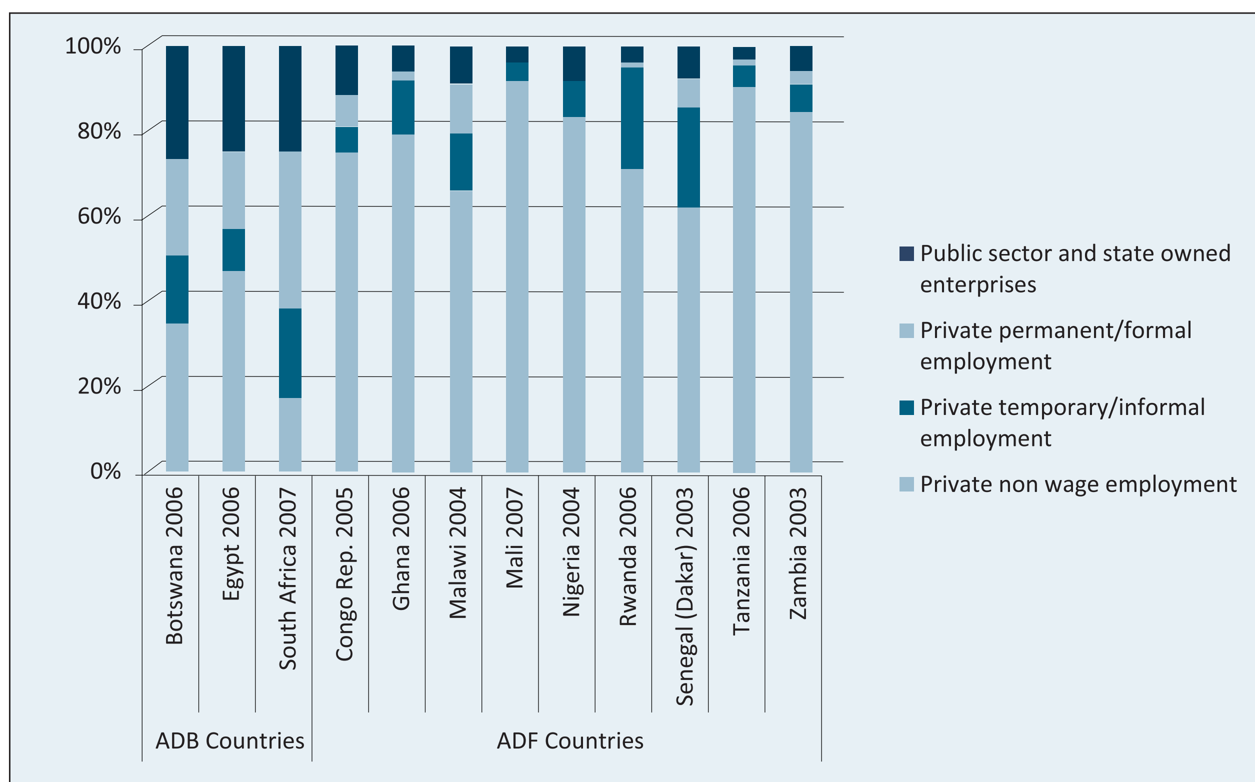
Source: AfDB calculations based on African Economic Outlook data for 50 countries.

Figure 1.13: Share of Private Investment and Credit in Selected African Countries, 1996-2008



Source: AfDB calculations based on African Economic Outlook data for 50 countries.

Figure 1.14: Public and Private Sector Employment in Selected African Countries



Source: AfDB calculations based on household and labor surveys for 12 countries.

the relatively larger role played by the formal sector in these economies. As they benefit from more advanced financial systems, private companies in these countries rely more heavily on bank credit and equity finance to meet their working capital and investment needs than elsewhere in the region.

The private sector in low-income countries accounts for a higher proportion of jobs (90 %) than in middle-income countries, as noted above. Private sector employment in these countries, however, is principally informal or temporary, with less than a tenth of these workers holding a permanent or formal job. Moreover, nonwage activities—mainly self-employment or involvement in a family business—account for the bulk of private sector employment[14]. The shares of private investment and credit, however, are in line with regional averages.

In Fragile States, a few large formal companies generally dominate the private sector, generating most of the value added and formal employment. Access to finance is particularly problematic for the private sector in these economies, as reflected in the lower share of total credit it absorbs (58 %) compared to elsewhere in the region. Yet the contribution of private businesses to production and investment in Fragile States is similar to what is observed in other low-income countries. Unfortunately, reliable data on employment in these economies are not available.

In oil-exporting countries, a few large state-owned enterprises involved in resource development dominate the economy. The private sector's share of total production in these countries is therefore lower than elsewhere in the region. While the share of private investment is in line with other country groupings, the share of credit to the private sector is higher.

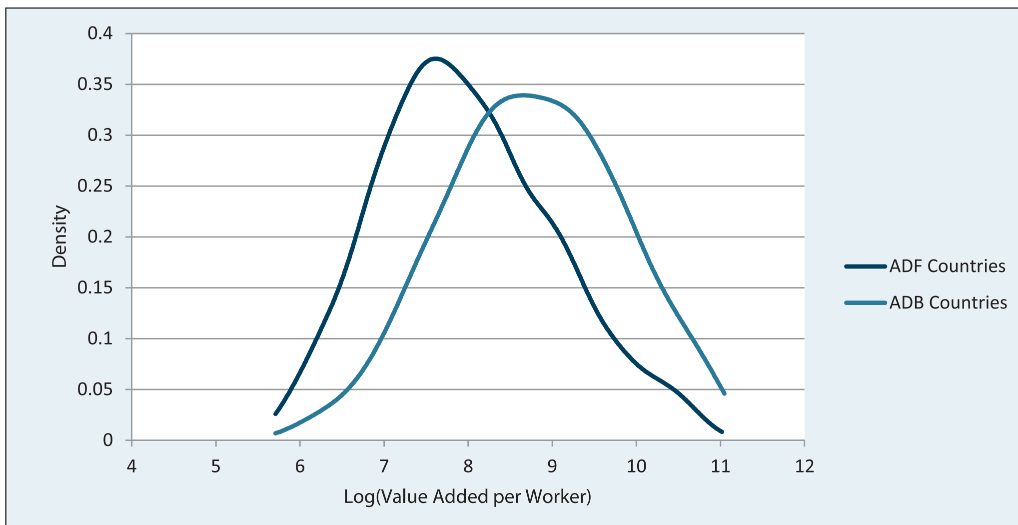
Private Sector Productivity

Average productivity in Africa is lower than other regions, however there are wide variations

14 In a sample of 12 African countries, two-thirds of the employed working-age population was involved in nonwage activities.

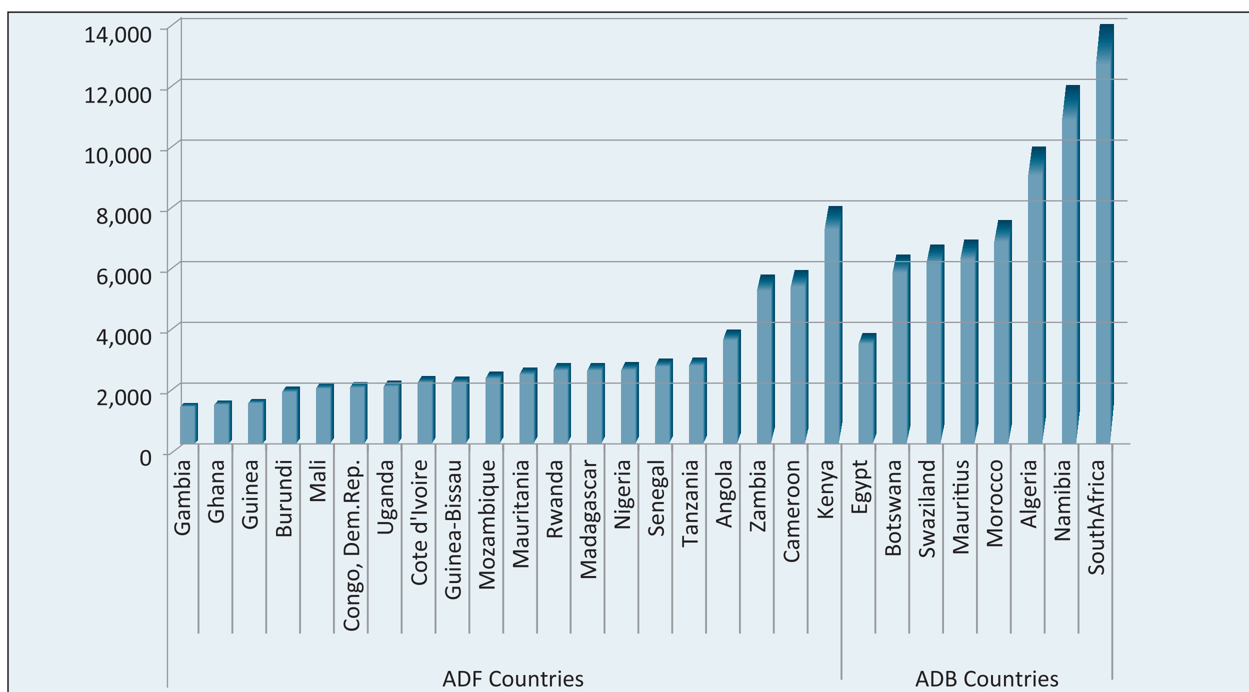
across the continent. For example, while labor productivity rates in private firms are very low for most low-income countries, a few economies (Cameroon, Kenya, and Zambia) have rates in line with middle-income countries (Figure 1.16). Labor productivity also varies across middle-income countries, with South Africa, Namibia, and Algeria having significantly higher rates than their peers. Income level does not appear to be a significant determinant of labor productivity, as many firms in low-income countries appear to be as efficient as those in middle-income economies (as illustrated in the overlapping curves in Figure 1.15). Levels of total factor productivity, however, are significantly lower for businesses in low-income countries than elsewhere.

Figure 1.15: Distribution of Firms by Value Added per Worker in ADB versus ADF Countries



Source: AfDB calculations based on World Bank Enterprise Surveys, 2006-2010.

Figure 1.16: Median Value Added per Worker in Manufacturing (Constant 2006 thousands US$)



Source: World Bank Enterprise Surveys, 2006-2010.

Yet the steady improvement of labor productivity over the past ten years, following two decades of decline and stagnation, is encouraging. It is mainly due to the expansion of the private sector and productivity gains in agriculture, which employs about half the population in sub-Saharan Africa, and has resulted in the general recovery in per capita GDP across most African countries. Similarly, a recent study found that total factor productivity in Sub-Saharan Africa, which improved by only 0.4 % per year from 1978 to 1993, recorded growth rates of 2.3 % in the subsequent decade, following policy reforms[15].

Underemployment and the misallocation of labor, due in part to market inefficiencies, weigh on Africa's productivity. These problems are particularly acute in the region's middle-income economies. Unemployment in South Africa, for example, stubbornly stands at around 25 %, with about 4.3 million persons looking for and unable to find work; yet behind high unemployment statistics lays an even deeper underemployment problem, as only 45 % of working-age South Africans are employed. This is significantly below the 60–70 % observed in many fast-growing developing economies and Organization of Economic Cooperation and Development (OECD) countries, which would translate into an additional 6.2–9.5 million more jobs in South Africa. Tunisia, where unemployment was 26 % in 2007, suffers from similar underemployment[16]. Unemployment amongst university graduates stands at an astounding 40 % (Table 1.2) and at 32 % for science graduates having completed a state-sponsored professional integration program.

Table 1.2: Labor Force Status by Gender and Education, Tunisia 2007

	Non-graduates			Graduates					Total
	Males	Females	Total	Males	Females	Total	Males	Females	Total
Unemployed	23,2 %	26,3 %	24,1 %	32,8 %	46,1 %	39,9 %	24,0 %	29,9 %	26,0 %
Regular wage earner	44,0 %	56,8 %	48,0 %	58,7 %	48,7 %	53,4 %	45,2 %	55,4 %	48,6 %
Casual wage earner	10,5 %	3,8 %	8,4 %	1,8 %	2,0 %	1,9 %	9,8 %	3,4 %	7,6 %
Self-employed	22,4 %	13,1 %	19,5 %	6,6 %	3,2 %	4,8 %	21,1 %	11,3 %	17,8 %
Total	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %

Source: AfDB calculations based on Tunisia's 2007 Labor Force Survey.

This suggests that alleviating labor market inefficiencies could potentially yield large gains in labor productivity. Such inefficiencies include matching skills to jobs to more fully utilized workers. If the large pool of unemployed and underemployed university graduates is reduced, their participation in the labor force would substantially raise overall wages and consequently, aggregate labor productivity. A university degree in developing countries translates into a wage premium higher than the 25–90 % observed in OECD countries for graduates able to secure jobs. This suggests that once the labor market mismatch is solved, skilled labor is effectively used. In Ghana, for instance, a high-school education means a 27 % salary bump, but employed university graduates earned almost three times more than workers having completed high school (Table 1.3). A South African university graduate can expect to earn 11 times more than someone with a high school degree. In Egypt, on the other hand, the financial reward for a university education is much lower than elsewhere in the region.

15 See the survey of the empirical literature in Block (2010).
16 Stampini and Verdier-Chouchane 2011.

Table 1.3: Returns on Education, Selected Countries (Percentage increase in wages)

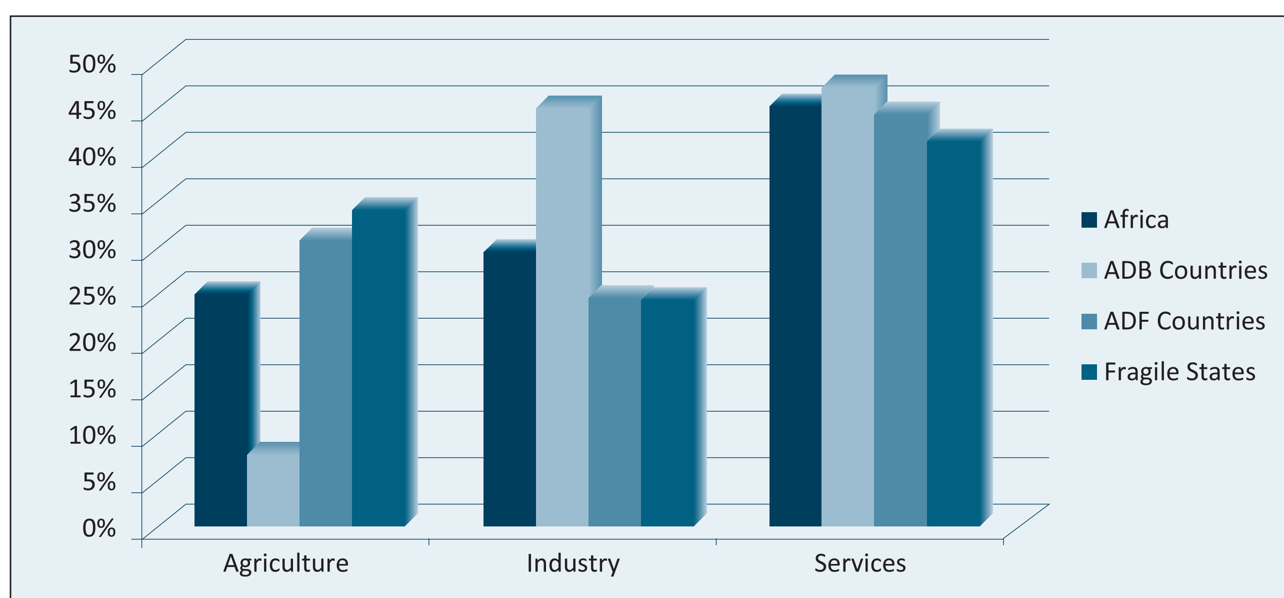
		Primary to Secondary	Secondary to Vocational	Secondary to University
Ghana	2006	27%	28%	297%
Nigeria	2004	32%	-11%	59%
Egypt	2006	37%	-17%	22%
Egypt	1998	63%	-32%	14%
Egypt	1988	57%	-23%	28%
S. Africa	2000	240%	413%	6751%
S. Africa	2007	168%	527%	11005%
Uganda	2006	88%	6%	862%
Rwanda	2006	60%	-33%	1230%

Source: AfDB calculations based on household survey data for each country.

Sectorial Analysis

The private sector in Africa is active in all economic areas. As a percentage of total GDP, agriculture contributes on average 25 %, industry contributes 30 %, while services are largest contributor at 45 % (Figure 1.17). This sectorial distribution is characteristic of almost all African countries. ADB countries are more developed than ADF countries, with a higher share of their value-added derived from industry and services. Although the national accounts data do not disaggregate private production in these sectors, employment data implies that the private sector constitutes the majority share of activity in each of these sectors, with the exception of the large role that government and state-owned enterprises play in oil and mineral exporting countries.

Figure 1.17: Value-Added by Sector as a Share of GDP, 1999–2009



Source: AfDB calculations based on World Development Indicators data for 50 countries.

Agriculture

Private activity in agriculture is crucial in Africa. Over 40 % of the continent's population lives in rural areas, and more than half the labor force is involved in formal or informal agricultural production. Although it generates less than a third of GDP, agriculture plays a key role in alleviating poverty through its significant contribution to employment, food security, and consumer price stability. Some nine out of 10 Africans involved in agriculture are subsistence farmers, who are particularly vulnerable to weather and other shocks. They often have to supplement their income through informal microenterprise activities, which provide a vital buffer against shocks. Small farm size is one of the leading causes of low agricultural productivity in developing countries[17] (Table 1.4). Sustaining labor productivity growth in Africa requires increasing the acreage per farmer and labor migration into manufacturing and other higher value-added sectors.

Table 1.4: Size Distribution of Farms across Selected Countries by Income (GDP per worker)

	Firm Size - Number of Workers									
Quintile	1 or less	1-2	2-5	5-10	10-20	20-50	50-100	100-200	200-500	500 or more
1st (lowest)	55 %	17 %	22 %	5 %	1 %	0 %	0 %	0 %	0 %	0 %
2nd	39 %	17 %	27 %	9 %	4 %	3 %	0 %	0 %	0 %	0 %
3rd	36 %	18 %	17 %	9 %	7 %	5 %	3 %	2 %	1 %	1 %
4th	25 %	11 %	20 %	12 %	11 %	10 %	4 %	3 %	2 %	3 %
5th (highest)	12 %	7 %	13 %	13 %	17 %	21 %	10 %	4 %	3 %	2 %

Source: Adamopoulos and Restuccia 2010.

As in other sectors, agriculture and agribusiness tend to be run by very small and medium-sized local operations such as input suppliers, transporters, agro processors, and commodity brokers. The relatively few large, firms are typically foreign-owned and involved in export activities, such as fertilizer companies, export merchants, and processing companies. Although the public sector dominates agriculture research, the private sector is playing an increasingly active role in this area.

Only 2 % of total investment in Africa's agriculture is private, compared to 50 % in more advanced agricultural sectors worldwide. Agriculture in most African countries captures only 10 % of FDI or less, with the share in 17 countries being less than 1 %[18]. Most of the little FDI going into agriculture is channeled into export-oriented cash crops, such as cocoa and cut flowers, or stable foods such as cereals.

Manufacturing

Most of Africa's manufacturing activities are in private hands; both domestic and foreign (Figure 1.18)[19]. Most manufacturing firms are small and informal. They operate alongside a small number of large businesses, with very few medium-sized firms. The growth of Africa's manufacturing is

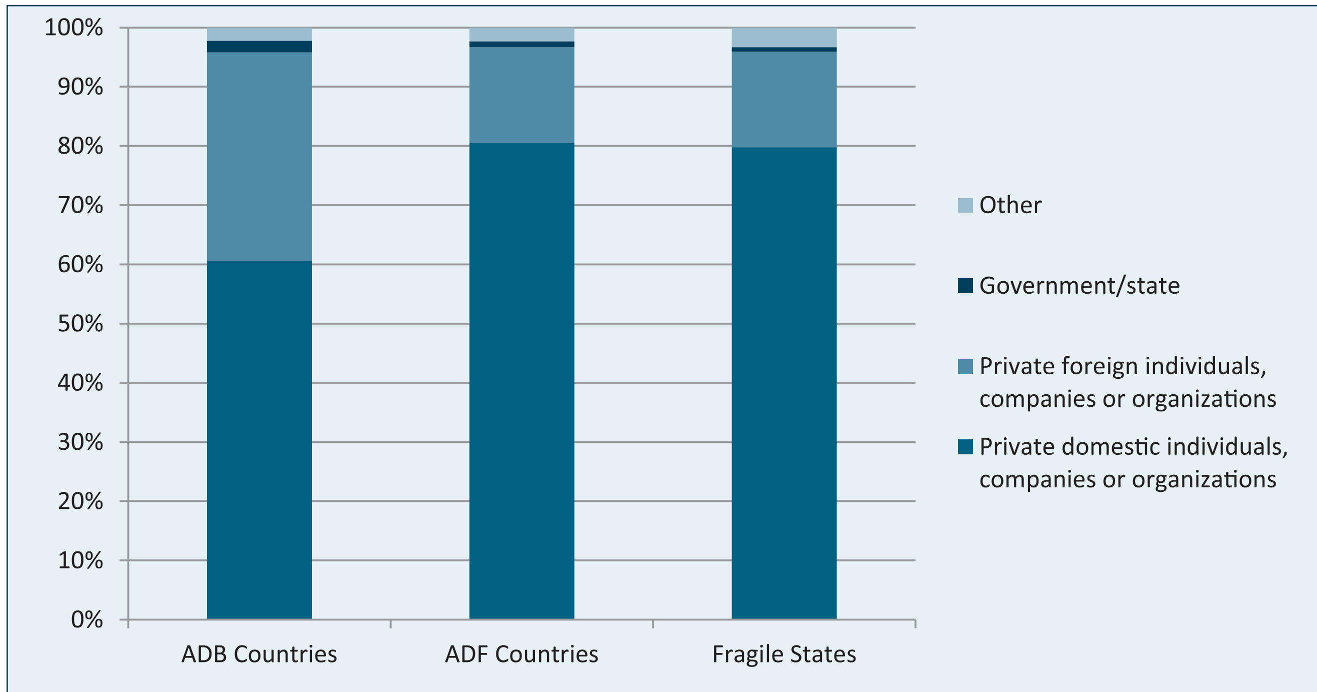
17 Adamopoulos and Restuccia (2010) use the World Census of Agriculture covering 60 countries and document a 34-fold difference in average farm size between rich and poor countries. They find that farm size and capital intensity accounts for up to three quarters of differences in productivity across countries.

18 UNCTAD 2009.

19 World Bank Enterprise Surveys 2006-2010.

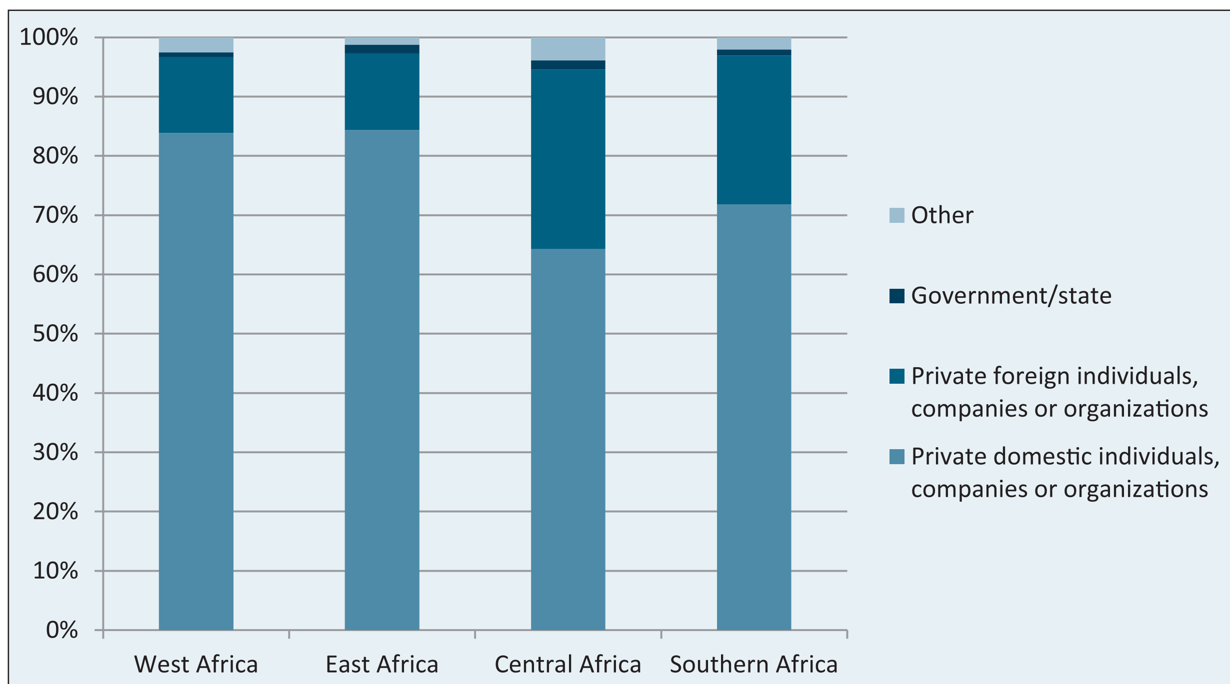
sluggish, and the rate of failure high, particularly amongst the smallest businesses[20]. The main regional variation has to do with foreign ownership, which is more pronounced in Central and Southern Africa (Figure 1.19).

Figure 1.18: Ownership Structure of Manufacturing Firms by Income Level (Percentage)



Source: AfDB calculations based on data from the World Bank Enterprise Surveys, 2010.

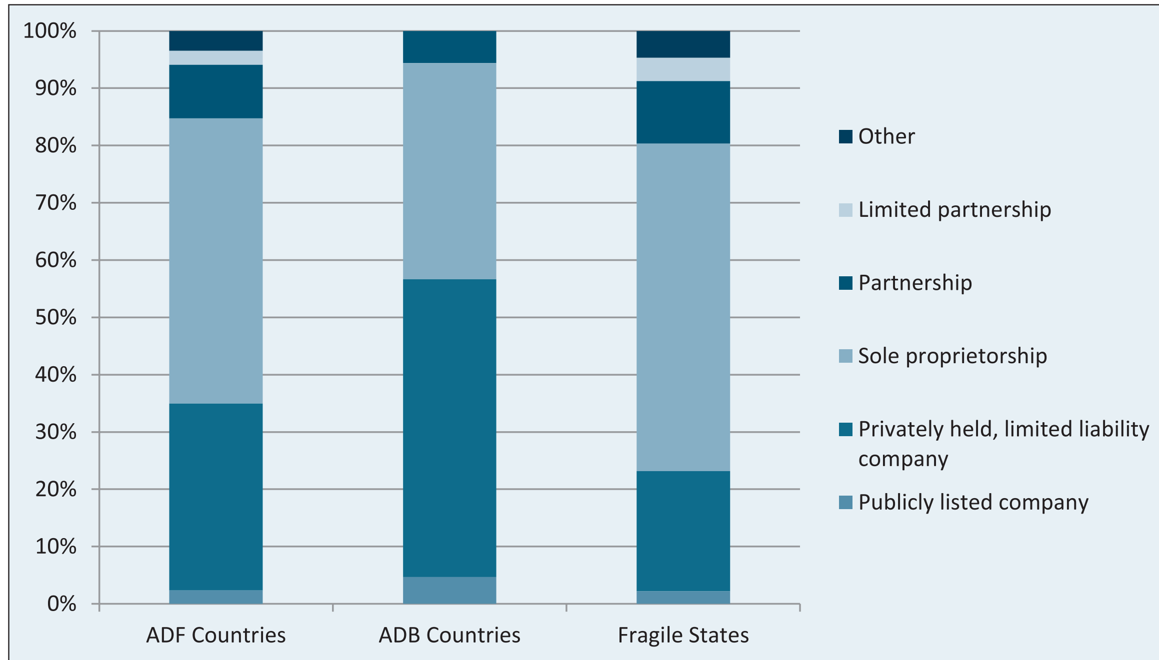
Figure 1.19: Ownership Structure of Manufacturing Firms by Regions



Source: AfDB calculations based on data from the World Bank Enterprise Surveys, 2010.

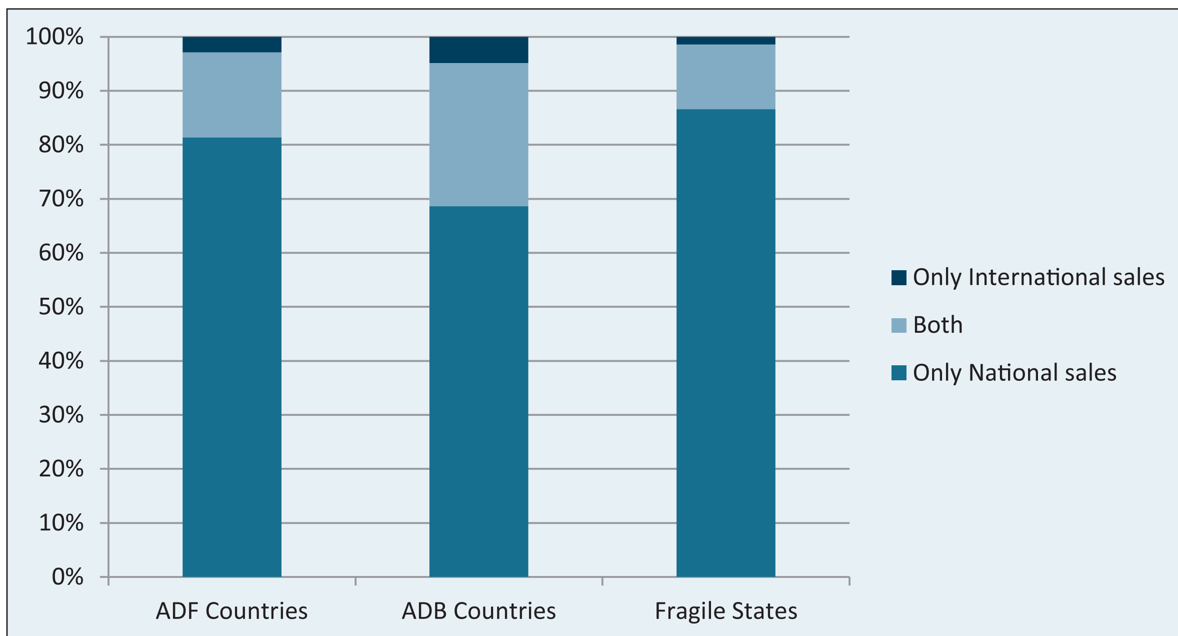
20 Fafchamps 2001 and Fisman 2001. Several other researchers, including Ramachandran and Shah (1999) as well as Sleuwaegen and Goedhuys (2002), have found a more positive relationship between growth and small and young manufacturing firms than with large and old ones, although others have found no such clear evidence (Harding Söderbom and Teal, 2004).

Figure 1.20: Legal Status of Africa's Manufacturers by Country Classification (Percentage)



Source: AfDB calculations based on data from the World Bank Enterprise Surveys, 2010.

Figure 1.21: Manufacturer's Markets by Country Classification (Percentage of total sales)



Source: AfDB calculations based on data from the World Bank Enterprise Surveys, 2010.

In terms of ownership structure, most manufacturing companies are privately held sole proprietorships or limited liability companies. Few businesses are publicly listed (Figures 1.20).

With few exceptions, most of the continent's private manufacturers are involved in the processing of natural resources or in the production of basic consumer goods. Most firms are neither technologically efficient nor involved in foreign trade (Figure 1.21).

Investment in manufacturing has been marginal over the last several decades. As in other private

sector activities in Africa, most firms (especially MSMEs) rely heavily on internal or informal sources of finance, with little access to bank and other financial institutions (Chapter 4).

The private manufacturing sector has the potential to play a more significant role in Africa's economic growth. First, manufacturing carries a higher multiplier effect than agriculture, and economies that rely more heavily on manufacturing usually generate higher per capita income. Second, productivity is generally higher in manufacturing than in agriculture. As a result, overall productivity and per capita income increase as labor migrates from lower-productivity activities to manufacturing. Third, manufacturing offers more significant opportunities for innovation and technological progress than agriculture, which in turn translates into faster capital accumulation, as new generations of equipment tend to involve the latest technologies. Finally, manufacturing generates more significant spillover effects.

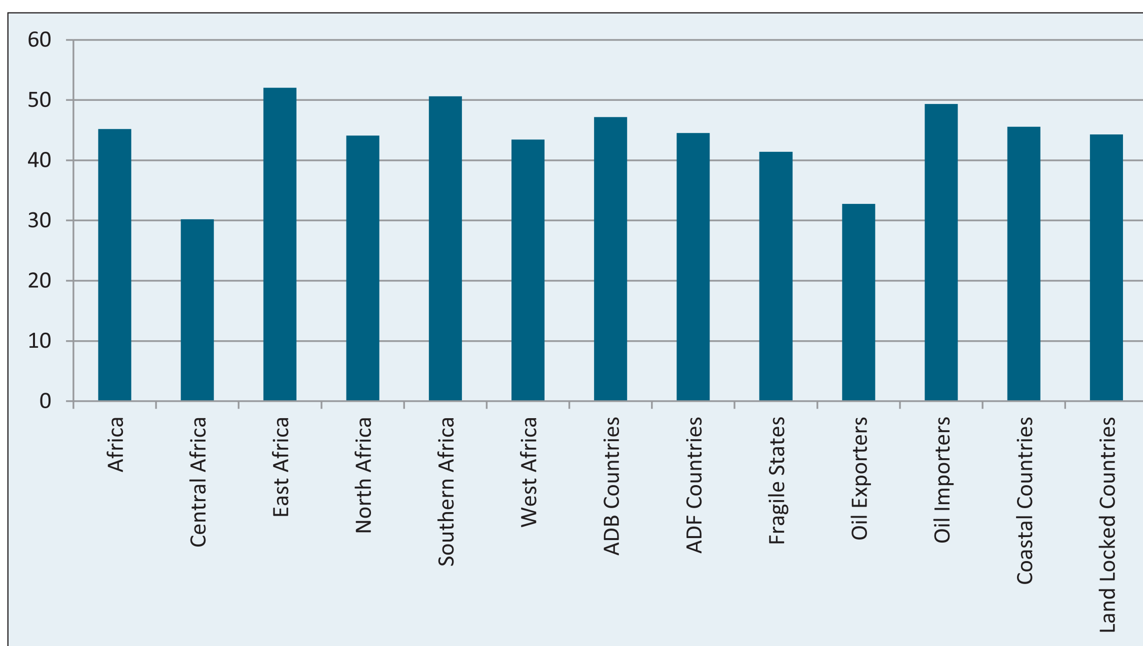
Services

Private sector activity in services across Africa is large and growing. Although still comparatively small, the continent's service sector has expanded significantly in recent years (Figure 1.22). It accounted for close to two thirds of the continent's GDP growth from 1999-2009.

Private activity in services is mainly concentrated in retail and wholesale trade, transportation and distribution, financial services and tourism. The services sector, led by the telecommunications industry, has become the second largest FDI recipient on the continent after the extractive industry. Whereas most enterprises are small, informal and domestic, large multinational firms are actively (and increasingly) in segments such as telecommunications, banking, insurance, hospitality and other more sophisticated services.

The potential growth in private services is significant, as Africa's rapidly emerging middle and transition class-consumers who can spend on more than just the necessities-is the largest in the developing world outside India and China. The African middle class is about 300 million people, out of a total population of 1 billion. Private sector activity has been further spurred by deregulation and investment in infrastructure. As a result, an increasing number of countries such as Kenya and Botswana now boast privately owned world-class hospitals, charter schools, and other high-value service firms, both local and foreign. The impact of this private sector expansion in services could have a far more positive impact on African economies in the coming years, as investments in consumer-oriented sectors often lead to the creation of many more jobs and stimulate consumer spending.

Figure 1.22: Average Value Added from the Service Sector, 1999–2009 (Percentage of GDP)

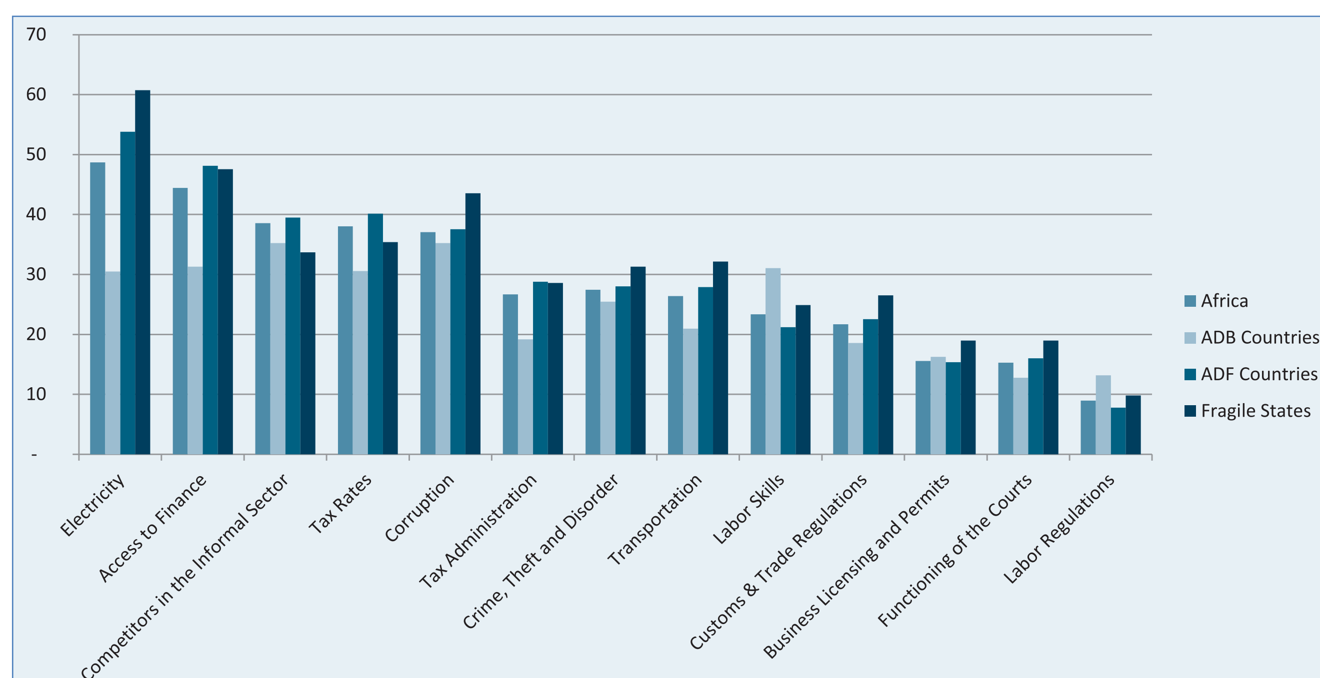


Source: AfDB calculations from World Development Indicators database.

Constraints to Private Sector Development

Although the private sector in African countries faces a common set of challenges, certain constraints are more binding depending of the country's level of economic development (Figure 1.23). While the top-two constraints in Fragile States and ADF countries are electricity and access to finance, these factors are much less of a problem in ADB countries. In addition, the only two constraints which appear to be more binding in ADB countries than in ADF countries and Fragile States are skills shortages and labor regulations.

Figure 1.23: Ranking of Business Environment Constraints in Selected African Countries (Percentage of firms ranking a problem as major or severe)

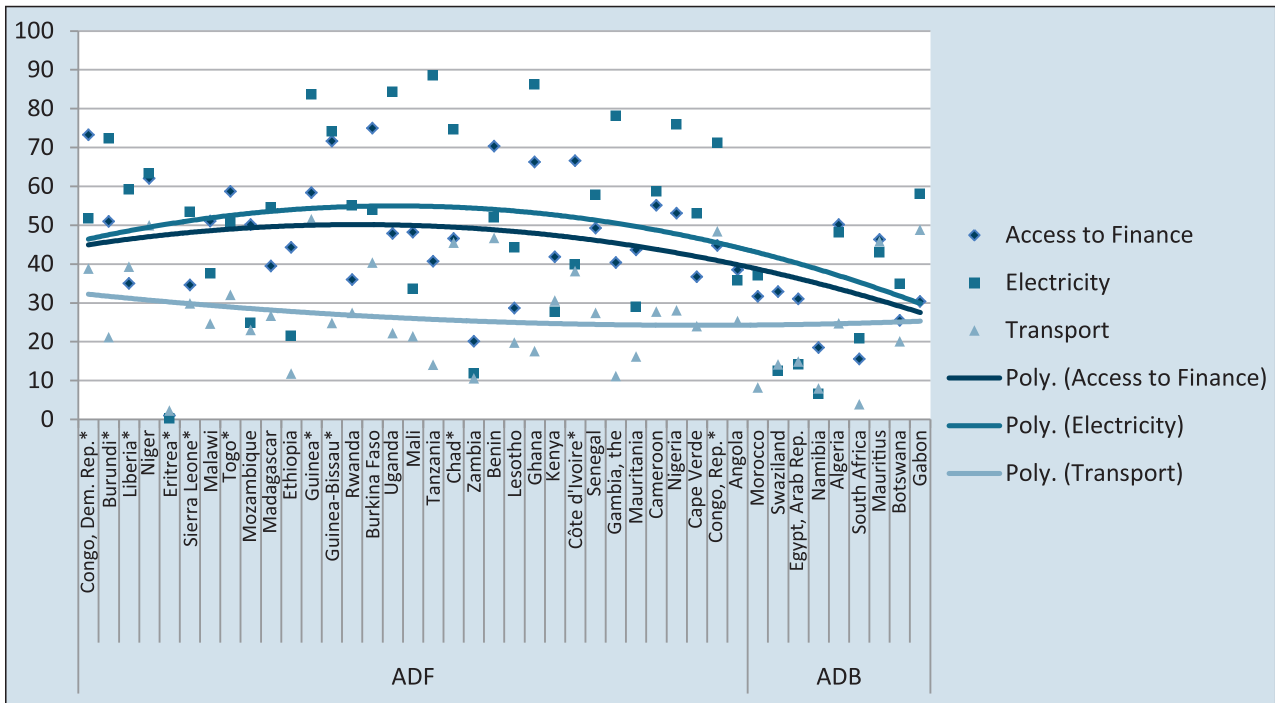


Source: AfDB calculations based on World Bank Enterprise Surveys for 41 African countries.

Given the wide range in the level of income and PSD that exists within the classification based on ADB and ADF countries and Fragile States, we have refined further the constraints analysis using three other classification schemes based on income levels, competitiveness and economic development. The analysis based on income levels confirms that business constraints vary by stages of economic development. Fundamental constraints involving insufficient transport networks and lack of access to power and finance are most critical in Fragile States and lower income ADF countries, while governance constraints regarding high tax rates and poor tax administration are relatively more binding in higher-income ADF countries (Figures 1.24, 1.25 and Box 1.3). In ADB countries, policy-related constraints are most important and include skills shortages and labor regulations (Figure 1.26). Hence, as countries move up the development ladder, basic constraints generally begin to be addressed and governance and policy constraints become more binding.

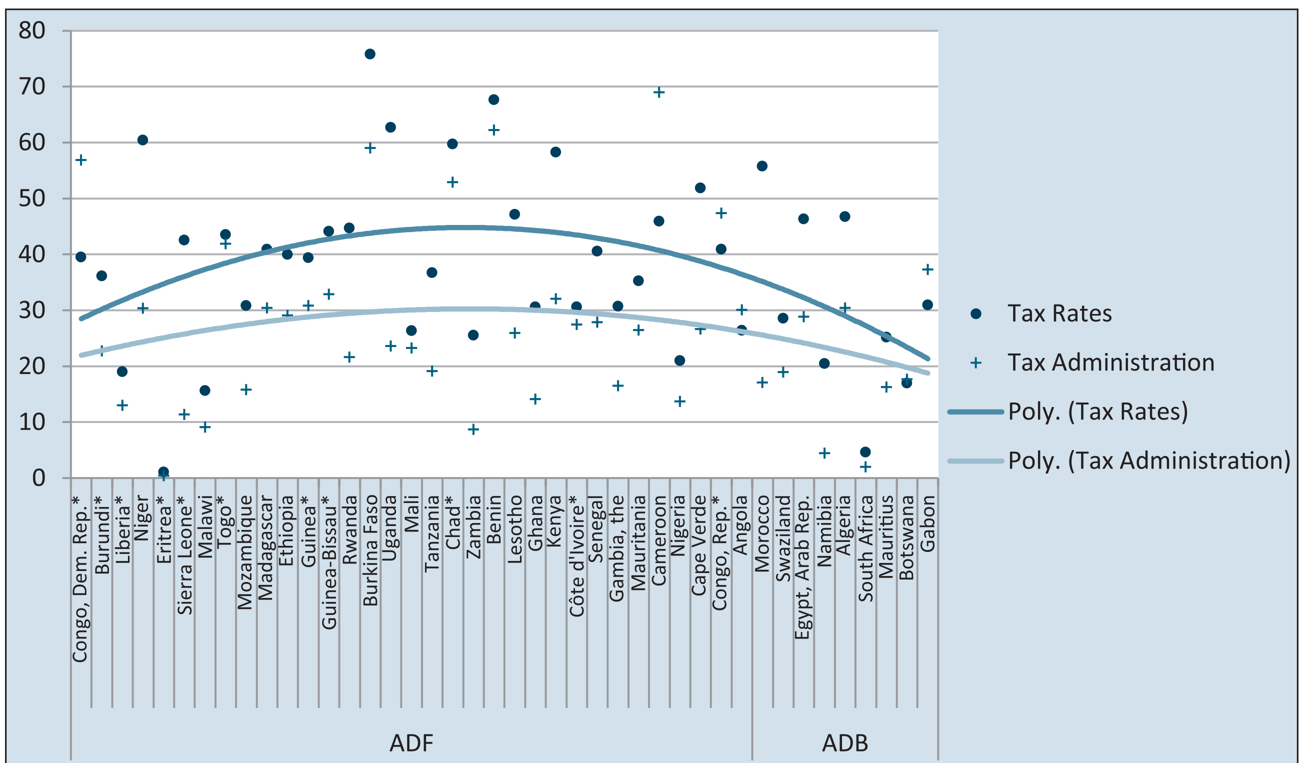
Constraints to private sector development also differ by type of firm. Large firms are more concerned about corruption, skill shortages, and labor regulations, while export-oriented firms place tax administration at the top of their list. These systemic factors are of less importance for small firms who instead find the lack of access to (and high cost of) finance, insufficient collateral, and the business owner's limited technical, management,

Figure 1.24: Percentage of Firms Ranking Fundamental Constraints as Major or Severe (Countries are listed by per capita GDP) *Fragile States



Source: AfDB calculations based on World Bank Enterprise Surveys, 2006–10.

Figure 1.25: Percentage of Firms Ranking Governance Constraints as Major or Severe (Countries are listed by per capita GDP) *Fragile States



Source: AfDB calculations based on World Bank Enterprise Surveys, 2006–10.

Box 1.3: Typology of Constraints to Private Sector Development by Level of Economic Development

In Gelb and others (2007), the authors have identified three sets of constraints affecting African countries and illustrate the evolution of constraints in a dynamic way showing three sets of constraints perceptions for each country sorted by income per capita in ascending order, together with fitted polynomial trend-lines. This report applied Gelb's methodology using the most recent data available from Enterprise Surveys as well as 2010 per capita GDP in current US$.

Fundamental constraints decrease in perceived severity with income. This set of constraints involving lack of access to power and finance as well as insufficient transport networks is more critical in Fragile States and low income ADF countries. Electricity and access to finance and to transportation are basic requirements for a dynamic business and were termed elemental constraints by the authors. Although fundamental constraints also exist in ADB countries, their relative significance declines as income levels increase, implying that basic business environment is relatively sound.

A second set of constraints is related to the quality of governance and state effectiveness. Although weak governance may cause fundamental constraints to be more severe (for example by reducing efficiency of power producers and grid operators), firms in lower-income ADF countries identify these problems explicitly and not as a consequence of poor governance. At higher levels of per capita income, and once the basic requirements for running a business are at least partially met, firms become more seriously constrained by governance issues arising from administrative capacity constraints and non-transparent public institutions. Tax rates and administration are more problematic for firms at the middle of the income scale, meaning in higher income ADF countries than in low income ADF countries and ADB countries.

Labor shortages and regulations are a third set of constraints that peak towards the end of the income scale. Once fundamental constraints are addressed and the capacity of the state to enforce regulations has improved, labor regulations and skills shortages become relatively more important in determining the quality of the business environment.

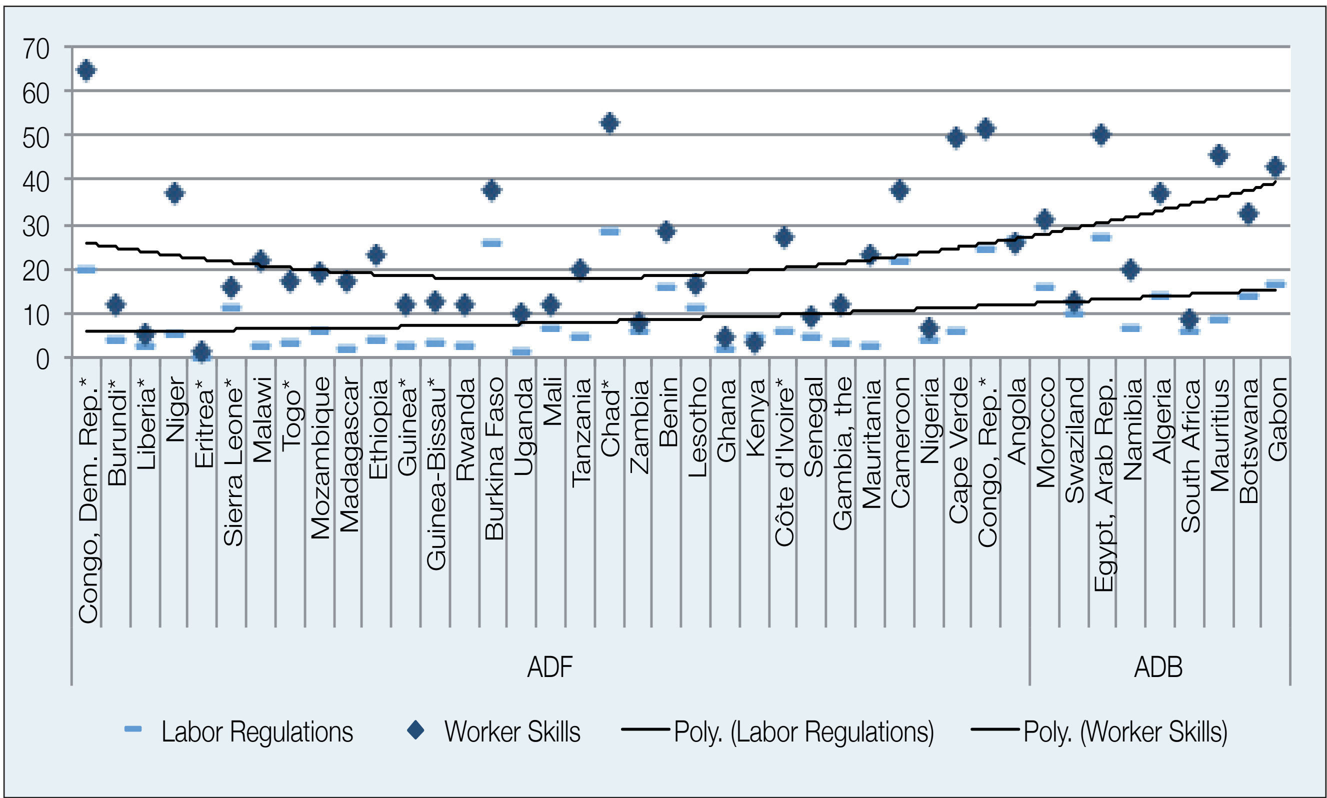
Source: Gelb and others 2007.

and accounting skills to be more binding. The most severe constraint faced by microenterprises in both middle- and low-income countries is access to finance (Figure 1.27). Microenterprises in middle-income countries also tend to be severely constrained by business licensing procedures, which may be a factor influencing their decisions to remain informal.

The relative importance of individual constraints to PSD also varies with regard to African countries' level of competitiveness as measured by their rankings on the global competeviness index. The results are similar to those based on rankings by income level. Some constraints decline in importance as countries' economies become more competitive. This set of constraints include access to transportation, access to finance, public order, tax administration, business licensing, corruption, customs and trade regulations, and the judicial system.

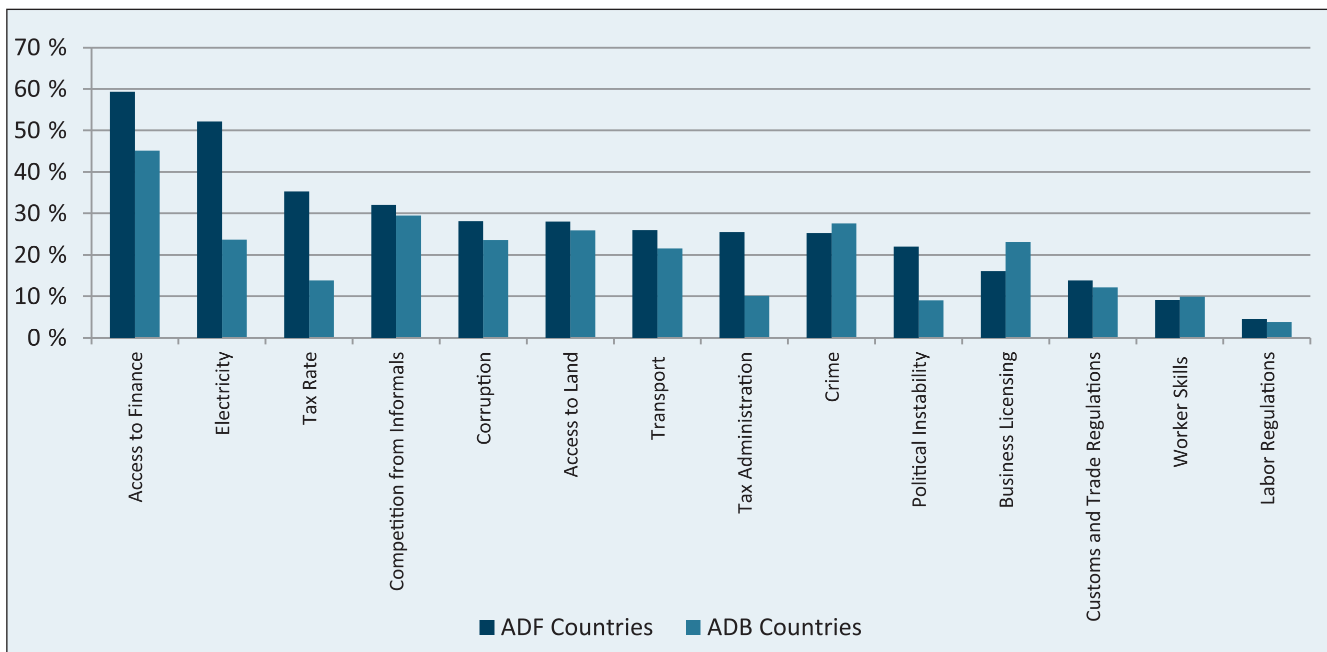
Tax rates and access to electricity become more constraining to businesses as countries' competitiveness improves. As a country moves from a low level of competitiveness to a middle level, more and more businesses register and greater concerns about tax rates arise. Similarly, more businesses are investing and growing in capital intensity as they become more competitive.

Figure 1.26: Percentage of Firms Ranking Policy Constraints as Major or Severe



Source: AfDB calculations based on World Bank Enterprise Surveys, 2006–2010.

Figure 1.27: Percentage of Microenterprises Ranking a Constraint as Major or Severe



Source: AfDB calculations based on World Bank Enterprise Surveys, 2006–2010.

The increasing capital intensity is accompanied by increasing energy utilization. This peaks for those middle-ranked countries where the gap between power supply and demand is relatively high. Although there is still a power supply gap in the higher-ranked countries, it diminishes relative to demand.

There is a final set of constraints related to skills. Labor regulations and skills are perceived as relatively less constraining as countries reach the middle of the competitiveness range. Yet constraints involving labor regulations and skill shortages become relatively more important once firms are provided with the basic requirements for operating a business, and governments are able to enforce rules and regulations.

The results are similar using the more disaggregated alternative classification scheme. Access to finance and electricity are perceived to be the most severe constraints across all country groups, except for ADB countries. In ADB countries, however, taxes, corruption and social stability are equally important. In the transition and pre-transition low-income countries, key constraints facing businesses are of relatively equal concern, with the exception of corruption[21]. Businesses' main concerns in resource-rich countries are similar to those in middle-income countries: with the exception of corruption, the share of businesses worried about electricity, access to finance, tax rates and competition from the informal sector is about 40 %, not much higher than the 35 % average observed in middle-income countries; that corruption is perceived as more of a problem in resource-rich countries is consistent with evidence on the adverse effects of resource booms on governance.

Conclusion

This chapter examined the key challenges facing private sector operators in Africa, noting that the relative importance of individual constraints varies across income levels, firm size, and other parameters.

The private sector helps reduce poverty in Africa by creating employment and generating income, providing essential consumer goods and services, and investing in infrastructure. Although African countries have grown over the past decade at impressive rates, inequality and unemployment particularly amongst youth have increased. So the challenge going forward is to promote growth that is inclusive and sustainable.

To achieve economic outcomes that lift greater numbers of people out of poverty requires a vibrant private sector in which micro, small, and medium-size enterprises thrive alongside large firms and labor intensive activities can also flourish.

In the following chapters, each of the main constraints to private sector development (PSD)—legal and regulatory environment, access to infrastructure and finance, human capital and skills development, entrepreneurial development, and corporate governance—are discussed in greater detail and an agenda of measures is put forward that RMCs and their development partners, including the AfDB, could pursue to address these challenges.

21 The differences in their constraints are not statistically significant from one another and this is due to the small sample size of seven countries in each group. The differences within each group are significantly larger than the differences across groups.

Chapter 2 :

THE LEGAL AND REGULATORY ENVIRONMENT

Africa's legal and regulatory environment ranks amongst the least business friendly in the world. Excessive business regulations, complicated permit procedures, and opaque tax assessment rules are among the major business regulatory issues noted. This chapter assesses the key challenges facing businesses, including impartiality of the court system, predictability of regulatory changes, building efficient and transparent institutions, simplifying business registration and start up, as well as for property registration and titling. It then assesses private sector competitiveness and the regulatory environment in Africa and discusses reforming the business environment. The chapter concludes that introducing one-stop shops for entrepreneurs, making the minimum capital requirement to start a business affordable, simplifying taxes, promoting fair competition, and strengthening insolvency laws would significantly help the private sector develop and thrive.

Historical Evolution

To develop, the private sector requires a legal and regulatory environment that fosters business and is backed by strong institutions with effective monitoring and enforcement powers. In such an environment, informal enterprises become formal; formal enterprises expand and employ more people; tax payments are affordable; property rights are respected, and lenders accept these properties as collateral; innovation picks up, spurred by inventions that can be patented and protected legally; and once the law protects investments against arbitrary expropriation, entrepreneurs have greater access to capital. When business entry, property registration, trading, and tax payments are simplified and streamlined, businesses have more incentives to invest, expand, create jobs, and respect the rules. Countries with heavy regulations of business entry, on the other hand, have higher levels of corruption and informal economic activities[22].

Over the past few years, African countries have adopted an increasing number of reforms seeking to transform the legal and regulatory environment and encourage competition, free trade, and FDI. Yet the business climate in the region still remains less attractive than in others parts of the world. The reform momentum therefore needs to be intensified and focus on an appropriate policy framework: transparent legal, regulatory, and administrative institutions.

Challenges Facing Private Sector Development in Africa

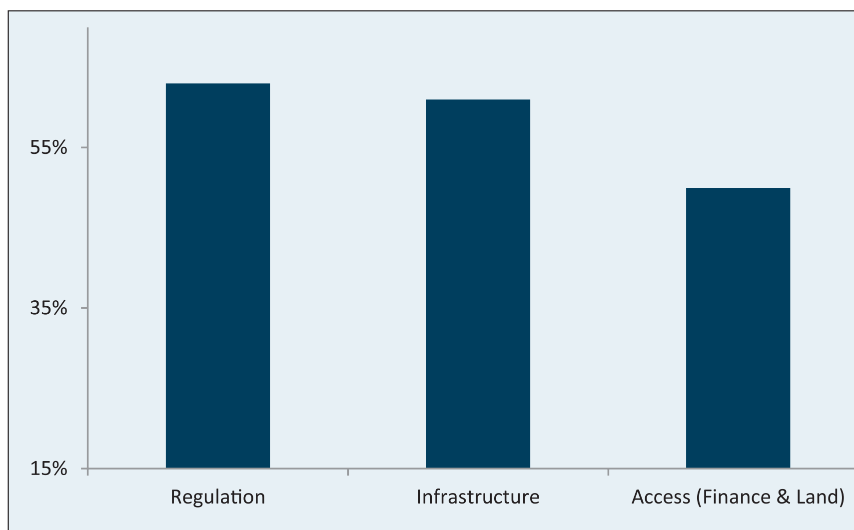
Africa's legal and regulatory environment indeed ranks amongst the least business-friendly in the world. African entrepreneurs face more hurdles to register businesses and obtain various permits than in other regions. Twenty of the bottom 25 countries ranked in the 2010 *Doing Business* report are in sub-Saharan Africa. According to the 2011 *Doing*

22 Djankov, and others 2002.

Business report, the average ranking of African countries on overall ease of doing business is 137 out of 183 economies, compared with 72 in Eastern Europe and Central Asia, 96 in Latin America and the Caribbean, and 87 for East Asia and the Pacific. Business registration and start-ups in sub-Saharan Africa cost almost 20 times that in OECD countries (relative to per capita income), which helps explain why many enterprises in the region remain informal (see Chapter 1). Similarly, out of the 10 countries in the world where starting a business is the easiest, there is only one African country (Rwanda). Moreover, there is no single African country among the 10 economies where getting construction permits or registering property is easiest. African countries are in the bottom 10 in several indicators: 7 of the most difficult countries to register a business, 4 of the most difficult for getting construction permits, and 5 of the most difficult countries in the world for registering property.

When asked about the major constraints to their operation and growth, almost two-thirds of African businesses rate at least one regulatory issue as a serious concern. The top reasons cited were perceived corruption; customs and trade regulations; tax administration and rates; labor regulations; ease of getting operating permits and licensing; or the judiciary (Figure 2.1). Collectively, overall regulatory challenges are perceived as more severe than even infrastructure and access to finance.

Figure 2.1: Major Business Obstacles in Africa
(Percentage of firms rating the constraint as severe)



Source: World Bank Enterprise Surveys database, 2010.

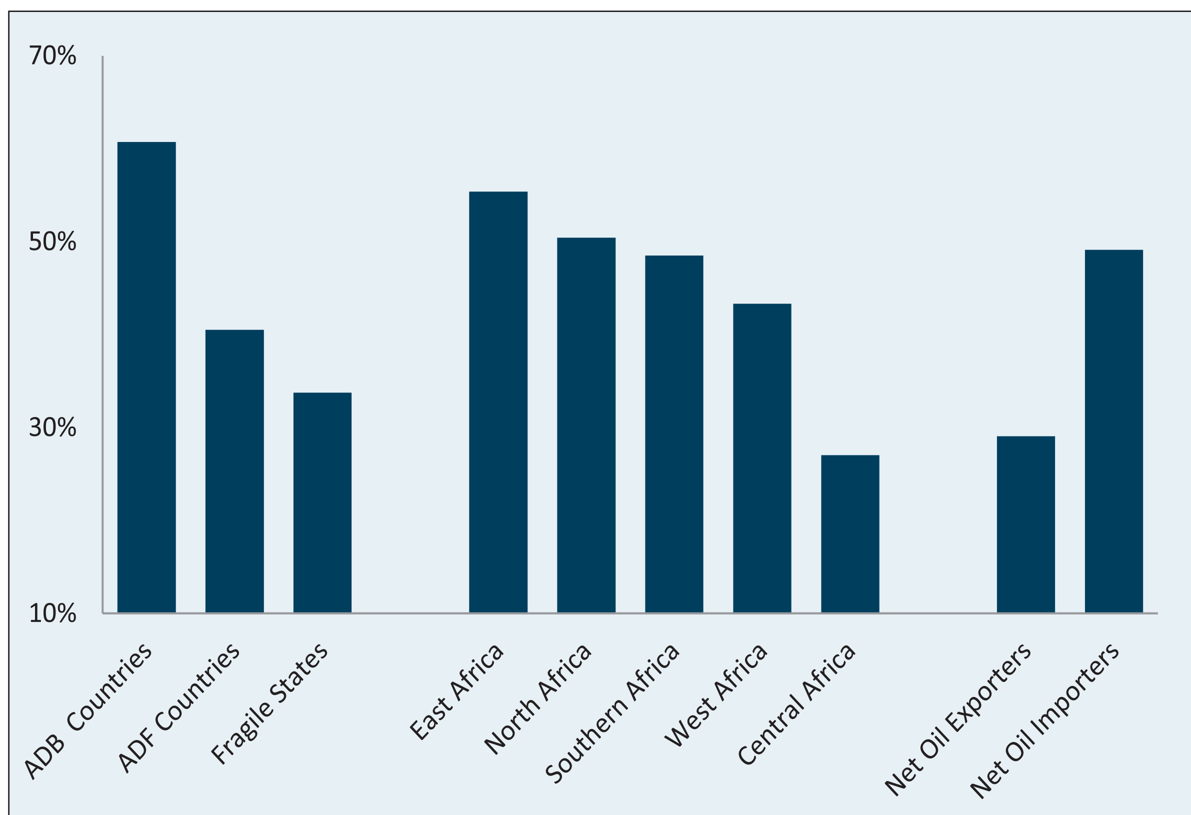
Excessive business regulations, complicated procedures to get permits, and lack of transparent rules in tax assessment are among the major business regulatory issues that enterprises complain about in Africa. Because of weak judiciary systems and weak enforcement mechanisms, enterprises do not feel confident that they will get efficient court services in case business disputes arise. Businesses also feel that these rules and regulations are subject to varying interpretations and seem to change from time to time without their knowledge. This section will briefly discuss confidence on court impartiality and policy predictability as perceived by African businesses.

Impartiality of the Court System

Court impartiality is essential to business confidence. When courts are believed to be impartial and court decisions are properly enforced, businesses are more likely to engage in contractual transactions such as credit with suppliers and clients, confident that they can rely on a fair and timely legal resolution in case of dispute. In addition, confidence in an impartial judiciary able and willing to penalize wrongdoing also discourages business corruption.

Less than a fifth of businesses surveyed in Africa believed that their court system was fully impartial. Perceptions differ across the continent, however. A majority of businesses in ADB countries (61 %) rated courts in their countries as fully or somewhat impartial, compared with only 41 % of businesses in ADF countries and 34 % in Fragile States (Figure 2.2). A majority of respondents in East Africa trusted their court system. Perceptions in Central African and oil-exporting countries, however, were significantly worse than elsewhere on the continent.

Figure 2.2: Court Impartiality
(Percentage of firms who rated courts as fully or somewhat impartial)



Source: AfDB calculations using World Bank Enterprise Surveys data, 2010.

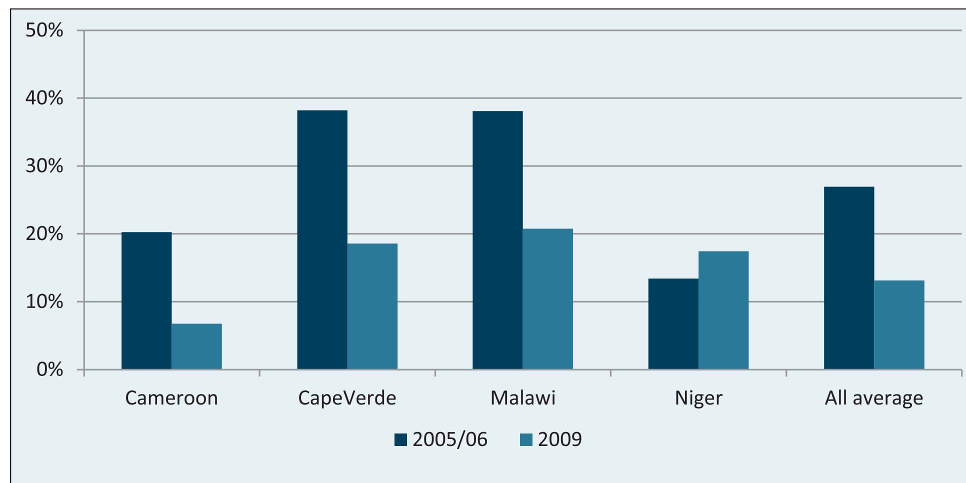
These averages obscure significant variations at the country level: while about 70 % of businesses surveyed in Botswana, Namibia and Malawi felt fully or somewhat confident about the courts' impartiality in their countries, only less than a quarter felt the same way in Benin, Guinea Bissau, Mozambique Togo, DRC, Chad, and Madagascar. In fact, only 5 % or less of respondents rated courts in their countries as 'fully impartial' in Chad, Benin, Madagascar, Mozambique, and Guinea Bissau. Only in nine of the 36 African countries for which this indicator is available did 20 % of respondents or more rated their courts as fully impartial; and only in 12 of them did a majority feel that courts were fully or somewhat impartial (Annex 2.1).

Repeated rounds of data collection in four countries (Cameroon, Cape Verde, Malawi, and Niger) reveal that business perceptions of court impartiality in their countries have in fact substantially worsened, except in Niger (Figure 2.3).

Predictability of Regulatory Changes

Perceptions that regulations are unpredictable are likely to have a negative impact on long-term business planning and investment, confuse interpretations of the rules, and increase the potential for corruption. In 20 out of the 26 African countries for which comparative data are

Figure 2.3: Perception of Court Impartiality by Year (Firms who reported that courts are fully impartial in percentage)



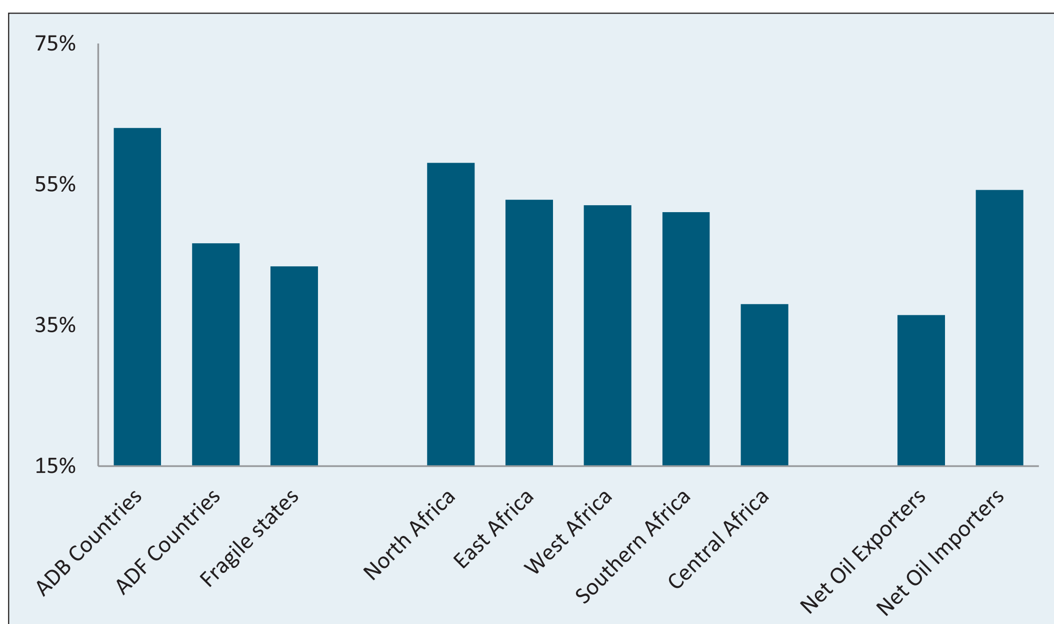
Source: World Bank Enterprise Surveys database, 2010.

available, less than a fifth of respondents believed that regulations affecting their operations were fully predictable. For all 26 countries, the average percentage of respondents who rated regulations as fully predictable was 17 %.

Results vary greatly across countries. The percentage of firms that think that regulations are fully or somewhat predictable ranges from 13 % in Guinea Bissau to 70 % in Rwanda and Ghana. In six countries more than 60 % of respondents rate changes in business regulations as fully or somewhat predictable (see Annex 2.1).

The majority of businesses in ADB countries (63 %) rated regulatory changes in their countries as fully or somewhat predictable compared with 47 % of businesses in ADF countries and 43 % in Fragile States. Central Africa and oil exporting countries rate significantly worse than the rest of the region (Figure 2.4).

Figure 2.4: Predictability of Regulatory Changes (Percentage of firms who rated regulatory changes as fully or somewhat predictable)



Source: AfDB calculations based on World Bank Enterprise Surveys data, 2010.

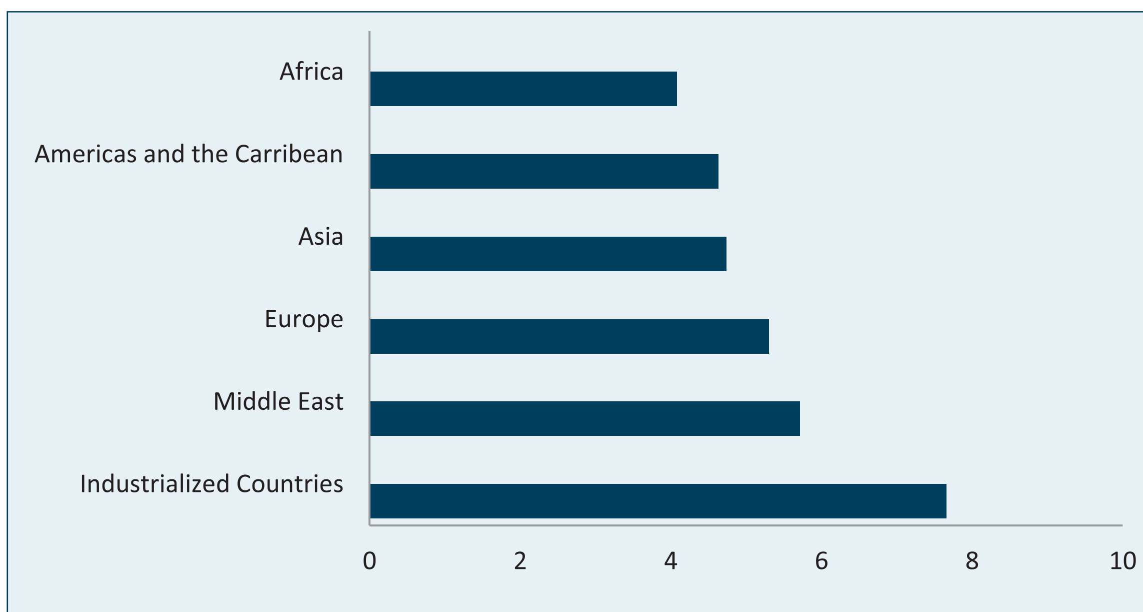
Building Efficient and Transparent Institutions

Besides impartial courts and predictable regulations, strong, efficient and transparent institutions not only contribute to business confidence and facilitate transactions, they also reduce transaction costs and opportunities for corruption. The strength of institutions relies on appropriate skills and equipment, a well-functioning judiciary and robust enforcement mechanisms. Such institutions ensure that procedures such as customs clearance and export/import documentation are streamlined and efficient, while detecting unlawful operations. They need to be coupled with well-functioning courts and appropriate legal penalties that discourage wrongdoing.

Efficient institutions play an important role in improving a country's business climate. Comparing the impact on businesses of Brazil's relatively complex and opaque legal and regulatory institutions with Chile's suggests that business transactions in Chile benefit from legal simplicity and more consistent enforcement compared to those in Brazil. Moreover, cumbersome regulations raise business transaction costs in Brazil due to greater uncertainty and frequent renegotiation of orders[23].

The institutional environment in Africa is, in most cases, weak. Africa's institutional environment compares poorly to other regions according to the Capital Access Index (Figure 2.5). Moreover, 13 out of the bottom 20 institutional environments in the Index are in Africa[24].

Figure 2.5: Institutional Environment (IE) Score



Source: Barth and others 2010.

Other business climate indicators also show that Africa's laws and regulations are more restrictive than other regions. Starting and running a business are, for example, hindered by multiple factors, including lack of capacity and burdensome bureaucracy.

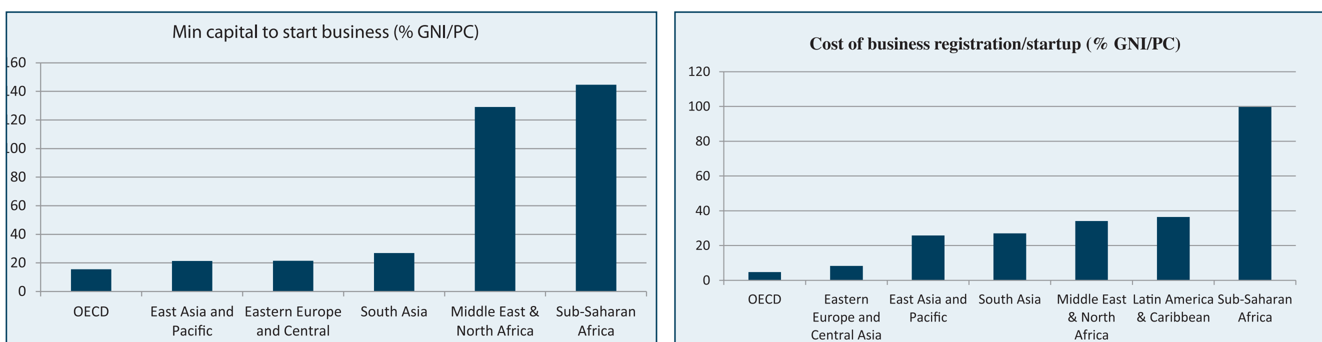
23 Stone and others 1992.

24 The Capital Access Index, published by Milken Institute, is a composite index aggregating the following seven components: macroeconomic environment, institutional environment, financial and banking institutions, equity market development, bond market development, alternative sources of capital, and international funding. The institutional environment score measures the extent to which institutions support and enhance business financing activities, based on variables that include the enforceability of property rights, the impartiality of the judicial system, the efficiency of bankruptcy procedures, and levels of corruption. The 2009 index ranks 122 countries on six continents (Barth and others 2010).

Businesses Registration and Startup

Businesspersons' first contact with the legal and regulatory environment is when they decide to formally register and open a business. Business registration and start-up processes vary significantly in complexity and cost across Africa. Overall, however, starting a business generally takes longer and is more costly in Africa than in any other region (Figure 2.6). In Australia, for example, the process requires two procedures that can be completed in just two days at a cost equivalent to 0.8 % of the country's per capita income. An entrepreneur in Djibouti, on the other hand, needs to go through eleven procedures requiring 37 days and costing the equivalent of 195 % of the local per capita income to complete the process. In addition, the minimum capital requirement in Djibouti is equivalent to about 500 % of per capita income[25].

Figure 2.6: Cost of Starting Up a Business



Source: World Bank 2009.

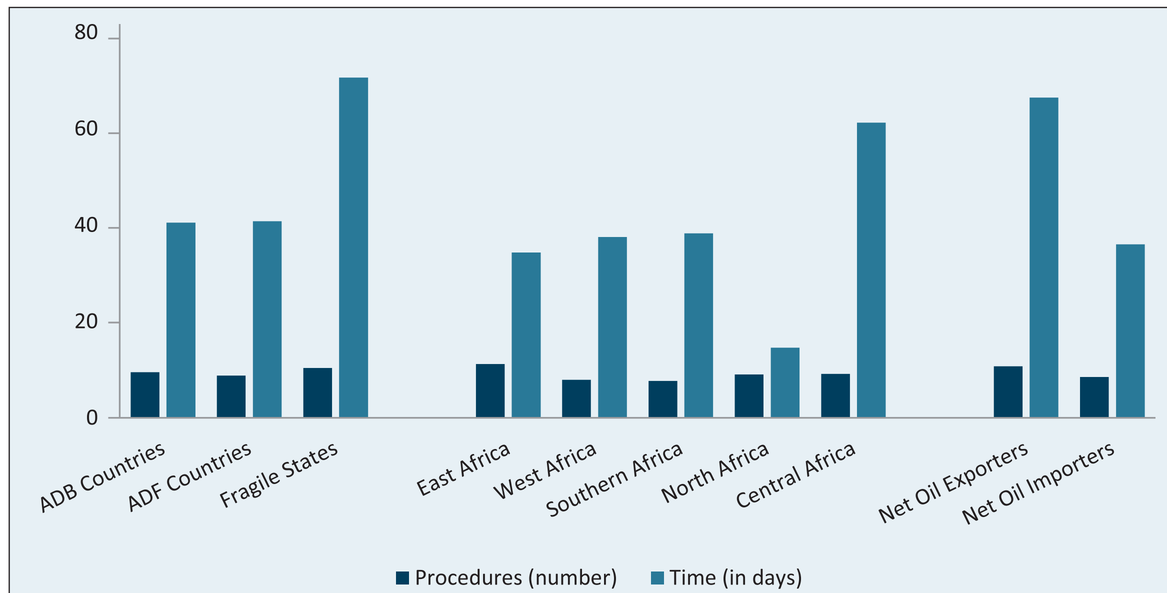
Ease and costs of registration procedures have significant implications for business. Business registry modernization (often a component of broader private sector reforms) eases business registration, and quick, efficient, and cost-effective business registration processes are critical for fostering formal sector entrepreneurship[26]. In contrast, cumbersome registration and business dispute settlement procedures impede business transactions and contribute to informality. According to a World Bank study based on enterprises surveyed in 82 countries, fewer procedures for dispute resolution are associated with improved fairness and impartiality in the legal system[27]. The speed and ease with which businesspersons are able to register and formally establish their businesses has been directly linked with economic performance[28]. Expensive business registration and high minimum capital requirements for starting a business also lower entrepreneurship[29].

Minimum capital requirements to start a business in Africa range from 12 % of per capita GNI in Lesotho and Equatorial Guinea to a crippling 614 % in Niger and 780 % in Guinea Bissau. Almost two-thirds of the 43 countries worldwide where starting a business costs more than 50 % of per capita GNI are in Africa. On the other hand, some 21 African countries require no minimum capital to start a business[30].In addition, registering a business in Africa takes time (Figure 2.7). Almost half of the 24 countries worldwide where it takes more than two months to register a business are in Africa[31]. This partly explains why informality

25 World Bank 2009.
26 Klapper and others 2009.
27 World Bank 2005.
28 Djankov and others 2002.
29 Van Stel and others, 2006.
30 The countries with no capital requirement are: Botswana; Burundi; Congo, Dem. Rep.; The Gambia; Kenya; Liberia; Madagascar; Malawi; Mauritius; Mozambique; Namibia; Nigeria; Rwanda; São Tomé and Principe; Seychelles; Sierra Leone; South Africa; Sudan; Tanzania; Uganda; and Zimbabwe (see Annex 2.1).
31 World Bank 2009.

on the continent is high relative to other regions, and why competition from informal businesses is perceived as a threat to the growth and performance of the formal sector (see Chapter 1).

Figure 2.7: Business Startup: Number of Procedures and Days



Source: AfDB calculations based on World Bank Doing Business data, 2010.

While the number of procedures does not vary significantly across sub regions or income level, it takes almost twice as long to register a business in Fragile States countries than in ADB and other ADF economies. It takes almost four times as long in Central African countries and almost twice as long in other regions than in Northern African countries. It takes almost twice as long to register a business in net oil exporting African countries than in net oil importers.

Property Registration and Titling

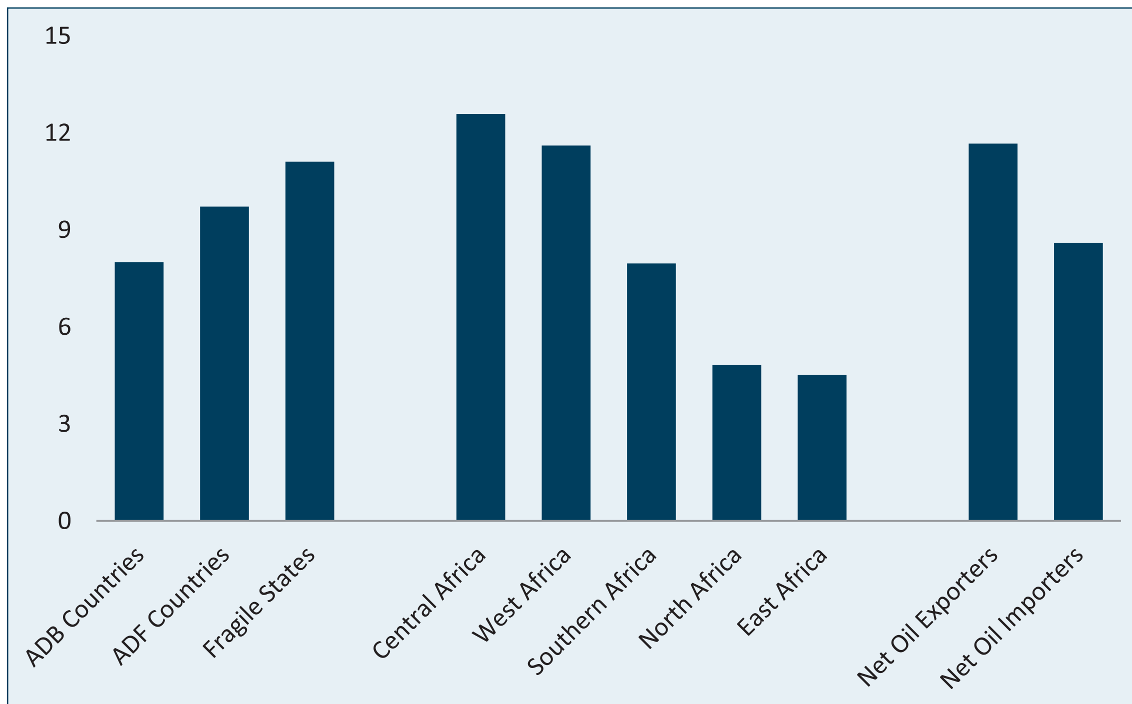
Securing formal ownership through efficient and simple property registration encourages long-term investment and facilitates access to finance. Complications and costs discourage business and create opportunities for corruption to expedite the registration process. Without property registration and title, banks are reluctant to extend credit due to the lack of proper collateral[32].

Registering property in Africa is relatively costly, time consuming, and complicated (Figure 2.8). An entrepreneur in the Netherlands, for example, can check ownership records as far back as 1832, register property online in just a few minutes by completing two procedures, and receive a registration certificate within five days, after paying the equivalent of 6.2 % of the property value. In Nigeria, completing property registration requires about 13 procedures, close to three months, and 21 % of the property value.

Property registration is significantly less time-consuming and cheaper in ADB countries than elsewhere in Africa (Figures 2.8, 2.9). Registering a property costs over twice as much in Central and West Africa, compared to North and East Africa. West Africa, where it takes over three months to register property, trails the rest of the region. Although registration is cheaper in oil-importing countries than in exporting ones, delays are not significantly different.

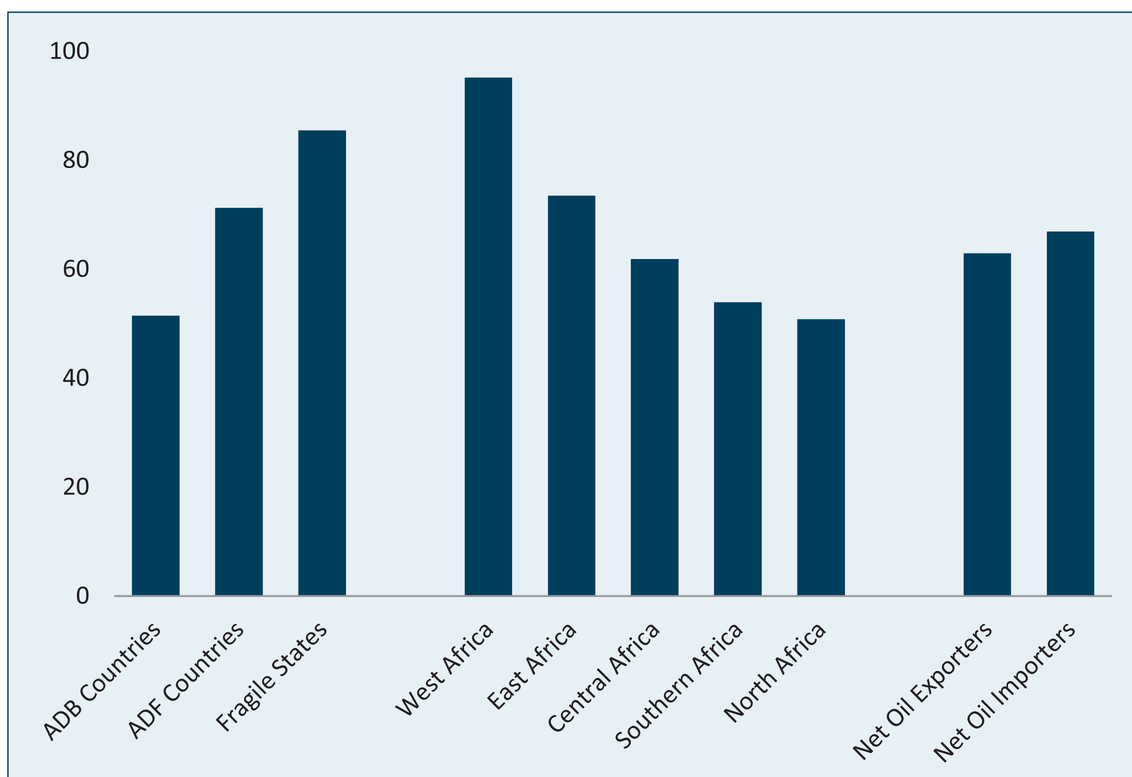
32 World Bank 2005.

Figure 2.8: Property Registration: Cost (Percentage of property value)



Source: AfDB calculations from World Bank Doing Business data, 2010.

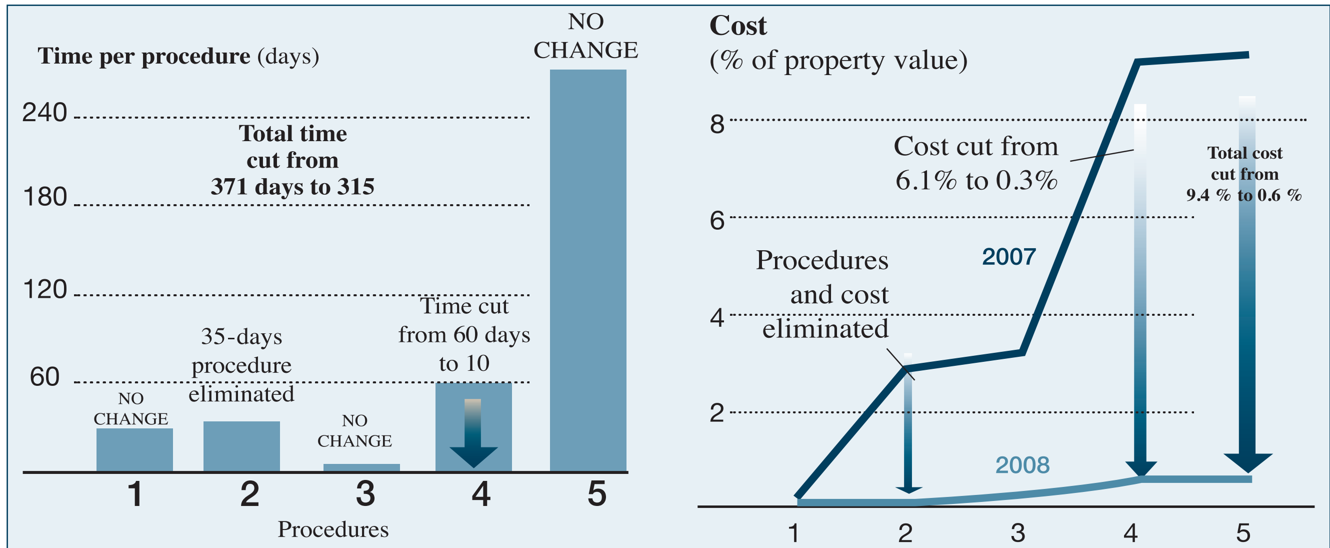
Figure 2.9: Property Registration: Time (Number of days)



Source: AfDB calculations from World Bank Doing Business data, 2010.

Unnecessary procedures weigh heavily on the cost and length of property registration in Africa. Rwanda, for example, was able to reduce the total registration cost from 9.4 % of property value to just 0.6 % between 2007 and 2008 by eliminating one procedure that used to take 35 days and by reducing the time required to complete another from 60 to 10 days (Figure 2.10).

Figure 2.10: Time, Cost, and Procedures for Property Registration in Rwanda



Source: World Bank 2009.

Private Sector Competitiveness and Regulatory Environment in Africa

There is a relationship between the legal and regulatory environment in Africa and the region's competitiveness (Box 2.1). The proxies for measuring the legal and regulatory environment are the 10 indicators from the World Bank's *Doing Business* report measuring the overall ease of doing business; each of these rankings/ indicators is derived from sub-indicators that measure different aspects of a country's business legal and regulatory environment. The indicator used as a proxy for competitiveness is the Global Competitiveness Index rankings from the biennial *African Competitiveness Report*.

Box 2.1: Relationship between Legal and Regulatory Environment and Competitiveness

In order to determine whether Africa's competitiveness is correlated with its business environment, AfDB performed a simple regression using selected indicators from the two data sources as follows:

$$CI\ (Africa)=\alpha+\beta\ DBI\ (Africa)$$

Where CI (Africa) = Competitiveness Index or ranking of a country within Africa; DBI (Africa) is Doing Business Index or ranking of a country within Africa; α is a constant and β is the coefficient to be estimated. The average of both the DBI scores and rankings for each country were used separately to determine if and how the results differ.

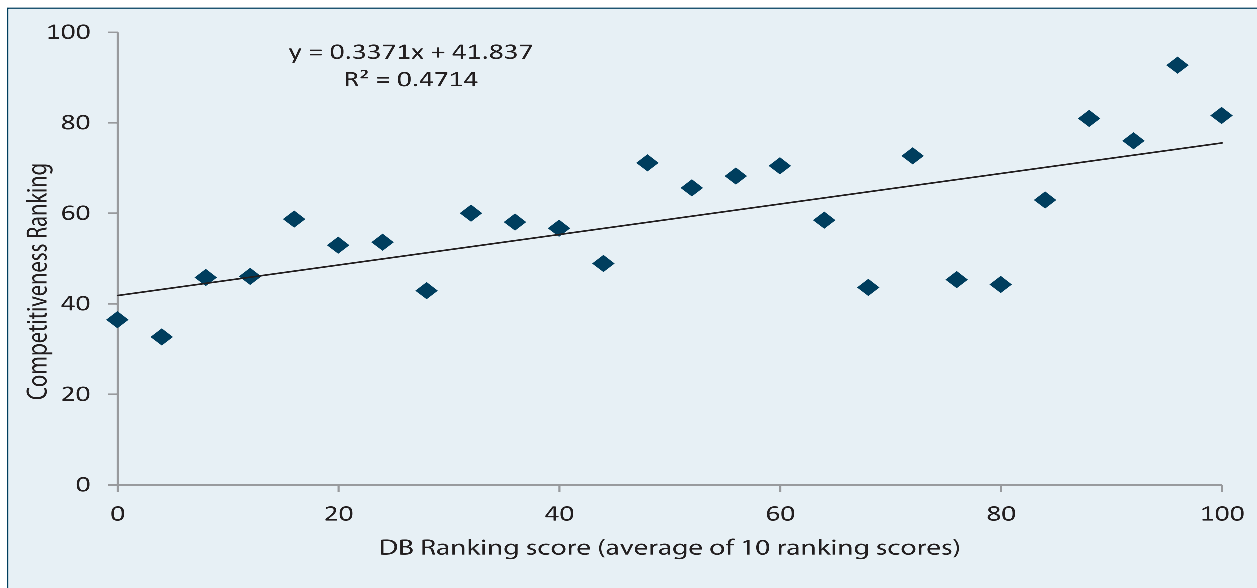
The regression line was calculated based on the average of the 10 Doing Business scores for each country and the competitiveness score for the 26 African countries for which data are available as follows:

$$CI\ (Africa) = 41.8+0.34 DBI\ (Africa);\ \text{with a corresponding}\ R^2 = 0.47.$$

Source: AfDB calculations based on data from World Bank 2009 and World Economic Forum and others 2011.

Despite the fact that the two sets of indicators were produced in two separate exercises using different methodologies, the regression analysis carried out by AfDB staff reveals that there is a strong relationship, regardless of whether scores or rankings are used. In other words, implementing key legal and regulatory reforms will not only improve the country's business environment, it is also associated with its overall level of competitiveness. As highlighted in Figure 2.11, African countries whose regulatory environment for businesses rank high (according to the *Doing Business Report*) also perform better in terms of their relative competitiveness rankings[33].

Figure 2.11: Competitiveness and Ease of Doing Business in Selected African Countries



Source: AfDB calculations based on data from World Bank (2010) and World Economic Forum and others (2011).

The strength of the association between each of the 10 *Doing Business* categories and competitiveness varies. Employing workers, registering a property and protecting investors were weakly associated with competitiveness, while starting and closing a business, dealing with construction permits, trading across borders, and accessing credit were strongly correlated to competitiveness scores. Reforms in the latter areas are therefore likely to have a greater impact on competitiveness.

Further research is required to determine whether an improved regulatory environment leads to greater competitiveness, or vice-versa. Most studies to date, however, have concluded that the causality is more likely to run from improved regulatory regimes to competitiveness. The U.S. General Accounting Office, for example, has found that a nation's competitiveness depends primarily on its productivity, which, in turn, is influenced heavily by different aspects of the business environment, including the interactions of government policies, corporate structures, governance, and business practices[34]. Similarly, deregulation in product and labor markets has been found to be critical in fostering productivity growth and in opening up the economy[35]. Finally, a study on EU countries concluded that macroeconomic and microeconomic governance mechanisms have a direct impact on both domestic and international economic competitiveness[36].

33 The rankings in both datasets were inverted and standardized (so that the best performer scores 100 and the least performer gets 0).
34 US General Accounting Office 1993.
35 Lipponen and Viitamo 2004.
36 Cuckovic and Jurlin 2009.

Reforming the Legal and Regulatory Environment in Africa

Over the past few years, African countries have adopted an increasing number of reforms seeking to transform the legal and regulatory environment and encourage competition, free trade, and FDI. For example, Joseph Kabila, President of the Democratic Republic of the Congo, publicly[37] noted: "The private sector initiative is limited, or even discouraged, by the investment climate. We need to change this situation urgently. I have decided that the improvement of the investment climate should be a priority objective."

Reforms include revamping tax codes, improving tax administration procedures and easing tax burdens, adopting insolvency laws, simplifying procedures for construction permits, improving contract enforcement, streamlining property registration, facilitating business start-up, and removing trade barriers. This wave of reforms has resulted in investors' renewed interest in Africa's emerging economies. In most African economies, it is easier and more affordable to start and run a business today than a decade ago (Box 2.2). In 2005, for instance, registering and starting a new business in Ghana would have required 12 procedures, 81 days, and the equivalent of 78 % of the per capita Gross National Income (GNI); today, it takes only 8 procedures, 33 days and 26 % of the per capita GNI to do so. As a result, Ghana's *Doing Business* ranking on the ease of starting a business has improved from 145th in 2006 to 99th in 2010 (out of 183 economies). Similarly, a Rwandan entrepreneur would have needed to complete 9 procedures, spend 43 days and about 232 % of the per capita GNI to start a formal business in 2004; to do the same today involves only two procedures that take less than three days and cost 9 % of the per capita GNI. Rwanda's ranking has improved substantially from 58th easiest country in which to start a business in 2007 to 9th in 2011. In addition, the country is among the top 10 global reformers.

Box 2.2: A Rwandan Businessman's Point of View

"… Of course some people I know would not probably have registered their businesses, but did so after and because of Rwanda's streamlined process. These days, you can just go to the one-stop center at the Rwandan Development Board (RDB), where people guide you through the whole process. Et voila! You complete registration almost right there and then.

That was not the case when I started my business more than a decade ago. Not only has the complexity and the time has been dramatically reduced, but the cost has dramatically gone down. You can now complete the registration process by yourself, without a lawyer. Also, the reforms by the Rwandan government are succeeding in providing incentives to entrepreneurs like me because they are discussed with private sector representatives. We have a say and we also feel that we co-own the reform process, too.

As a businessman in this country and as a private sector representative who interacts with different types of business owners, I can tell you that the complaints from the private sector are not as bad as they used to be. I used to hear several and harsh complaints from friends who own businesses like me about land and property registration, as well as the bureaucracy. Now there is a lot of improvement in land and property registration, and the mapping exercise throughout the country is to be completed within a year. Of course, I am not saying that things are completely satisfactory to everybody. There may be complaints here and there. This shows you that there are still things to be done; but clearly there are substantial improvements in our business environment. We were rated as among the best reformers in the world during the last two years according to the World Bank, and I strongly hope that improvements in our rankings will also appear in the next report as well."

Source: AfDB discussions with a Rwandan businessman and private sector representative, September 8, 2010.

37 Remarks during a workshop in Kinshasa on the Organization for the Harmonization of Business Law in Africa (OHADA), February 2010.

Ghana and Rwanda are not alone in embracing reform. According to the *Doing Business* reports, 24 African countries implemented 49 regulatory reforms in 2006/07, 28 countries implemented 58 reforms in 2007/08, and 29 countries implemented 67 reforms in 2008/09. In 2009/10, about 60 % of sub-Saharan African countries undertook at least one reform to facilitate doing business, compared with 47 % of the developing countries in Latin America and the Caribbean[38]. Out of the 10 countries in the world that most improved requirements to start a business in 2009/10, four were in sub-Saharan Africa—Zambia, Cameroon, Mozambique, and Cape Verde. Similarly, three African countries (Rwanda, Cape Verde, and Zambia) were named among the top 10 global reformers in the 2011 *Doing Business Report* (Box 2.3). In addition, four of the world's top 10 economies that made the largest strides in making their regulatory environment more favorable to businesses over the last five years are from Africa—Rwanda, Burkina Faso, Mali, and Ghana—and each of them implemented more than a dozen business reforms during this period.

Box 2.3: Top African Business Environment Reformers and Reforms, 2011

Rwanda

- Dealing with Construction Permits: Passed new building regulations and mandated new time limits for the issuance of various permits.
- Getting Credit: Allowed borrowers to inspect their own credit report and mandated that loans of all sizes be reported to the central bank's public credit registry.
- Trading Across Borders: Reduced the number of trade documents required and enhanced its joint border management procedures with Uganda and other neighbors, thereby facilitating trade logistics.

Cape Verde

- Starting a Business: Eliminated the mandatory municipal inspection before a business begins operations and computerized the system for delivering municipal licenses.
- Registering Property: Switched from fees based on a percentage of the property value to lower fixed rates.
- Paying Taxes: Abolished the stamp duties on sales and checks.

Zambia

- Starting a Business: Eliminated the minimum capital requirement.
- Trading Across Borders: Set up a one-stop border post with Zimbabwe, launched web-based submission of customs declarations and introduced scanning machines at border posts.
- Enforcing Contracts: Introduced a court-case management system that provides electronic referencing of cases, a database of laws, real-time court reporting and public access to court records.

Source: World Bank 2010.

38 World Bank 2010.

Most of the recent reforms in Africa have focused on trade facilitation. According to the 2011 *Doing Business* report, more than a third of all trade facilitation reforms in 2009/10 took place in sub-Saharan Africa (with 9 such reforms). The majority of these reforms were motivated by regional integration initiatives, such as the Southern African Customs Union and the East Africa single border control.

These efforts are paying off. Mauritius, for example, was ranked 10th and 17th out of 183 economies in ease of doing business both in the 2010 and 2011 *Doing Business* reports. It has become number one in Africa for ease of paying taxes, while at the same time raising tax revenues. The 2010 *Doing Business* report noted the country "adopted a new insolvency law, established a specialized commercial division within the court, eased property transfers, and expedited trade processes". As a result, Mauritius became the top Sub-Saharan country for four consecutive years (2008 to 2011) on overall regulatory ease of doing business.

Some Fragile States are also actively improving the regulatory framework for business. Liberia was the second-fastest reforming economy in the region according to the 2010 *Doing Business* report. The country eased procedures for business start-up, reduced fees for construction permits, and facilitated trade with a new one-stop center. Coming out of a devastating civil war, the country has been able to cut business start up time from 99 days to 22 days, and the time required to get construction permits from 398 days to 77 days in one year. Similarly, Sierra Leone introduced a law that strengthened investor protection, enhanced access to credit, and provided for the reorganization of troubled firms. It also established a one-stop center for business registration.

Egypt was also among the global top 10 reformers in the 2010 *Doing Business* report and in 4 of the previous 7 years. Mali and Burkina Faso each reformed 5 of the 10 areas covered by the 2010 Doing Business report, including easing business start-up, property registration, and improving contract enforcement. In Senegal, small businesses now pay a single tax that is less than the aggregate total tax they paid a few years ago.

The pace of reforms is thus gathering momentum with a continuous increase in the cumulative number of reforming countries and the number of reforms implemented in Africa over the years to improve the legal and regulatory environment. Africa's regional ranking regarding the pace of reforms as well as the cumulative number of African countries regarded as top reformers is also rising over the years: there were four African countries among the top 10 global reformers in the 2009 *Doing Business* report, and there were three in each of the 2010 and 2011 *Doing Business* reports.

Despite all the efforts and achievements, however, Africa's business environment, particularly south of the Sahara, remains amongst the least business friendly, as noted earlier in this chapter. The depth of problems in the regulatory environment itself seems to be the main reason, as most African countries lag in terms of several indicators, lack of capacity both in terms of human capital and resources to undertake the required reforms, and have insufficient continuous political commitment to the reform process. More, therefore, remains to be done to build up on the achievements to date. Reforms need to be accelerated and intensified. Prioritizing areas where African countries lag the most would result in the greatest impact, therefore maximizing scarce financial and human resources: indeed, simulation exercises using the World Bank's *Doing Business* data confirms that a single reform in the worst performing area can improve a country's rankings significantly (Box 2.4), thus making it more attractive as an investment destination.

Box 2.4: Impact of a Reform on a Country's Doing Business Ranking

Targeted changes can make a big difference.

The 2010 Doing Business report ranked Ghana 135th in the world in terms of starting a business. Yet if Ghana reduced the number of procedures required to start a business from the current eight to just four (other things remaining constant), its ranking would improve to 113th; and if it reduced the number of days it takes to start a business from 33 to 15, its global ranking would improve to 119th. Most strikingly, if the country scrapped the

minimum capital requirement (currently at 13.4 % of per capita income), it would rank 91st on the ease of starting a business.

On the other hand, if the country reduced the number of procedures required for construction permits from 18 to just nine, its ranking in terms of dealing with construction permits would substantially improve from the current 153rd to 99th; while by reducing the number of taxes from 33 to 10, and the number of hours required to pay them from 224 to 90, its ranking on paying taxes would improve from the current 79th to 36th and 39th, respectively.

Similarly, if Djibouti scrapped its minimum capital requirement (currently equivalent to 500 % of the country's per capita GNI), its global ranking on the ease of starting a business would improve from 178th to 135th. If, at the same time, it took 15 days to start a business instead of the current 37, Djibouti's ranking would improve to 115th. If the number of procedures required was also reduced from 11 to 5, the country's global ranking would become 62nd.

Source: World Bank 2009.

Conclusion

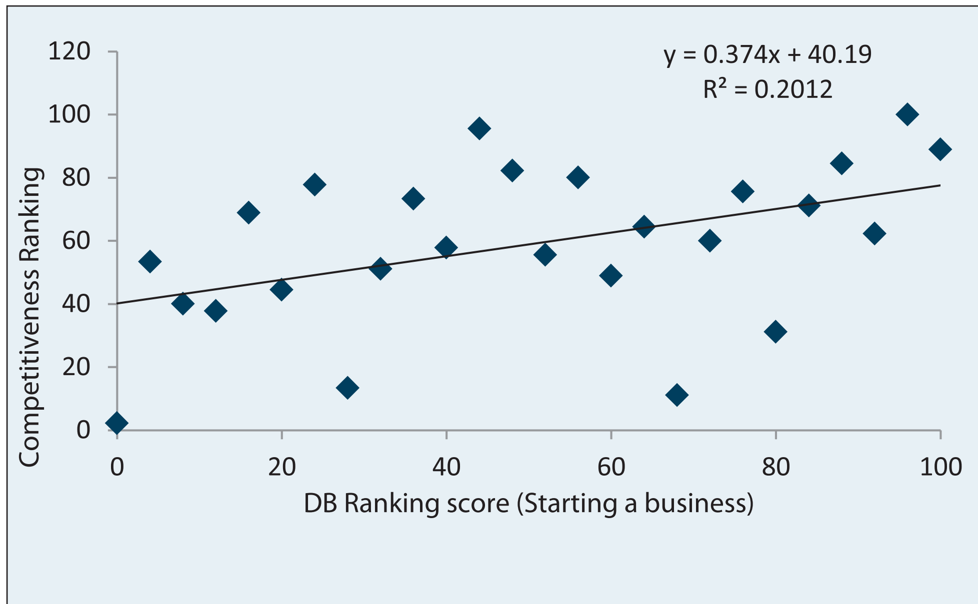
The legal and regulatory environment is critical for PSD in any country. Businesses can thrive and drive economic growth only when there is a sound legal and regulatory environment characterized by a level playing field, transparent and supportive rules and regulations, as well as strong enforcement institutions and mechanisms. Such a legal and regulatory environment reduces transaction costs and non-commercial risks and helps to create fair competition for businesses.

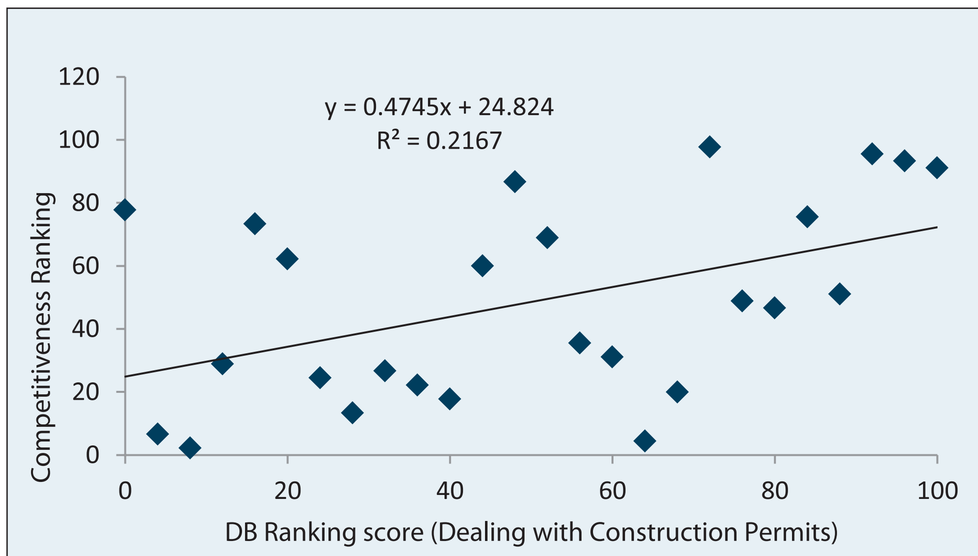
Over two-thirds of businesses in Africa rated at least one or a combination of regulatory issues as major or severe business constraints. Other indicators confirm that the legal and regulatory environment in Africa is relatively restrictive. Starting a business in most African countries is complicated and costly compared to other developing regions, as is obtaining construction permits and property registration. Corruption also weighs on doing business. If Africa's private sector is to become more competitive, the region's legal and regulatory environment needs to make starting and doing business easier.

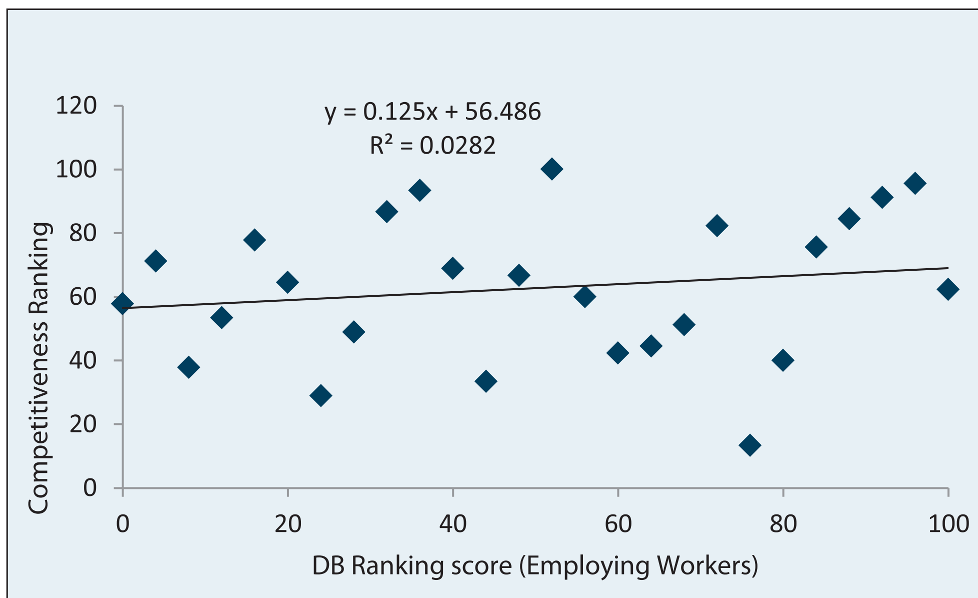
Introducing one-stop shops for entrepreneurs, making the minimum capital requirement to start a business affordable, simplifying taxes, promoting fair competition and strengthening insolvency laws would significantly help the private sector develop and thrive. In addition, perceptions that doing business in Africa is riskier than anywhere else are greatly influenced by whether regulations are believed to be unpredictable and unclear, courts unreliable and contracts hard to enforce. Reducing such non-commercial risks requires clear and transparent regulations that foster and safeguard innovation and property rights, together with the ability to detect and punish illegal business practices.

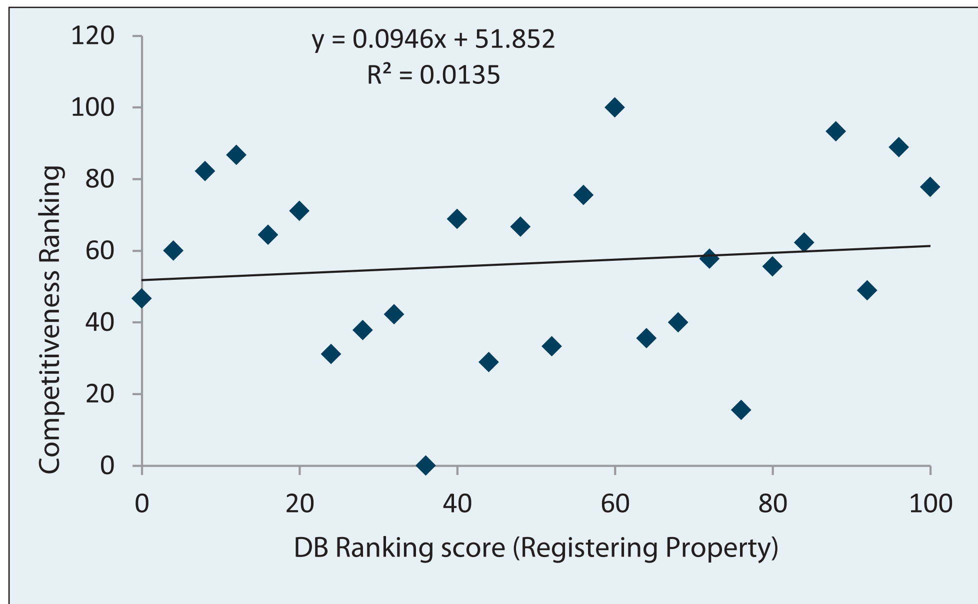
Unwavering commitment from, and cooperation amongst, policy makers, the private sector and civil society are essential for the necessary reforms to succeed. Crafting and enforcing supportive business rules, while essential for Africa's private sector to thrive is not sufficient. Developing the continent's private sector and boosting its performance also require tackling additional challenges, particularly poor infrastructure (Chapter 3) and inadequate access to finance (Chapter 4).

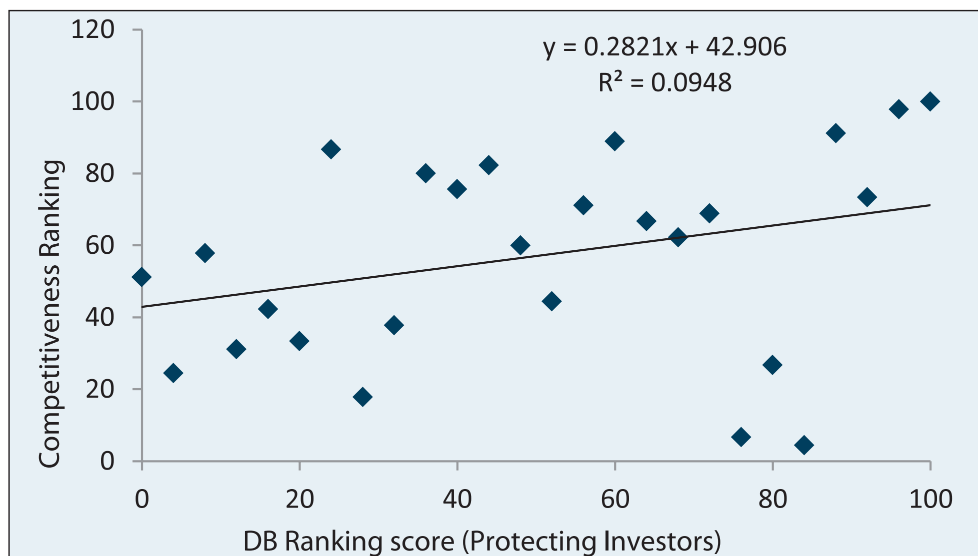
Annex 2.1: Competitiveness and Doing Business Rankings (Individual indicators)

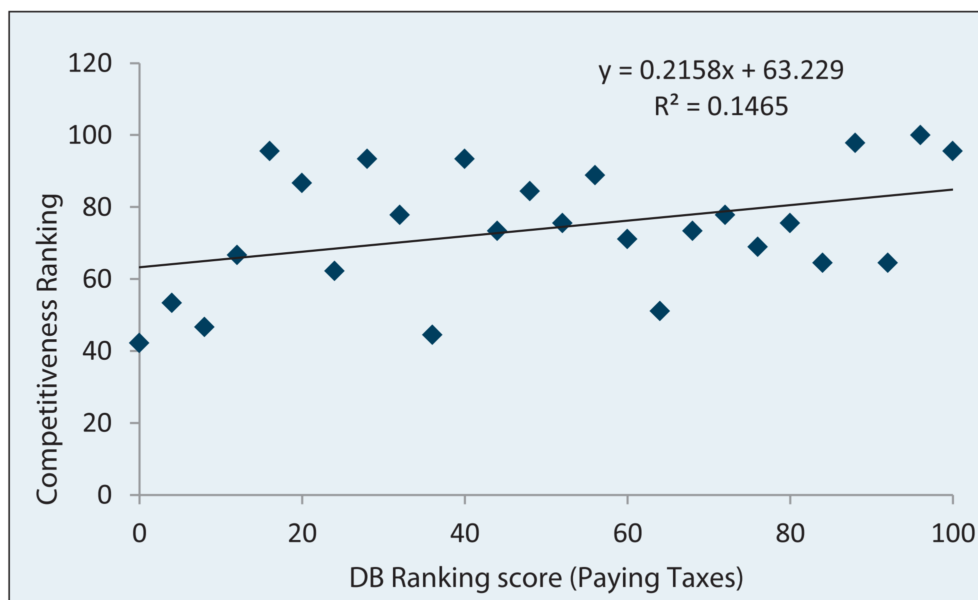


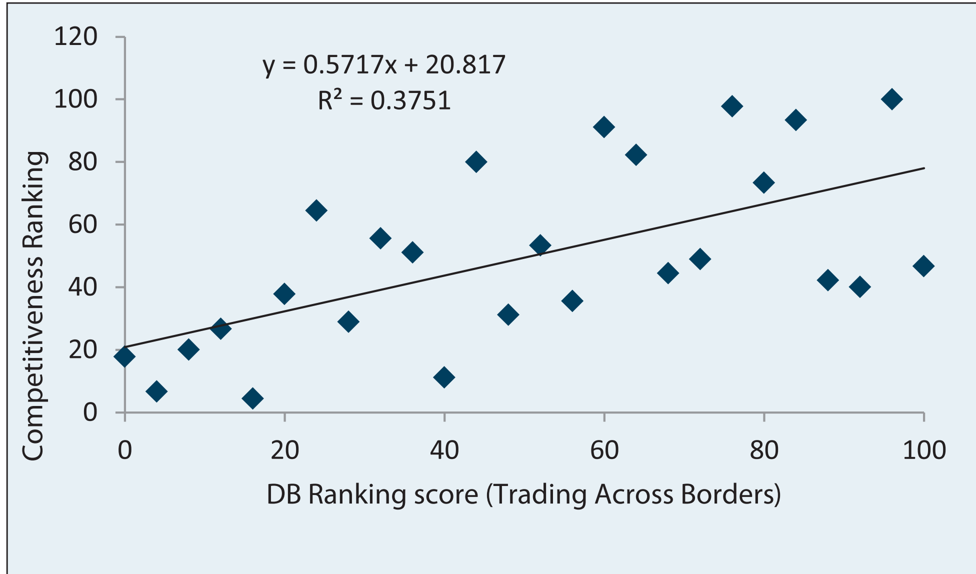




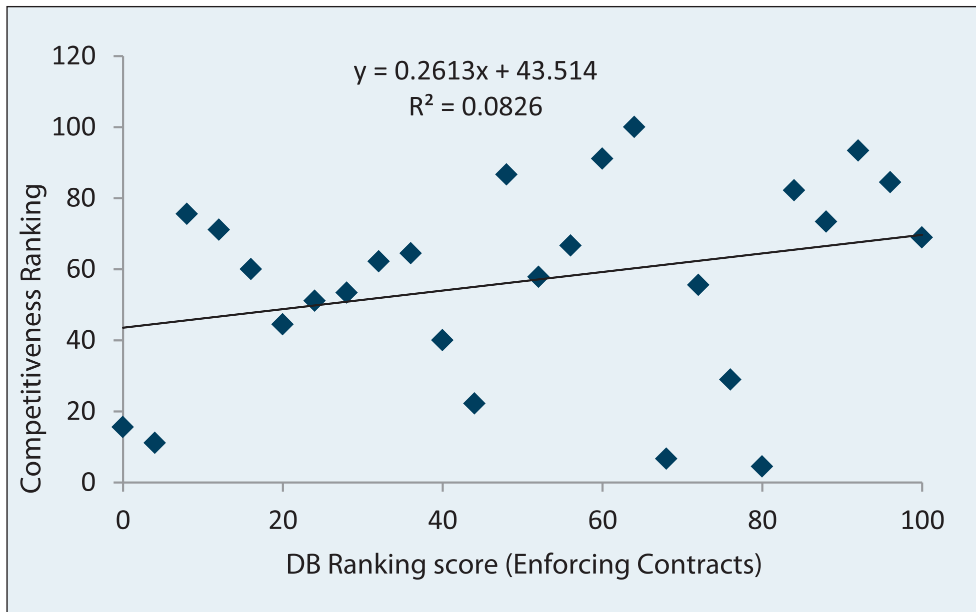

y = 0.0946x + 51.852
R² = 0.0135
Competitiveness Ranking
120
100
80
60
40
20
0
0
20
40
60
80
100
DB Ranking score (Registering Property)


y = 0.2821x + 42.906
R² = 0.0948
Competitiveness Ranking
120
100
80
60
40
20
0
0
20
40
60
80
100
DB Ranking score (Protecting Investors)

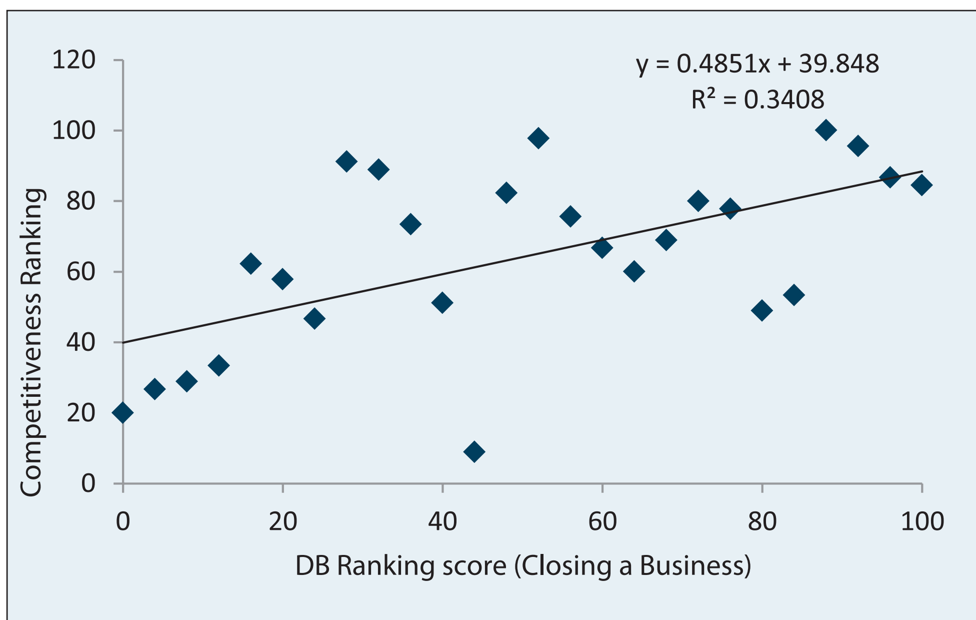

y = 0.2158x + 63.229
R² = 0.1465
Competitiveness Ranking
120
100
80
60
40
20
0
0
20
40
60
80
100
DB Ranking score (Paying Taxes)



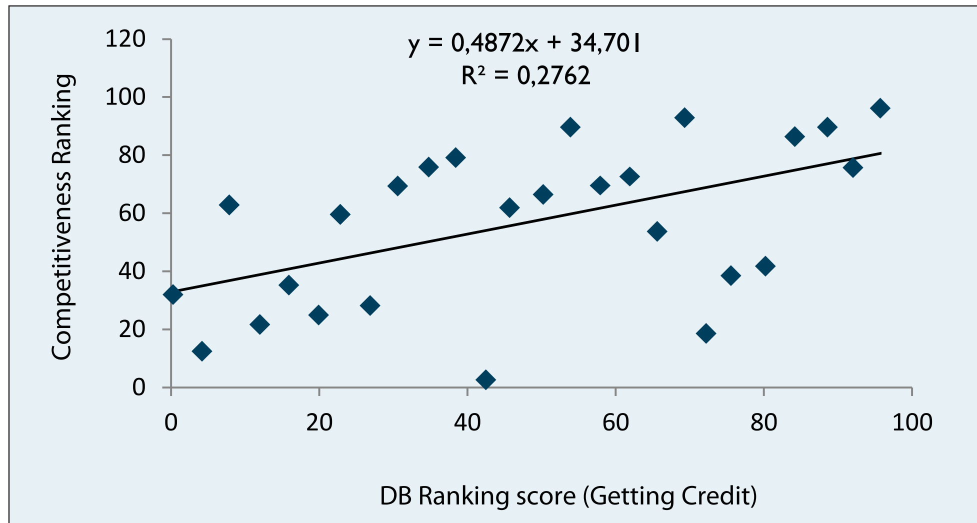
y = 0.5717x + 20.817
R² = 0.3751
Competitiveness Ranking
120
100
80
60
40
20
0
0
20
40
60
80
100
DB Ranking score (Trading Across Borders)



y = 0.2613x + 43.514
R² = 0.0826
Competitiveness Ranking
120
100
80
60
40
20
0
0
20
40
60
80
100
DB Ranking score (Enforcing Contracts)



y = 0.4851x + 39.848
R² = 0.3408
Competitiveness Ranking
120
100
80
60
40
20
0
0
20
40
60
80
100
DB Ranking score (Closing a Business)


y = 0,4872x + 34,701
R² = 0,2762
Competitiveness Ranking
120
100
80
60
40
20
0
0
20
40
60
80
100
DB Ranking score (Getting Credit)

Chapter 3 :

INFRASTRUCTURE DEVELOPMENT

While Africa's infrastructure needs are extensive, growing interest from private investors, development agencies and governments is creating renewed momentum to address this challenge. Both the volume and range of financing instruments are increasing, and sizeable gains are expected over the medium term. Yet private capital needs to be further mobilized, the capacity of public entities strengthened, procurement rules reformed, and interventions of traditional financiers fine-tuned to capitalize on areas of comparative advantage. This chapter maps Africa's infrastructure stock, explores the key challenges to infrastructure development, and highlights innovative solutions to address those challenges.

Introduction

Infrastructure contributes to economic activity by lowering the costs of doing business, improving the competitiveness of local production, and facilitating trade and foreign direct investment (FDI). Firms with reliable power supply are able to produce more. Those with access to a world-class highway network can reach their customers faster and cheaper, while those with easy port access are able to source their inputs and export their finished products at a lower cost. Construction of infrastructure has the added benefit of directly contributing to economic output. Hence, in addition to being a factor of production that influences a firm's production and location decisions, infrastructure contributes to the development of both upstream and downstream industries as well as financial markets.

This positive relationship is supported empirically. African countries with the most advanced manufacturing export industries, such as South Africa and Mauritius, have benefited from world-class infrastructure to support their industries[39]. Several studies find a positive correlation between foreign direct investment in Africa (other than investments in extractive industries) and a critical mass of favorable factors, including good quality infrastructure in particular[40]. Both volume and quality of infrastructure also appear to be positively correlated with marginal productivity of capital and with private sector investments[41]. With adequate infrastructure, African firms could achieve productivity gains of up to 40 %[42]. And bringing Africa's infrastructure stock to the level of Mauritius' could enhance Africa's GDP growth by as much as 2.2 % percent per year[43].

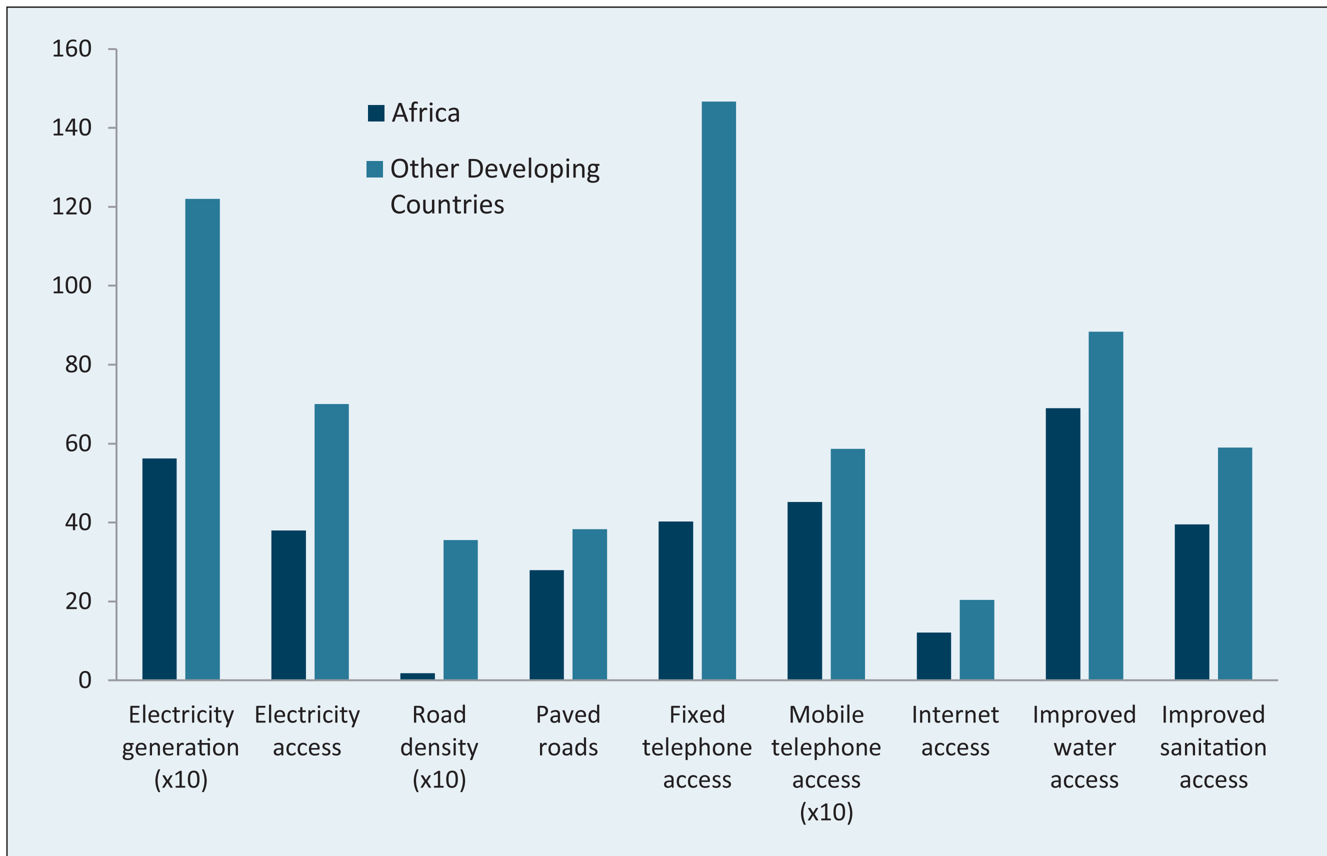
Current State of Infrastructure Access[44]

African countries suffer from a critical shortage of infrastructure. Infrastructure coverage lags behind

39 Soderbom and Teal 2001.
40 Basu and Srinivasan 2002; and Asiedu 2002.
41 Ayogu 2007.
42 Escribano and others 2008.
43 Foster and Briceño-Garmendia 2010.
44 Statistics are drawn from the Africa Infrastructure Country Diagnostic (AICD) database (2010) which covers 24 African countries, and from the African Development Bank Statistics Department (2011).

other developing countries, particularly regarding access to electricity, transport networks, water and sanitation, irrigation, and information and communication technologies (Figure 3.1). Power deficits are the continent's biggest infrastructure challenge: per capita power generation is less than half the rest of the developing world's and declining. Not only has electricity access stagnated, but supply has also become less stable, with regular outages reported in at least 30 countries by 2007. Power outages are estimated to cost Africa between 1 and 2 % of GDP.

Figure 3.1: Africa's Infrastructure Stock



Note: Electricity generation is measured in kilowatt hours per capita; road density in kilometers per 100 square kilometers of land; paved roads in percentage of total roads; electricity, improved water and improved sanitation access in population percentage; fixed telephone, mobile telephone and internet access in users per 1000 people.

Source: Foster and Briceño-Garmendia 2010; and AfDB 2011 (m).

Transportation bottlenecks are equally critical. While Africa's road kilometers per capita have been on the rise thanks to the traditionally extensive public investments into the sector, the continent's highways remain largely fragmented. In addition, road infrastructure in African low-income countries is still plagued by poor quality, as well as low connectivity to ports and international commercial centers. Paved roads account for as little as 5 % or less of total roads in some of the least developed countries and Fragile States. In these markets, poor road infrastructure forces some firms to serve only the local market[45].

Rail infrastructure is far less developed. Only 33 countries have operational rail networks, which are geared toward long-haul general freight, mineral freight, and non-urban passenger services. Most of these countries operate single track, un-electrified systems. Decades of under-

45 Ramachandran and others 2009.

capitalization, poor management and general neglect of railways on the continent has rendered some networks defunct, while the majority of operational networks experience a variety of capacity, efficiency and safety problems. When they exist, however, railways tend to be linked to ports and carry lower long-haul costs per unit of freight relative to roads.

Maritime transport in Africa suffers from limited berth and storage capacity. African ports struggle to efficiently handle vessels exceeding 2,000 twenty-foot equivalent units (TEUs), compared to East Asian ports, which have enough capacity to handle vessels of up to 11,000 TEUs. In 2007, African vessels accounted for less than 0.6 % of the world's merchant fleet. In the same year, Port Said (Egypt) and the Port of Durban (South Africa) were the only African ports ranked in the top 50 for container traffic, and the continent's containerized cargo throughput was half the volumes handled by large ports in China and Singapore. Moreover, Africa's ports are running out of capacity. While port throughput has grown by about 10 % annually since 2007, reflecting growing interest from emerging market economies in Africa's natural resources, capacity expansions have not grown as fast.

Air transport services also remain largely inefficient and expensive. Most African airlines' fleets are aging, airports struggle to meet international security standards, and air travel within the continent is among the most expensive in the world. The air transport industry, however, is making significant strides. The sector has grown by 5.8 % per year between 2001 and 2007. Three major hubs have emerged in Sub-Saharan Africa—Johannesburg, Nairobi, and Addis Ababa—dominating both international and domestic markets. New budget airlines are also gaining ground in deregulated markets such as Nigeria, Kenya, the DRC and South Africa, improving service and reducing prices[46].

Access to clean water has improved over the past two decades. While only 49 % of sub-Saharan Africans had access to clean water in 1990, the rate had improved to 67 % by 2009. Africa still lags behind other developing regions, however. Access to improved water sources is significantly higher in Latin America and the Caribbean (91 %) and in South Asia (87 %) than in Africa (69 %). In addition, 60 % of the population has no access to improved sanitation, and only 5 % of agriculture is under irrigation.

Access to Information and Communications Technology (ICTs), on the other hand, has not only dramatically improved in the past decade, but also exceeds levels observed in some other developing regions. The proportion of Africans with access to mobile telephones has risen from about 1 % in 2000, to over 40 % by 2009, well above the access rates for South Asia (33 %). Access to internet services is higher in Africa (12 %) than in South Asia (6 %) but lower than in Latin America (32 %) and East Asia (24 %).

These measures mask significant regional and cross-country differences. AfDB's *Africa Infrastructure Index*, which ranks countries on the basis of electricity generation per capita, share of population with access to mobile or fixed phone line, percentage of roads paved and share of population with access to improved water and sanitation, illustrates this diversity (Table 3.1).

There is wide variability in performance across eighteen access, quality, and cost dimensions (Annex 3.1). The infrastructure deficit in low-income countries is worse than in middle-income ones, and fragility further weighs on most dimensions. Differences are particularly marked with regard to power generation, the density of paved roads and access to landline and mobile telephones as well as the internet, but less so for access to improved water and sanitation (Figure 3.2). Low-income countries perform better than middle-income ones on two cost dimensions: charges for general cargo handling and for fixed telephone. This is due to high business telephone prices in South Africa, Morocco and Botswana and to the high cargo handling charges in South African ports.

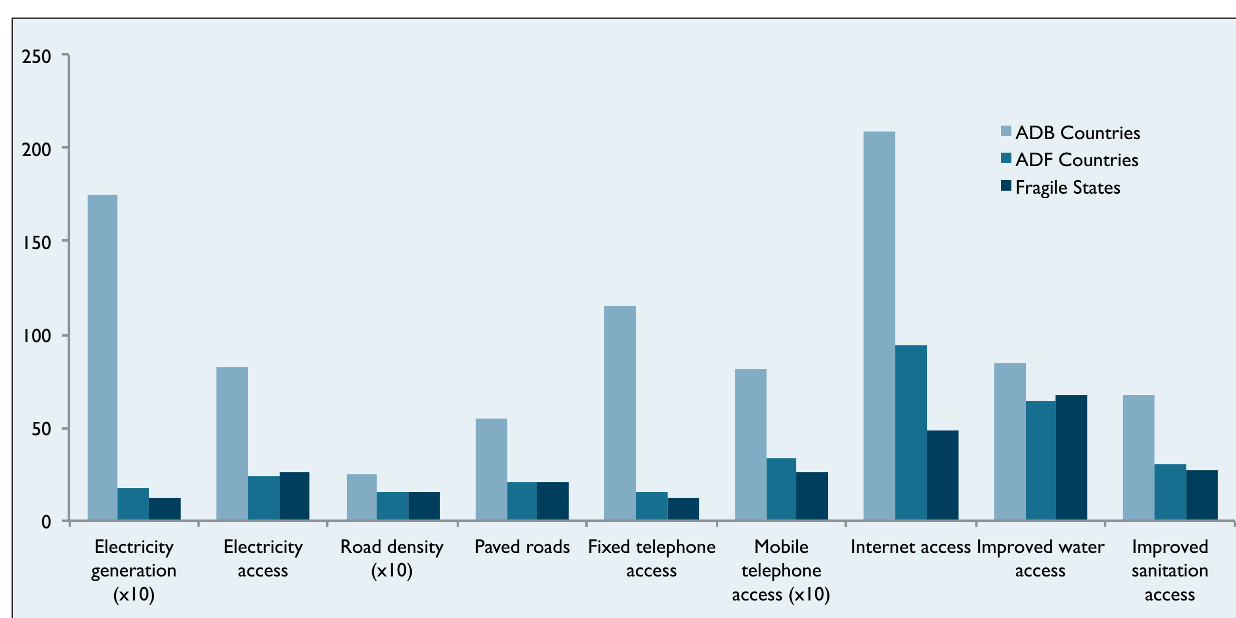
46 The Economist, 2011

Table 3.1: Africa Infrastructure Development Index

Rank	Country	Index	Rank	Country	Index	Rank	Country	Index	Rank	Country	Index
1	Seychelles	100	14	Comoros	43	27	Ghana	28	40	Burkina Faso	18
2	Mauritius	90	15	Swaziland	39	28	Cote d'Ivoire	27	41	Togo	17
3	South Africa	81	16	Namibia	38	29	Uganda	26	42	Mozambique	14
4	Libya	80	17	Djibouti	37	30	Rwanda	25	43	Liberia	13
5	Egypt	80	18	Senegal	34	31	Burundi	24	44	Tanzania	12
6	Tunisia	77	19	Malawi	31	32	Angola	24	45	RCA	12
7	Algeria	71	20	Zimbabwe	30	33	Sudan	21	46	Eritrea	11
8	Morocco	59	21	Guinea	29	34	Benin	21	47	Madagascar	7
9	Cape Verde	58	22	Mauritania	29,4	35	Guinea-Bissau	21	48	Niger	6
10	Botswana	57	23	Zambia	28,6	36	Kenya	20	49	Chad	5
11	Gambia, The	49	24	Congo, Rep.	28,6	37	Nigeria	20	50	Sierra Leone	5
12	Gabon	45	25	Lesotho	28,5	38	Équatorial Guinea	19	51	Congo, Dem. Rep.	5
13	Sao Tome and Principe	43	26	Cameroon	28,0	39	Mali	18	52	Ethiopia	4
									53	Somalia	-

Source: AfDB 2011 (c).

Figure 3.2: Access to Infrastructure by Income Level and Fragility



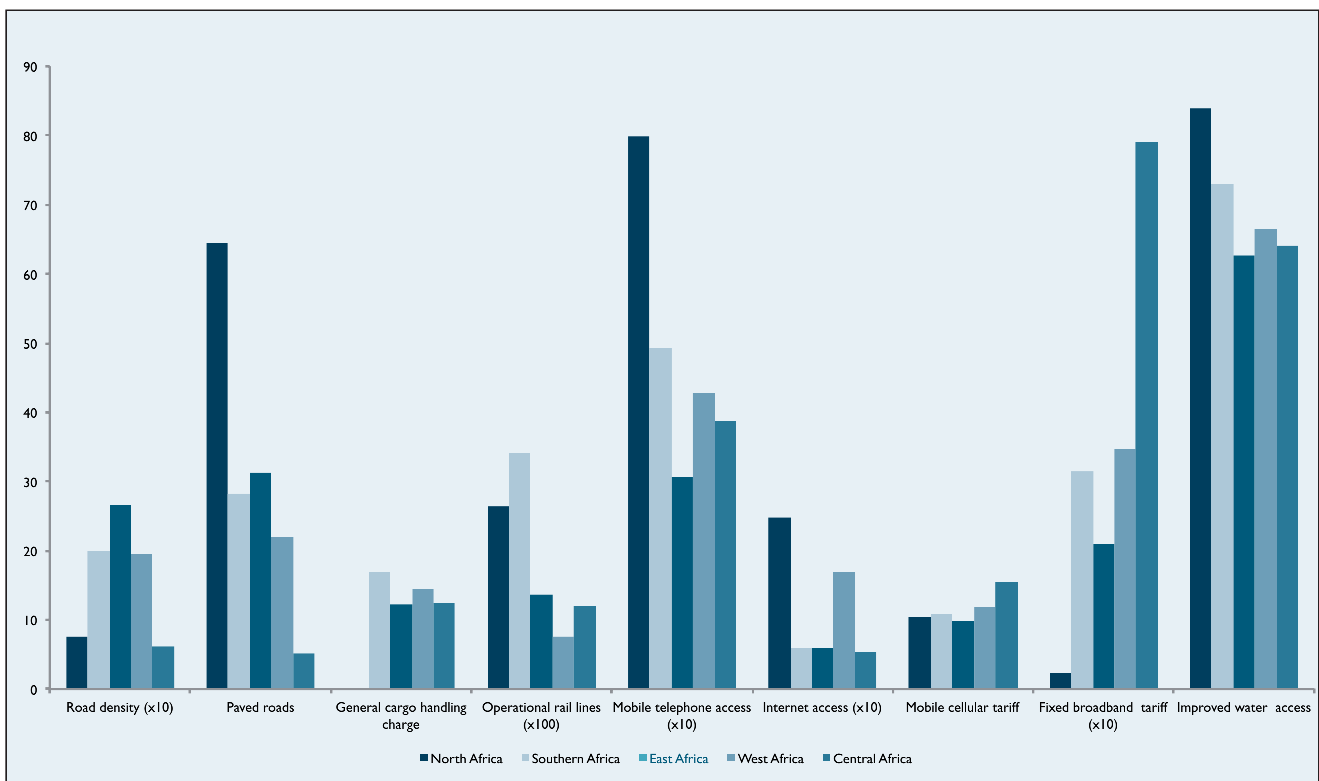
Note: Electricity generation is measured in kilowatt hours per capita; road density in kilometers per 100 square kilometers of land; paved roads in percentage of total roads; electricity, improved water and improved sanitation access in population percentage; fixed telephone, mobile telephone and internet access in users per 1000 people.

Source: Foster and Briceño-Garmendia 2010; and AfDB 2011 (m).

The divide between rural and urban areas is generally even more pronounced. Access to improved water, for example, is almost twice as high in cities compared to rural areas[47]. Only one in 10 Africans living in rural areas has access to grid electricity, compared to well over 50 % of the urban population. Mobile phones, on the other hand, are shattering the isolation of rural areas, with one out of every two rural Africans now in range of a mobile signal. However, the cost of ICT services, including mobile telephony, remains high in Africa relative to other developing regions (Annex 3.1).

Overall access to infrastructure across African sub-regions is less variable, although some patterns are noteworthy (Figure 3.3). North African countries lead in overall performance, but are out-ranked by Southern African countries on density and quality of rail infrastructure. This is principally due to South Africa's extensive rail system, which accounts for 32 % of the continent's total rail infrastructure. South Africa is also the only country with a dual track for part of its network and an operating inner-city fast train passenger service. North Africa's rail network, on the other hand, is largely electrified, while only part of Southern Africa's network—including in South Africa, DRC, and Zimbabwe—is so.

Figure 3.3: Access to Infrastructure by Region



Note: Road density is measured in kilometers per 100 square kilometers of land; paved roads in percentage of total roads; general cargo handling charges in US dollars per ton; rail lines in kilometers; improved water and sanitation access in population percentage; mobile telephone and internet access in users per 1000 people; mobile cellular and fixed broadband tariffs in US dollars per month.

Source: Foster and Briceño-Garmendia 2010; and AfDB 2011 (m).

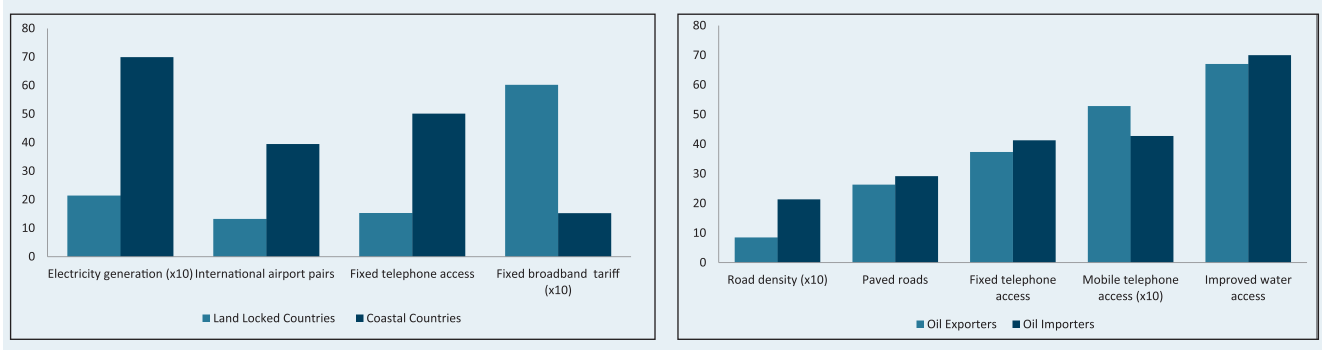
Southern Africa outperforms the rest of sub-Saharan Africa except when it comes to the quality of roads, and mobile phone and internet user fees, as well as general cargo handling fees, which are the highest on the continent. The latter is explained by South Africa's relatively high cargo handling

47 United Nations 2011.

fees, which are based on cost recovery[48]. Central Africa, on the other hand, trails other regions on most measures.

Performance in landlocked countries is below Africa's average on all measures. Coastal countries outperform landlocked countries by a factor of three or more on measures such as electricity generation, fixed telephone line access, and airport connectivity. Broadband tariffs in landlocked countries are four times those in coastal countries on average (Figure 3.4a). Infrastructure stock in oil importing countries, while mostly worse than in oil exporting ones, is on par with the continent's average on measures such as access to clean water, quality of road infrastructure, and access to fixed and mobile telephony (Figure 3.4b).

Figure 3.4: Access to Infrastructure by Location and Oil Resources



Note: Electricity generation is measured in kilowatt hours per capita; road density in kilometers per 100 square kilometers of land; paved roads in percentage of total roads; fixed telephone mobile telephone and internet access in users per 1000 people; business telephone, mobile cellular and fixed broadband tariffs in US dollars per month; water outages in hours.

Source: Foster and Briceño-Garmendia 2010; and AfDB 2011 (m).

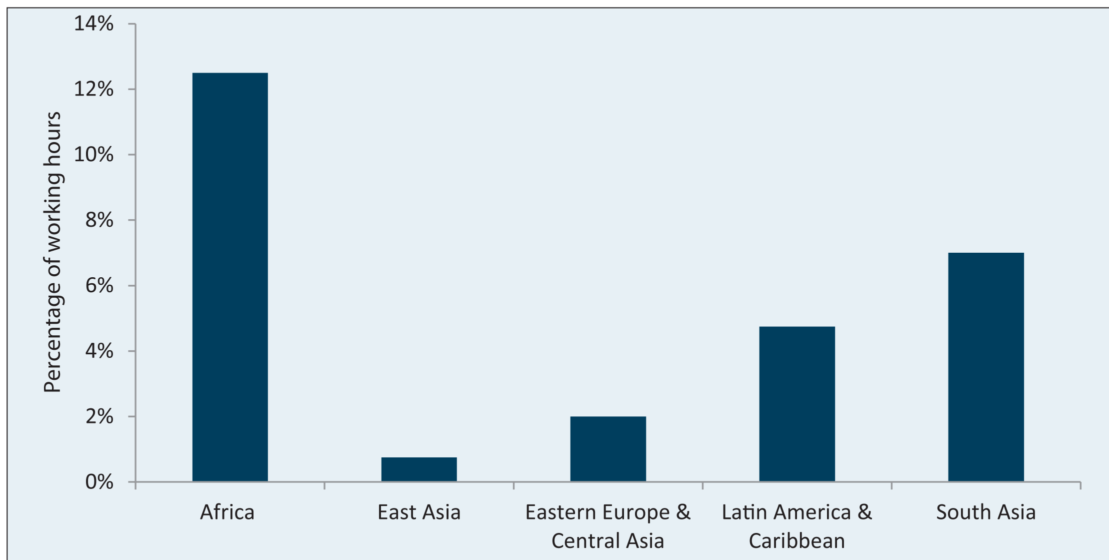
Constraints to Infrastructure Development

The infrastructure deficit holds Africa back from achieving its economic potential. Power shortages, for example, cost the region 12.5 % in lost production time, compared to 7 % in South Asia (Figure 3.5). The shortage and poor quality of infrastructure, added to the lack of competition in service delivery, have also resulted in exorbitant connection and user costs when compared to other developing countries. Infrastructure services in Africa cost twice as much on average as in other developing regions and are exceptionally high by global standards (Annex 3.1). In the transport sector, for example, East Asia, South Asia and Latin America enjoy a significant comparative advantage, with East Asian firms saving close to 70 % in transportation costs, while Latin America and South Asian firms save approximately 50 % relative to their African counterparts (Figure 3.6). These costs weigh heavily on Africa's competitiveness.

African countries face several constraints regarding infrastructure development and maintenance, including geographical constraints, deficiencies in planning, inadequate financing for project preparation and implementation, poor management of existing infrastructure assets, institutional inefficiencies and regulatory bottlenecks, as well as demand side constraints.

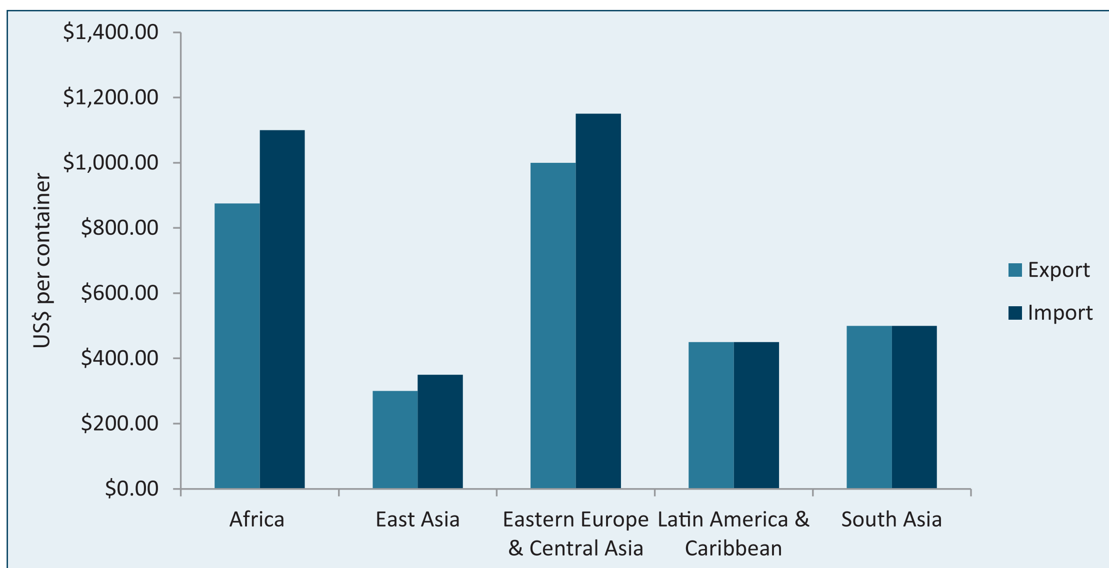
48 South African ports are operated by state-owned Transnet, which operates on a cost-recovery basis (Foster and Briceño-Garmendia, 2010).

Figure 3.5: Productivity Loss from Power Outages



Source: Iarossi 2009.

Figure 3.6: Inland Transport Costs



Source: Iarossi 2009.

Geographic and Demographic Constraints

Islands and landlocked countries suffer from geography, as do small economies and resource-poor countries. Fifteen countries in Africa are landlocked and depend on regional infrastructure networks for international trade. A quarter of the countries on the continent have a population of 2 million or less, which limits opportunities to capitalize on economies of scale. About half lack conventional energy resources and rely on imports to meet their power needs. The continent's water resources are also mostly shared, so damming must be negotiated or financed regionally. In addition, a large proportion of the population lives in rural, geographically dispersed settlements. These factors help explain the comparatively higher costs of providing infrastructure services in some

countries, particularly when investments are at the national level.

The cost of broadband internet in landlocked countries reflects their significant disadvantage compared to coastal economies in accessing existing broadband infrastructure (Figure 3.7). Similarly, the isolation and fragmentation of the continent's five island states translates in higher costs of electricity and broadband internet services (Box 3.1). Electricity generation in African economies with small national power systems can be up to twice as costly as in countries running larger national systems[49].

Figure 3.7: Africa's Optical Fibre Links or Satellite Coverage

Source: AfDB 2009 (k).

49 Foster and Briceño-Garmendia 2010.

Box 3.1: Cost and Market Size—Cape Verde Power and Seychelles Submarine Cable

Cape Verde's geography presents challenges for electricity generation, transmission, and distribution. The country consists of ten islands and is both isolated and a small energy market. The construction of the 25.5 MW Cabeolica wind power project, for example, required sites on four islands (Santiago, São Vicente, Sal, and Boa Vista) to be identified. Construction on each island entailed the installation of towers with wind turbines, transformers, a substation, a command center, access roads, and underground transmission lines to connect to the electricity grid on each island. Such requirements make electrification of the country technically complex and very expensive.

Seychelles' isolation explains its dependence on costly satellite technology. The ongoing Seychelles East African System (SEAS) project will connect global internet exchange centers through a high bandwidth link. SEAS includes construction and roll-out of an optical submarine cable system to link Seychelles (Victoria, on Mahé Island) to Tanzania (Dar-el-Salam). Although the use of submarine cables is the most viable solution, the complexity of the project is compounded by the distance between mainland Africa and Seychelles. The submarine cable will cover about 1,917 km on the sea bed and about 9 km on land. The total cost of the project is US$39 million. The expected cost per user for this project, which will generate large overcapacity, is over US$850, compared to US$44 per user for the Main One submarine cable. The latter stretches from Portugal to South Africa along the west coast of Africa, and will serve 10 mainland African countries when fully operational.

Source: Mutambatsere and Mukasa 2011; and AfDB 2010 (b) and (g).

Deficient Planning, Preparation and Procurement

Africa's infrastructure suffers from vague sector policies and project selection based on social targets or ad hoc political priorities, rather than on spatial distribution of economic activity and growth prospects. Sector plans often lack adequate detail on pipeline projects, their sequencing, sources of financing and strategies to mobilize funds. As a result, construction of new assets often begins too late to come on stream when needed, and maintenance backlogs are common[50]. In addition, plans across ministries often lack coherence, leading to poor integration of infrastructure. This is particularly problematic in the transport sector, where well-functioning trans-shipment infrastructure is often necessary to ensure optimal benefits from new sub-sector level investments.

Technical, capacity and financing constraints explain the limited number of bankable infrastructure projects in African markets. There is a shortage of financing and skills at the project preparation, procurement, and monitoring levels. For example, although governments in well-functioning markets absorb the costs and risks associated with preparation of infrastructure projects, most African governments and public utilities face financing and capacity constraints in assuming this role. In addition, procurement rules are often not conducive for innovation, especially with regard to financing project preparation. Addressing lapses in the role of government is imperative to catalyzing private capital towards infrastructure.

Inadequate Financing

Addressing the deficiencies in sub-Saharan Africa's infrastructure will require investments of

50 Briceño-Garmendia and others 2008.

about US$ 93 billion per year[51]. In most countries, infrastructure investment needs far exceed available public resources. Fragile States would require the equivalent of 37 % of their GDP per year, stable low-income countries 23 % of their GDP, and sub-Saharan middle-income countries the equivalent of 10 % of their GDP. While spending on Africa's infrastructure had reached US$ 45 billion a year in 2008, the financing burden still falls disproportionately on government budgets, which shoulder 66 % of the expenditures, while the private sector covers 20 % and traditional development partners and emerging markets (i.e., fast-growing economies outside of the OECD) another 14 %.

Doubling existing investment levels will be a significant challenge. Domestic resources are constrained by low savings rates in most African countries, especially oil importers, a narrow tax base, ineffective budget administration, and under-developed capital markets. Traditional official development assistance remains low relative to the continent's extensive needs, is pro-cyclical, and tends to fluctuate in response to changes in donor's development aid agendas. Infrastructure financing from emerging markets is growing, but remains largely unpredictable. Private investments in infrastructure, on the other hand, are hampered by regulation and a dearth of bankable projects on the continent. Meeting Africa's infrastructure financing needs will require innovation to address these barriers.

Poor Management of Existing Infrastructure Assets

An estimated 30 % of Africa's infrastructure assets required rehabilitation in 2010[52]. This reflects the historical legacy of underfunding maintenance, which has largely been funded from government budgetary revenue. User tariffs are supposed to cover operation and maintenance in sectors such as electricity and water, while in non-income generating sectors such as roads, these expenditures are financed through the budget. Under-pricing and inefficiencies in bill collection leave most infrastructure utilities cash-strapped and unable to meet their maintenance obligations. Governments also often renege on maintenance in the face of competing demands on fiscal resources. Multilateral Development Banks (MDBs) unfortunately shy away from financing maintenance, a result of changes in their infrastructure financing over the past two decades. Similarly, private sector financing for maintenance is still confined to a sub-set of public-private partnership (PPP) agreements that allocate maintenance obligations to the private partner. In light of the significant financial resources required to cover maintenance expenditures—a third of the aforementioned infrastructure investment needs—innovative ways of financing maintenance are necessary.

Institutional Inefficiencies and Regulatory Bottlenecks

Among other factors, budget and utility inefficiencies and restrictive sector regulation have held back Africa's infrastructure development. Opportunities to improve efficiency in delivering available infrastructure financing exist, however. On average, only two-thirds of the budget allocated to public investment in Africa is utilized[53]. Africa's infrastructure assets also face high technical and non-technical losses in the form of distribution losses, under pricing, low bill collection rates, etc. It is estimated that up to US$ 17 billion a year could be recovered simply by improving efficiency[54].

51 This figure pertains to an investment and maintenance program to develop the following infrastructure in sub Saharan Africa: (1) 7,000 megawatts a year of new power generation capacity (about half through multipurpose dams); (2) Cross-border transmission lines with a capacity of 22,000 megawatts; (3) Fiber optic cable to complete the intraregional fiber-optic backbone network and continental submarine cable loop; (4) Good quality road network to interconnect capitals, ports, border crossings, and secondary cities; (5) All-season road to access high-value agricultural land; (6) Irrigation infrastructure to more than double Africa's irrigated area; (7) Infrastructure to meet the MDGs for water and sanitation; (8) Electricity network to raise household electrification rates by 10 percentage points; and (9) Network to provide global systems mobile voice signal and public access broadband to 100 percent of the population (Foster and Briceño-Garmendia, 2010).

52 Foster and Briceño-Garmendia 2010.

53 Briceño-Garmendia and others 2008.

54 Foster and Briceño-Garmendia 2010.

In addition, regulation governing infrastructure sectors restricts the range of financing and/or asset management options. This arises from the public-good nature of most infrastructure services and the fact that most infrastructure industries operate as natural monopolies. The result is poor governance of state-owned enterprises leading to operational inefficiencies, as well as poor regulation of monopolies sometimes resulting in profiteering, especially in transport and the ICT sectors. An uncompetitive pricing model used in the trucking industry, for example, has traditionally contributed to high shipping costs in West Africa. Likewise, a lack of competition on many African routes has led to inflated prices in the air transport sector. Strict regulation has also constrained port development on the continent. At the same time, regulatory reforms have at times produced disappointing results, as evidenced by the poor record of concessions in the water and rail sector.

Finally, the development of cross-border transport corridors without concurrent elimination of non-tariff trade barriers has resulted in a suboptimal utilization of transport infrastructure. Such barriers are often regulatory in nature, such as onerous sanitary and phyto-sanitary compliance requirement. They could also be institutional, such as inefficiencies in trade tax administration. These institutional and regulatory constraints result in sub-optimal use of existing resources and infrastructure assets.

Demand Side Constraints

Over 60 % of Africans live on less than US$2 a day (Chapter 2). The majority of consumers therefore have little capacity to pay cost-recovery tariffs for infrastructure services, and the uptake of new, lower-cost alternative technologies has been lower than expected. Many African countries face higher-than-usual costs of supplying infrastructure services to their citizens. Cost recovery tariffs on infrastructure services in those high-cost low-income countries are about US$ 8 per household[55] per month, which is simply not affordable for the majority of the currently un-served population. Cost recovery tariffs, however, appear to be affordable for most subsistence consumers in Africa's middle-income countries, and for the more affluent consumers in low-income countries. The challenge is to optimize pricing policies by ensuring cost-recovery from more affluent consumers and improving revenue collection from all consumers, including those who benefit from subsidized rates. Under-pricing infrastructure services currently costs the continent US$ 4.7 billion annually[56].

Developing and Financing Infrastructure

Developing Africa's economic infrastructure at the pace necessary to realize its economic potential will require, among other things: (1) improving capacity in line ministries and relevant sector units to prepare sector plans and execute project preparation, procurement and monitoring activities; (2) strengthening institutions to improve efficiency in service delivery; (3) innovation to mobilize sufficient financial resources for capital investments and maintenance; (4) adoption of a regional approach to infrastructure development; and (5) promoting inclusive access to infrastructure services.

Improving Capacities

Experience shows that successful delivery of projects requires strong and capable country counterparts who can promote and drive projects. Line ministries in infrastructure sectors, utilities, and PPP units—where they exist—have the responsibility to develop detailed sector plans, lead and finance project preparation, carry out procurement, and monitor project implementation. Where private managers are involved, public partners also perform important regulatory roles. These tasks require diverse and sometimes

55 Based on a typical modest household consumption of 50 kilowatt-hours of electricity and a high-cost country tariff of $0.16 per kilowatt-hour OR a typical modest household consumption of 10 cubic meters of improved water and a full cost recovery tariff of $0.80 per cubic meter.

56 Foster and Briceño-Garmendia 2010.

specialized expertise. Weak public sector capacity to identify, design, and supervise infrastructure investments, however, remains a significant binding constraint to infrastructure development in low-income countries. Contractual terms of project preparation are sometimes inappropriate or change midcourse, resulting in poor estimation of technical specifications, costs and budgets. Procurement and contracting processes are also impaired by inadequate investment and financial planning, and low coordination capacity.

Enhancing infrastructure planning in Africa will involve, among other things, developing policy, legal and institutional frameworks, and strengthening capacities. Egypt's power sector offers a recent example of good practice in planning (Box 3.2). Planning authority was vested in one agency to ensure coherence in the planning process. Countries with effective PPP units, such as Senegal, Kenya, South Africa and Uganda, have used these entities to enhance cross-sector planning (Box 3.2). Setting up sub-regional planning units could be envisaged, especially where the skills pool is particularly shallow at the national level.

Box 3.2: Centralizing planning: Egypt's Electricity Sector and Public and Private Infrastructure Investments in Senegal

Two examples of successful centralized infrastructure planning are in Egypt and Senegal.

Egypt's Ministry of Electricity and Energy and the state-owned Egyptian Electric Holding Company (EEHC) are driving power sector policy reforms and the power generation expansion plans. To address the recent surge in peak demand, Egypt embarked on an aggressive capacity expansion program financed through soft loans to EEHC. The plan is expected to increase production capacity by almost 8 GW over 2007–2014—a 36 % increase.

Egypt also has a longer term plan that guides investments. Going forward, the 2012-2022 power sector expansion plan is to almost double Egypt's electricity generation output by 2020. The plans detail location, type and size of power plants and associated infrastructure required to meet demand projections, and include detailed financing plans. The US$ 30 billion worth of investments will be financed through long-term concessional debt to EEHC's and through private financing. Ongoing sector reforms are expected to increase private participation to the point where up to 50 % of electricity will be produced by independent power producers by 2020.

With a similar long term vision, starting in the 1990s, the government of Senegal sought private sector participation in the design, financing and construction of infrastructure projects. To support this strategic shift to public private partnerships (PPP), Senegal began several institutional and structural reforms.

In addition to legislative reforms, multi-sectoral entities were created to support infrastructure procurement through PPPs. These include (i) the Agence Nationale chargée de la Promotion de l'Investissement des Grands Travaux (APIX), under the Presidency, in charge of promoting investment and major works; (ii) La Direction de l'Appui au Secteur Privé (DASP), under the Ministry of Economy and Finance, which mobilizes private sector participation; and (iii) the Infrastructure Council, an independent body that manages PPP project implementation.

The reforms seem to be successful. Between 2009 and 2011, Senegal concluded financing plans for four PPP projects in energy and transport valued at EUR 1.1 billion: the Dakar Container Terminal, the Dakar Toll Highway, the Senegal Coal Power Plant; and the Blaise Diagne International Airport.

Source: AfDB 2010 (i) and Shendy and others 2011.

Efforts to enhance the capacity of sovereign and sub-sovereign entities to perform project preparation, procurement, and monitoring activities are currently dominated by development partners and international finance institutions through technical assistance packages and policy-based concessional lending for public institution reforms and capacity building (Box 3.3).

Box 3.3: Capacity Building for Infrastructure PPPs in Nigeria

In Nigeria, efforts to attract private finance into the power and transport sectors through more extensive use of PPPs have been derailed by limited public service capacity to appraise and implement these projects. Challenges include low capacity to complete project preparation and bankability studies, unfamiliarity of staff with relevant legislation, and lack of experience to ensure quality at entry and concession contract monitoring, among other things.

In 2010, with financing from the AfDB, the Infrastructure Concession Regulatory Commission of Nigeria launched a US$31 million capacity building program. The program will (i) familiarize stakeholders in public service, civil society and the private sector on PPP processes; (ii) provide specialized training to key public sector personnel; (iii) prepare project feasibility studies; and (iv) provide hands-on technical support in procurement processes and project management. The program also facilitates setting up mechanisms for competitive procurement processes and establishing rules for handling unsolicited proposals. If successful, Nigeria's capacity development program will facilitate the processing of key projects in power and transport, including seven major highways and bridges, commuter rail lines in Lagos and Abuja, and the 32 independent power projects already licensed by the electricity sector regulator.

Source: Brixiova and others 2011.

Current approaches to capacity building, however, tend to deliver short-term solutions not extensive enough to ensure that the required skills are developed and retained. There are too many technical assistance facilities and they to provide ad hoc services which limit their effectiveness. Ongoing initiatives must therefore be enhanced with more extensive advisory services from non-profit organizations to complement existing capacity.

Advisory services such as those provided by the International Finance Corporation (IFC) through the Infrastructure Development Collaboration Partnership Fund (DevCo) offer crucial support to governments and private firms in structuring complex infrastructure projects. MDBs could also expand advisory instruments such as the AfDB's African Legal Support Facility. This Facility seeks to improve the legal environment and contractual terms for the private sector involved in infrastructure development, by building countries' capacity to negotiate complex commercial contracts. Private participation in project preparation activities through reform of procurement rules is another option (see Section C below).

Strengthening Institutions

Strengthening institutions is more than a good idea: it has huge cost savings potential. Addressing institutional inefficiency including misallocation of public funds, under-utilization of budget allocations, and high technical and non-technical losses in delivering infrastructure services could result in additional financial resources equivalent to almost 20 % of the continent's annual financing requirements for infrastructure.

Budgetary processes in most Africa countries, including middle-income countries, require reforms to reduce leakages. Better planning and expenditure monitoring is needed to align budgetary allocations to sector priorities. Streamlining public procurement and disbursement processes would improve budget utilization. Better

timing of upstream project activities, which often is a bottleneck to project disbursements, would also help. Moving from annual to medium-term budgeting for infrastructure investments would also prevent mid-course delays in project execution. In some sectors, planning should be moved from line ministry to sector level. For example, ensuring the integration of the different modes of transport and concurrent investments in transshipment infrastructure requires a sector level approach.

Even larger efficiency gains can be expected from eliminating technical and non-technical losses in infrastructure service delivery. Most technical losses, such as those in power distribution, can be addressed through rehabilitation of old assets and effective maintenance. Lessons from middle-income countries, where performance in asset maintenance tends to be stronger, could be used. For example, Transnet Freight Rail—South Africa's rail utility—is pursuing an expansion program with a maintenance strategy that seeks to increase the transfer of technology and knowhow to local engineers to reduce maintenance costs (Box 3.4). Some low-income countries are slowly catching-up: in Kenya, for example, a fuel levy is being used to capitalize the road maintenance fund. For assets under private management, performance-based contracts have improved maintenance effectively (for instance, the maintenance of South Africa's toll highways concession)

Box 3.4: Transnet's Maintenance Program: Transferring Know-How

Under the Department of Public Enterprise's Competitive Supplier Development Program (CSDP), Transnet aims to localize a reasonable part of the value chain of manufactured goods or services, and promote South Africa as an off-shore site of choice for original equipment manufacturers and multi-nationals' procurement personnel.

The program ensures key suppliers who handle all maintenance of acquired assets transfer their knowledge to Transnet engineers. Transnet then is leveraging its spending to negotiate capacity building for local suppliers to meet its future manufactured equipment requirements. Specifically, Transnet tenders awarded to overseas suppliers include requirements to source basic components or acquire assembly services from South African firms. So far, two CSDP transactions valued at about US$ 500 million have been secured. One involves transfer of skills and relevant intellectual property to Transnet to produce and market Electro-Motive Diesel spare parts on the African continent. The other involves a technology partnership between Transnet and General Electric for locomotive overhauls and modernizations. Both initiatives have potential demonstration effects for other rail companies on the continent.

Source: Mutambatsere and Mukasa 2011; and AfDB 2010 (h).

The commercialization and private management of state-owned utilities has reduced non-technical losses, such as overstaffing, low bill collection rates or illicit connections. Commercialization includes corporate governance reforms such as providing state-owned utilities management autonomy under performance-based contracts. However, private management requires effective regulation. Progress has been slow in addressing under pricing and best practice cases such as Ghana, with its targeted life-line tariff for electricity users, are few. Besides better subsidy targeting, moving from contractual service delivery to pre-paid systems would also improve revenue collection.

In the transport sector, improving trade tax administration and efficiency of border posts would enhance the economic value of existing infrastructure. Projects to modernize and streamline border processes, such as the recently established one-stop Zambia-Zimbabwe border post at Chirundu are ongoing across the continent. Other options include establishing regional clearinghouses to facilitate cross-border accounting. Examples include the Common Market for Eastern and Southern Africa Clearing House.

Innovative Financing Instruments

Africa's infrastructure has been predominantly financed from public resources. The public sector has been most prominent in water, sanitation and transport, where it contributed above 50 % of capital investments in 2001-2006. Private investment, on the other hand, accounted for over 75 % of capital investments in Information and Communications Technology (ICT) over the same period[57].

More recently, infrastructure financing in Africa has been changing and a new mix of sources — including increasingly private and innovative ones— is emerging. There is no "one size fits all" solution. The right financing mix depends on factors such as the country's level of financial sector development, indebtedness and business environment. As traditional strategies and sources of finance are not enough, closing Africa's infrastructure gap requires innovations on the part of the public sector, development partners, and the private sector.

African governments can increase and channel private savings to productive uses by facilitating the development of local capital markets, as well as inflows from international capital markets. Instruments such as corporate bonds or government infrastructure bonds are limited to countries with sufficiently developed domestic bond markets, while others, including diaspora bonds and external sovereign bonds, tap into international capital markets or foreign-exchange denominated private transfers (Box 3.5). Other schemes such as sovereign wealth funds and resource-backed infrastructure financing are better tailored for resource exporting countries.

Box 3.5: Innovative Instruments for Infrastructure Financing

Innovative Government Financing Instruments	
Government infrastructure bonds: These are government bonds issued on the domestic market to finance public infrastructure projects. Since February 2009, Kenya has issued three such bonds with a total value of US$1 billion, which, in turn, paved the way for corporate bond issues by private and state-owned companies. Kenya's success is partially attributed to its use of incentives, such as allowing the bonds to be used as collateral for bank loans and exempting bond holders from tax on the interest earned.	***Resource-backed infrastructure financing***: These are loans for infrastructure backed by natural resources. For example, Chinese investments in Angola, Nigeria, and Sudan are backed by oil, in Gabon by iron, in Ghana by cocoa, and in the Democratic Republic of the Congo by copper. It is critical that African governments negotiate equitable deals that correctly value the resources assigned and environmental externalities. The share of royalties and dividends should also be robust to fluctuations in world commodity prices.
Sovereign wealth funds: These are government investment funds capitalized from the proceeds of resource exports. When well designed and implemented, these funds can be a significant source of finance for both domestic and foreign projects. The Libyan Arab African Investment Company, which invested US$ 800 million in 13 African countries in 2008, is a best-practice example.	***Remittance securitization***: This is an instrument whereby countries with fairly predictable remittance flows borrow on international markets on the basis of expected future revenues. Securitization allows a country to tap into the foreign exchange component of remittances without interrupting the funds transfer. It requires, however, supportive legislation, a low foreign exchange premium and skills.
Diaspora bonds: These are government bonds targeted at a country's diaspora, but can also be offered to the local population. Ethiopia pioneered diaspora bonds with its Millennium Corporate Bond in 2007. The bond raised capital for the state-owned Ethiopian Electric Power Corporation. Other Sub-Saharan African countries with large diaspora could rise up to US$ 5-10 billion per year through the issuance of such bonds.	***External sovereign bonds (ESB)***: This is a foreign-exchange denominated government bond issued in international capital markets. Ghana's issuance of a US$ 750 million ESB in 2007 was an innovation amongst low-income countries and underscored the importance of achieving macroeconomic stability before attempting to access these markets. After a lull due to the recent international financial crisis, demand for African ESBs is expected to rise in 2011.

57 Biau and others 2008; and OECD 2010.

Innovative Private Financing Instruments

Corporate bonds: These are domestic bonds issued by private firms. South Africa's private sector has been able to tap local capital markets to finance infrastructure projects in water, transportation, and power. The country's capital markets are well developed and long-term credit is available, as well as expertise to arrange more complex transactions such as the EUR 2.5 billion Gautrain project.

Specialized infrastructure funds: These are funds created by established infrastructure firms, including upstream industries that invest in various infrastructure projects. They provide a mix of financing instruments, such as equity, senior debt, subordinated debt, or mezzanine finance with exposure ranging from about US$ 5 to 120 million per project and longer tenors (up to 15 year). The Emerging Africa Infrastructure Fund is an example.

Private equity funds: These funds mobilize financing primarily from both international and local institutional investors and traditional financiers, such as Development Finance Institutions. The Africa Infrastructure Investment Fund, for example, was able to mobilize US$ 5 billion in additional financing in addition to its initial fund of US$ 500 million.

Commodity-linked debt instruments: These are domestic notes linked to specific commodities that can be traded on local exchanges. In August 2010, for example, South Africa's Standard Bank Group offered Rand-denominated notes traded on the Johannesburg Stock Exchange whose returns were linked to the performance of precious metals. The capital was protected and the notes had specific redemption dates. Commodity exporters across Africa could potentially use such instruments to raise funds and hedge against commodity price fluctuations.

Source: Brixiova and others 2011.

While not necessarily innovative, direct and indirect lending by foreign banks has expanded, as foreign investors seeking to diversify their portfolios have taken an increasing interest in African infrastructure. Export credit agencies (ECA) have also been providing the requisite insurance. Airlines have traditionally borrowed on international markets with ECA cover. For example Ethiopian Airlines uses ECA for its ongoing fleet expansion. The same tools are becoming more common in sectors such as rail and ports, thanks to ownership and management reforms. China's investments into Africa, for example, are channeled mainly through the Export-Import Bank and the China-Africa Development Fund. Such increased use of non-concessional financing for infrastructure investments, however, requires greater diligence in debt management to ensure sustainability.

FDI in infrastructure, especially from investors based in emerging markets, is on the rise. In addition to large institutional investors, infrastructure FDI increasingly includes investors with a stake in the developed asset, such as extractive industries companies that need infrastructure to conduct their operations. The benefits of investments tied to mining can be enhanced if access to developed infrastructure is not limited to the resource extraction operations. New private investors are also emerging in sectors where infrastructure-related revenue streams from off-take agreements are not the main source of revenues. This includes co-generation in the power sector, where electricity is generated as a by-product of sugar and ethanol production in countries like Tanzania, Kenya, and Mozambique, and oil sector gas-powered electricity in Nigeria and Tanzania.

Given the abundance of natural resources, African countries can tap carbon finance markets to finance low-carbon infrastructure (Box 3.6). So far though, access to carbon credits by clean technology projects in emerging markets and developing countries has had mixed results across regions, with Africa lagging substantially behind.

Box 3.6: Tapping Carbon Finance Markets

Africa's reserves of renewable energy—solar, hydro, wind and geothermal—are the highest in the world. On a global ranking of countries by renewable energy reserves, 17 out of the top 35 countries are African.

Given its abundant natural resources, Africa could embark on a low-carbon infrastructure development path. This would unlock financing from carbon-credit markets through the Clean Development Mechanism and other clean technology funds. The former has the advantages of being market-based, legally enforceable and generally more predictable than concessional financing sources. The latter are crucial to reduce the costs and risks of such investments. Examples include the Clean Technology Fund (CTF), which supports the adoption of low-carbon technologies in middle-income countries. CTF is expected to leverage at least five times its value in clean energy solutions, including energy efficiency, renewable energy, and sustainable transport investments.

The Global Environment Facility (GEF) provides grants to low-income countries for projects that promote sustainable development. The challenge for African countries is poor capacity to tap these global funds to adapt to, and mitigate climate change. To facilitate access, the AfDB is leading resource mobilization into the Africa Green Fund, which will provide direct financing towards qualifying projects on the continent.

Source: Duarte and others 2010; and Buys and others 2007.

As the scope of financing vehicles expands, traditional partners must refine their services and enhance their involvement in areas of comparative advantage. In playing its role as financier, the public sector should seek to improve efficiency in the delivery of infrastructure finance. Public savings from efficiency gains can be achieved in part by planning for timely delivery of projects to avoid costly emergency measures, maintaining existing infrastructure to limit expensive rehabilitation, improving efficiency of utilities, and strengthening medium-term expenditure and accounting frameworks and auditing procedures.

African governments should also mobilize domestic resources. Removing exemptions and strengthening tax administration would increase public tax revenues. In low-income countries, where the large informal sectors impede effective direct taxation, excise, value added and other indirect taxes can be relied upon. Post-conflict countries may consider utilizing trade taxes and other simplified direct tax structures, before a balance between indirect and direct taxes can be reached.

To mobilize private savings, formal financial institutions could offer long term saving instruments, and governments could provide corresponding tax incentives. African governments can also remove regulatory barriers that discourage institutional investors such as pension funds from relying on long-term savings instruments. Moreover, they can help diversify capital markets by developing institutional frameworks encouraging Islamic finance institutions and private equity funds.

African governments also have a critical role to play in providing incentives for private investment in infrastructure projects. Such incentives could include risk mitigation instruments, such as viability gap financing[58], and addressing the risk of foreign exchange fluctuation through currency hedging, devaluation liquidity schemes, and government exchange rate guarantees, among others. Adding incentives to risky partnerships, such as guaranteed floor returns and tax holidays, could also increase the private investors' appetite in infrastructure transactions. Such a strategy was recently employed in the Dakar Toll Road project[59].

58 This is a subsidy that can be used as partial capital cost financing for up-front investment needs to encourage private operators' involvement in critical infrastructure projects with high economic benefits but low financial returns. Competitive pricing of the viability gap is crucial if such subsidies are to be utilized successfully.

59 AfDB 2011 (a).

Financing from emerging markets for infrastructure development has increased in the past decade. Chinese commitments reached US$ 5 billion in 2009; flows from India averaged US$ 500 million per year between 2003 and 2007; while Arab and Islamic finance institutions reported flow of US$ 2.4 billion and US$ 1.7 billion in 2008 and 2009, respectively[60]. It is unclear, however, what proportion of these flows constituted aid and concessionary financing. Reporting for this new official development assistance (ODA) is still evolving, which makes it difficult to establish the exact volume, source, destination, and/or purpose of these financial flows[61].

The proliferation of donors has certainly added to challenges of quality, effectiveness and predictability of ODA flows to Africa. Given the relevance of external flows, solid public expenditure management requires that donors improve the predictability of their support and streamline and harmonize their procedures. There is a case to focus on multi-donor initiatives that pool funds for general budgetary support of sector-wide interventions. Outside of the 2002 Monterrey Consensus and subsequent agreements, attempts to adopt common ODA frameworks and streamline processes are ongoing. Such efforts should encompass both traditional and new development partners.

To unlock private infrastructure finance, Africa needs to increase the number of bankable projects. In addition to project preparation championed by MDBs and donors, private investors should develop and bring projects to the market. In most African countries, however, this is constrained by the absence of relevant procurement processes, rules for handling unsolicited proposals, or mechanisms for competitive bidding. In such an environment, the risk that private investors' proposals losing proprietorship is high. MDBs and the donor community should consider supporting the development of an enabling environment for project identification and development by private partners.

Aside from reforming procurement rules, consolidating project preparation financing from grant facilities could generate immediate gains. Combining official development assistance in upstream project preparation activities with private finance in project preparation can also be seen in the case of Infraco (Box 3.7) where development assistance is channeled through a commercial vehicle that, because of its higher risk tolerance, is able to absorb project preparation costs and risks.

Box 3.7: InfraCo – Innovation in Project Preparation Finance

InfraCo is a donor-funded infrastructure development company that acts as an 'honest broker' to link finance providers, the private sector, and host governments in low-income developing countries.

InfraCo is mostly involved in early stage project development activities and, as such, shoulders much of the upfront costs and reduces entry costs for private sector infrastructure developers.

After securing in-principle commitments from finance providers to support an investment, InfraCo offers the structured investment opportunity to the private sector through a competitive bidding process and in return will get compensated for its time, effort, and cost in the form of a minority carried interest in the venture. Over time, InfraCo may sell its interest to national, institutional, and public investors.

InfraCo is managed as a private sector infrastructure development company with its capital provided by way of share subscription by the Private Infrastructure Development Group (PIDG) which is made up of the development agencies of Austria, Ireland, the Netherlands, Sweden, Switzerland, and the UK, and the World Bank.

Source: InfraCo Africa.

60 ICA 2009.

61 Ramachandran and others 2009.

With improvements in investment climate and project processes, private investments are scaling up, including in sectors traditionally dominated by the public sector, such as roads and electricity. Total private investment into African roads grew from a cumulative US$ 1.4 billion in 1990–99, to more than US$ 21 billion between 2000 and 2005. A new wave of private road projects in South Africa, Mozambique, Kenya, Senegal, Cote d'Ivoire adds to the list. The toll road model in particular has now been adopted on the continent under both public (South Africa, Tunisia, Morocco, and recently, Zimbabwe) and private systems (South Africa)[62] The strongest recent growth in private investment, however, has been in electricity generation through independent power producers (IPPs) (Box 3.8).

Box 3.8: Private Sector Participation in Power Generation

The evolution of Independent Power Producers (IPPs) demonstrates opportunities for private sector participation as infrastructure financiers and developers on the continent. Cote d'Ivoire was among the first African countries to attract foreign investors via IPP concessions with the Build Own Operate and Transfer (BOOT) model, soon followed by Egypt, and later Ghana, Morocco, Kenya, Tanzania, Tunisia and Uganda, among others.

IPP funding on the continent peaked in 1997 with US$ 1.8 billion in private investment. IPPs contributed US$ 5.6 billion, or 75 % of cumulative investments in Greenfield power sector projects in sub-Saharan Africa, over the period 1990-2008. The trend parallels the power sector reforms implemented across Africa in the past two decades, which liberalized power generation and facilitated regulated competition in the sector.

Private sector participation in the power sector, while offering encouraging potential, also carries some risks. The expected benefits of private participation of competition, efficiency, cost recovery, and innovation are not always realized. Competitive bidding processes, competitive pricing and intellectual property rights protection are necessary. In Cameroon, for example, private participation has not fostered competition. Market power is concentrated in one public-private entity, AES-Sonel, which limits the potential benefits of regulated competition.

Source: Mutambatsere and Mukasa 2011; and Gratwick and Eberhard 2007.

Promoting a Regional Approach for Infrastructure Development

Africa's geography demands a regional approach to regional infrastructure development to ensure service efficiency and maximize resources. The continent could save US$ 2 billion a year in energy costs by utilizing the existing regional power pools to their full potential[63]. For example, developing the continent's largely untapped hydropower potential through investments in regional infrastructure such as the Grand Inga Project (Box 3.9) would generate financial returns for Africa's power pools of 20 to 30 %, and as high as 120 % for the Southern African Power Pool. Similarly, developing a transnational highway network linking all capitals in sub-Saharan Africa could result in trade gains of up to US$ 250 billion over fifteen years[64]. Developing regional hubs, particularly in maritime and air transport infrastructure (Box 3.10), would also boost efficiency.

62 Brixiova and others 2011.
63 Foster and Briceño-Garmendia 2010.
64 Buys and others 2006.

Box 3.9: The Grand Inga Project

Inga Falls' power-generation potential is second only to the Amazon's. The ambitious Grand Inga Project, worth US$ 80 billion, could develop 39,000 MW of hydropower capacity on the Congo River in the Democratic Republic of Congo. The project's target power generation capacity is equivalent to a third of Africa's total electricity generation capacity in 2009. When complete, the dam would have more capacity than the largest hydropower project in the world, the 18,000MW Three Gorges Dam in China, which became operational in 2009.

The project has been identified as a priority by the Southern African Development Community (SADC) and the NEPAD. At completion, the dam is expected to supply power to African consumers in Angola, Egypt, Nigeria and South Africa. While the project is far from reaching financial closing, it has drawn considerable interest from leading players in the energy industry, including power companies and development finance institutions such as the World Energy Council and the World Bank, which are leading project development. Issues surrounding the environmental and the social impact of the project, such as the potential exclusion of poor local households, remain to be addressed.

Source: International Rivers.

Box 3.10: Developing Regional Hubs—Ethiopian Airlines

For airlines, regional hubs improve efficiency not only in capital investments, but also in operation and asset maintenance. Ethiopian Airlines has emerged as a hub on the east coast and is a major African carrier dominating international and domestic markets along with two other carriers: South African Airways and Kenya Airways.

Ethiopian Airlines' aviation training center, established in 1956 to train domestic technicians and pilots, has become a regional hub servicing numerous African carriers.

As of 2008, Ethiopian Airlines had the highest number of destinations, serving 35 African cities in 26 countries, and accounted for 45 percent of all the seats on routes served by one carrier. They are currently increasing and modernizing their fleet to increase passenger traffic by about 175% by 2018.

Source: Mutambatsere and Mukasa 2011; and AfDB 2011 (d).

While cross-border infrastructure projects are transformative, they are also challenging relative to single-country projects. Differing priorities across borders and poor coordination of national projects with a regional dimension, among other factors, explain the slow progress in completing strategic investments such as the Trans-African Highways initiative. Inadequacies in project preparation are also particularly evident in regional projects. In addition, these projects have markedly higher transaction costs and complex risk factors for potential financiers. They involve multiple financiers, requiring careful coordination to ensure that transactions are efficient and effective. Moreover, execution of multinational projects requires full, effective cooperation among countries and in some cases, harmonization of policies, rules and regulations.

Regional infrastructure operations thus require innovative planning, procurement, and financing. Initiatives such as the Presidential Infrastructure Champion Initiative (the 'Zuma initiative') and the Programme for Infrastructure Development in Africa (PIDA) have taken significant steps towards spotlighting regional integration projects and national projects with regional significance. Success of such regional planning instruments will

depend primarily on political commitment and buy-in at multiple levels of government. It will also depend on the extent to which regional plans are harmonized with national ones in terms of funding priorities, and balancing growth and pro-poor infrastructure investments.

Support for project preparation is making notable progress thanks to technical assistance funds, such as the NEPAD-sponsored Infrastructure Project Preparation Facility (IPPF) (Box 3.11). In addition, the Infrastructure Consortium for Africa (ICA), in partnership with IPPF, EU-Africa Infrastructure Trust Fund, and the Development Bank of Southern Africa, is developing the "Tunnel of Funds" concept, whereby project preparation activities and costs necessary to advance priority regional projects from concept to bankable prospect are identified, and financing packages assembled. The concept is still at a nascent stage, however, and its effectiveness yet to be proven. Facilities to support regional infrastructure projects are also increasingly being established by regional economic communities including the Economic Community of West African States (ECOWAS) and the Southern African Development Community (SADC).

Box 3.11: The Infrastructure Project Preparation Facility

The Infrastructure Project Preparation Facility (IPPF) is a up to US$ 15 million per year multi-donor fund established to assist African countries, regional economic communities and their specialized institutions to (i) prepare high-quality and viable regional infrastructure projects, and (ii) develop consensus and broker partnerships for their implementation through public, private or other sources of finance. IPPF is a NEPAD initiative managed by the AfDB with project preparation financing.

The Facility supports regional infrastructure development in the energy, transport, water resources and ICT sectors. In 2010, IPPF contributed about US$ 9 million to 10 projects. IPPF prepared regional infrastructure projects worth around US$ 4.7 billion between 2005 and 2010.

While the Facility is a step in the right direction, the US$ 42 million in committed resources—currently standing—are not nearly enough to meet the regional project preparation for the continent.

Source: AfDB 2010 (g).

Innovation in funding regional infrastructure is also required to ensure an equitable allocation of risks and rewards among partnering countries. Investing in regional infrastructure may represent a disproportionately high, even prohibitive, cost for small economies, while geography often dictates that investments be concentrated in one country.

Challenges to the development of regional infrastructure can be addressed by MDBs providing a higher proportion of their financing towards cross-border projects. Progress at the country level includes the creation of national units in Kenya, Malawi, Mozambique, Nigeria, and Tanzania to help develop multinational projects involving private operators and investors. Such projects are inherently more complex, and often require instruments to help reduce the high upfront risk borne disproportionately by private investors. Coordinating PPP regulatory frameworks across sub-regions would facilitate the implementation of such projects.

Promoting Inclusive Access

Improving access to infrastructure services across the board is vital to support strong and sustained economic growth in African countries. While countries are pursuing this long-term goal, existing infrastructure services also need to be better shared. As discussed in earlier, access to infrastructure services in Africa remains skewed towards urban and better-off areas. The implication is that micro

and small-scale entrepreneurs, including rural farmers, face worse deficits than medium and large producers.

Ongoing infrastructure investments should therefore strive to reach marginalized populations. Cost-effective mechanisms to do so include (i) incorporating feeder roads in the design of major highways to facilitate market integration and access to basic services for the population in the highway's catchment area (ii) investing in electrification projects-such as the two-phased Rural Electrification Programs in Ethiopia and the project for electrification of 17 rural centers in Benin-that extend power distribution networks to rural areas, (iii) tapping major transmission line projects to electrify communities in the line's catchment area, (iv) investing in information and communication technologies which reach areas with no internet service cost-effectively, such as the Other 3 Billion (O3B) satellites project.

Inclusion also entails addressing the soft side of infrastructure access. This includes reforming current social pricing policies in both low- and middle-income countries to ensure that cost-reflective tariffs are applied to more affluent users, and subsidies targeted to ensure access by poorer consumers.

Opportunities to exploit cost-effective second-best solutions also exist, in particular in the energy sector and in water and sanitation. Off-grid electrification options such as rooftop solar panels are often more cost-effective than unreliable grid electrification, even more so when all the emergency generation costs are accounted for. For generation capacity of 5 kilowatts, off-grid electrification has been shown to be the most cost-effective option. The upfront costs of such technologies, however, are still beyond the reach of most poor households.

Mini-grids are also an option for the electrification of isolated, sparsely populated areas that cannot be reached cost-effectively through grid network extension. Mini-grids could be developed either by national utility companies or in hybrid markets[65] by private developers (Box 3.12) or industrial users. Operating costs are substantially lower where such systems use locally available energy resources and conventional technologies (for instance hydro, biogas and biomass powered systems). Adoption requires integrating these units into the national development plan, and, where the mini-grids are run by private operators, ensuring cost recovery in markets characterized by price distortions and subsidies.

Box 3.12: Mini grid: The Buseruka Power Plant, Uganda

The 9MW Buseruka hydropower plant, to be run as a 40-year build-own-operate-transfer (BOOT) scheme, will supply electricity to the rural area of Buseruka in Uganda. Total project costs are estimated at US$ 41 million. Project financing is provided by the sponsor Dott Services Ltd (44 % of project costs) and by MDBs (56 %) as long-term debt. The power generated will be sold through a take-or-pay power-purchase agreement to the national power utility, which will in turn distribute power to local rural customers. Electricity from the plant will reach roughly 1,500 households, 500 businesses, and 150 institutions, which will be charged US$ 0.1235 per kWh—well below the cost recovery tariff for Uganda's national grid.

Source: AfDB 2011 (l); and Mutambatsere and Mukasa 2011.

In the water sector, standposts for improved water access and latrines have been widely developed on the continent as alternatives to piped water and flush toilets. Yet access to these alternatives has stagnated and coverage rates remain low, mainly due to the reduction in ODA

65 Regulated markets in which public sector players co-exist with private developers.

supporting these sectors in the late 1990s and to domestic budgetary constraints. The public-good nature of improved water standposts has also restricted their private provision. Countries such as the Central Africa Republic, however, are experimenting with innovative PPP models to improve access to clean water in small towns based on cost-recovery. Overall, infrastructure development strategies must seek to balance pro-growth with pro-poor investments if the current bias in access between say urban and rural areas is to be redressed.

The Role of Multilateral Development Banks in Infrastructure Development

In addition to financing infrastructure and supporting capacity building on the continent, MDBs have refined their instruments to meet evolving needs and unlock restrictions to individual country's borrowing. Examples include blended financing packages and risk management instruments to catalyze private finance, building capacity and country systems, and brokering complex regional projects. The AfDB's extended role in infrastructure development is highlighted in Box 3.13.

Box 3.13: AfDB's Infrastructure Development Activities

Lending	**Technical assistance**
US$3.7 billion to infrastructure projects in 2010 (60 % approvals) • US$ 1.9 billion for transport • US$ 1.2 billion for energy • US$ 650 million for water and sanitation • US$ 50 million for communication • US$1.7 billion earmarked for regional operations for the period 2011 to 2013	• Fund for African Private Sector Assistance (US$ 16 million per year for private operations). • NEPAD Infrastructure Project Preparation Facility (US$ 15 million per year for regional projects). • MICs Technical Assistance Fund (US$ 16 million for operations in middle income countries). • Technical Assistant for bond issues in RMCs.
Risk management instruments	**Support to access climate finance**
Guarantees • Partial credit guarantee • Partial risk guarantee • Hedging products • Currency swaps • Interest rate swaps, caps, collars • Commodity/index swaps • Indexed loans	• Setting up the Africa Green Fund to mobilize resources. • Supporting pioneer development of clean energy projects at commercial scale (i.e., Cabeolica wind farm in Cape Verde. • Financing energy efficiency projects (reached US$ 5 billion for MDBs collectively in 2009) • Improving uptake from existing facilities (i.e., Climate Investment Funds, Global Environment Facility).

Source: AfDB 2010 (i).

The increased role of the private sector in Africa's infrastructure has been paralleled by changes in the lending policies of MDBs. Countries supported by the International Monetary Fund (IMF), for example, can now borrow externally on non-concessional terms, provided they have solid debt indicators and debt management capacity[66].

Several instruments have emerged to improve the bankability of projects in high risk environments. Some projects can now attract a blend of concessional funding and private investment that either raises the overall return on investment or enhances credit structures to acceptable risk levels. Such financing is

66 Redifer 2010.

required for projects where up-front investment is high and the time until revenues are generated is long. Blended financing is also crucial to improve the bankability of complex regional projects, such as the Kenya-Uganda Railways (Box 3.14).

Box 3.14: MDBs in the Kenya Uganda Railways Concession

In 2006, with the support of MDBs, the Kenyan and Uganda governments jointly concessioned their rail networks to a private operator under a 25-year agreement.
IFC acted as transaction advisor and, in partnership with AfDB, KfW, FMO and BIO, as a financier of the project. IFC's early involvement catalysed additional financing from the World Bank Group: Concessional funds from IDA financed the environmental and social impact management plans, including a retrenchment plan for the Kenya Railway Corporation. IDA also provided partial risk guarantees to cover the concessionaire and lender from possible failure by the two governments to fulfill their contractual obligations. IDA support to the residual railway corporations helped prepare them to take on regulator roles. In addition to financing, the AfDB prepared the resettlement action plans covering the full network, both of which were financed by IDA. MDBs were also able to use their convening power to draw new interest and salvage the deal when the concessionaire faced possible termination of the agreement in 2008 after failing to meet performance targets and to pay concession fees.

Source: Mutambatsere and others 2011.

MDBs can also ramp up risk management support. Commercial and political risk premiums can be covered by both debt and equity insurance and by guarantee instruments. While commercial instruments exist, concessional ones such as partial risk guarantees (PRGs) offered by the International Development Agency (IDA) and the African Development Fund (ADF), and political risk insurance offered by the Multilateral Investment Guarantee Agency (MIGA), are more suitable for ADF countries. PRGs, for example, have been shown to generate as much as ten times the value of the guarantee in additional financing[67] Political risk management instruments also provide governments with incentives to implement reforms that address performance risk. Partial credit guarantees (PCG) have been used to cover losses in the event of a debt service default caused by either political or commercial risk. PCGs improve the borrowers' access to financial markets by sharing the borrowers' credit risk vis-à-vis the lenders and guarantors. Full credit guarantees or wrap guarantees may also be applied to provide full debt-service cover.

The AfDB is proposing to cover country risk premiums through first-loss guarantees for a portfolio of transactions supported by the Bank. A portfolio guarantee mitigates the cost of the country risk premium affecting low-income countries and Fragile States. The risk capital freed up could be used exclusively for low-income countries. This option would allow these countries to leverage at least five times the value of the guarantee in additional financing from a non-sovereign pool of lending sources.

MDB-led syndications and B-loans are intended to enable project-level risk mitigation for commercial lenders, spurred by MDBs' preferred creditor status[68]. But risk capital utilization and institutional constraints may not allow these institutions to take on this role to significantly match market demand. The same holds for direct equity participation in projects. MDBs can mitigate the equity risk premium arising primarily from political uncertainties through direct or indirect equity participation in infrastructure projects. Indirect participation through equity funds focusing on infrastructure is ongoing but on a small scale so

67 Ramachandaran and others 2009.

68 Preferred creditor status protects the Bank's properties and assets from requisition, confiscation, expropriation or any other form of taking or foreclosure by executive or legislative action.

far[69]. MBD sponsorship of such specialized funds can influence geographic reach, and facilitate the adoption of international best practices.

In addition, MDBs are experimenting with participation in infrastructure projects through direct equity, although this is still uncommon. Being an equity partner allows MDBs to participate in the early stages of project preparation and attract funding from other sources to cover project development costs incurred by developers prior to financial closing. Quasi-equity instruments like subordinated loans are more common. The risk of foreign exchange rate volatility can be addressed through currency hedging, government exchange rate guarantees and devaluation liquidity schemes, among others. However, much greater attention needs to be paid to affordability of these instruments in the African context. In 2007, the Board of the AfDB authorized the participation of the Bank in the Currency Exchange Fund (TCX). TCX is a fund established to provide hedging products to its investors in emerging market currencies[70].

To address capital market bottlenecks, the AfDB has increasingly become more involved in issuing bonds denominated or linked to African currencies, technical support for bond issues, participating in currency swap markets. MDBs have also traditionally supported financial markets development through policy-based lending.

MDBs can also provide investment services to institutional investors, who are attracted to infrastructure investments' long-horizon and steady returns, but often lack sufficient local knowledge and information of on pipeline transactions. The AfDB provides such investment services to the Japan International Cooperation Agency (JICA), and opportunities exist to extend these services to a range of similar investors.

MDBs play a critical role assisting countries to access special envelops of financing, such as climate finance. For example, the donor-funded Clean Technology Fund leverages at least five times their value in clean energy solutions, including energy efficiency, renewable energy, and sustainable transport investments. Africa's perspective must be taken into account when decisions on disbursements of global funds for climate change adaptation and mitigation are made. To help facilitate access to these funds, the AfDB is setting up the Africa Green Fund to receive and manage resources to address climate change on the continent.

IFIs, as investors in infrastructure development, can also play a role in improving maintenance particularly in low-income, low-capacity environments. This could be achieved by, among other things, establishing a sound maintenance framework as a prerequisite to major capital investments. They can also play a countercyclical role to support maintenance activities during periods of economic recession. During the recent economic downturn, for instance, MDBs including the AfDB and the World Bank targeted the preservation of strategic assets by providing soft loans or grant facilities for maintenance.

Conclusion

Infrastructure deficits are condemning African firms to operate at sub optimal levels. The development and maintenance of Africa's infrastructure is constrained by unfavorable geography, low public service capacity to execute upstream activities and monitor project implementation, inadequate financing for project preparation and implementation, poor management of existing infrastructure assets, institutional inefficiencies and regulatory bottlenecks.

Addressing Africa's infrastructure gap would not only improve private sector development, it will further boost the continent's economic growth, foster regional integration, and improve integration of the continent into the global economy. This requires resources to the tune of 10 % of Africa's GDP, of which only half is currently being spent. Innovation and reforms are therefore essential complements to traditional strategies and sources of finance.

Investment priorities should be driven by location of economic activity, aiming first to deliver strong, sustained and shared growth. Sector plans and

69 Brixiova and others 2011.
70 Brixiova and others 2011.

strategies must seek to engage the full range of potential partners. This involves enhancing the capacity of public entities, reforming regulation, and strengthening institutions to handle innovative financing and procurement methods. Developing local capital markets is crucial to mobilize excess savings from domestic, regional and international markets towards infrastructure. Institutionalizing and coordinating emerging markets' engagement is essential to improve the predictability of financial flows. In light of their geography, most African countries must also actively seek regional cooperation for cost-effective infrastructure development.

Africa's traditional partners should refine their modus operandi to reflect comparative advantages. MDBs, in particular, have a unique opportunity to augment efforts in capacity building, catalyzing private capital and brokering complex regional projects-areas of clear comparative advantage. The role of the AfDB is further explored in Chapter 8.

Annex 3.1 : Infrastructure Stock by Region

	Electricity			Roads		Ports		Rail		Airports		ICT						Water and Sanitation		
	Net Electricity Generation (kWh per capita)	Grid Electricity, Access Rates, % of population (2008 and 2009)	Effective tariff on 500 kWh consumption per month, US$ cents / kWh (2005)	Road density (km of road per 100 sq. km of land area) (most recent data 2001-08)	Roads, paved (% of total roads) (most recent data 1995-2008)	Container handling capacity, million TEU per year (2008)	General cargo handling charge (ship to gate) average US$ per ton (2008)	Rail lines, total km (most recent data 1991-2009)	Operational lines, total (km)	Number of international city pairs served (2007)	International seats, total annual number in thousands (2008)	Fixed telephone lines per 1000 inhabitants (2009)	Mobile cellular subscribers per 1000 inhabitants (2009)	Internet users, per 1000 people (2009)	Business telephone monthly subscription, US$ (2009)	Mobile cellular prepaid tariff, US$ per month (2008)	Fixed broadband internet access tariff, US$ per month (2008)	Improved water source access, % of total population (2006)	Water outages, hours (most recent data 2006-09)	Improved sanitation facilities % of total population (2006)
Africa	562.0	38.0	-	-	28.0	7.8	14.3	2 393.5	2 042.4	32.1	1876.4	40.3	452.0	78.6	7.4	11.1	290.8	68.9	13.0	40
America & Caribbean		90.0	-	18.0	24.0	18.4	9.0	-	-	-	-	190.0	825.0	29.0	-	-	--	91.0	16.0	78.0
East Asia		67.0	-	47.0	34.0	71.1	8.0	-	-	-	-	220.0	604.0	19.0	-	-	-	87.0	7.8	66.0
South Asia		53.0	-	1 001.0	57.0	14.7	-	-	-	-	-	30.0	330.0	5.0	-	-		87.0	10.8	33.0
Middle East and North Africa			-		76.0	31.7	-	-	-	-	-	160.0	580.0	19.0	-	-		74.0	10.9	74.0
North Africa	1 568.3	86.4	-	7.7	64.6		-	2 949.4	2 647.4	109.5	7 947.3	104.4	798.7	201.5	7.3	10.4	24.0	84.0	5.8	73
East Africa	370.3	19.9	13.5	26.7	31.3	0.5	12.3	1 807.7	1 370.4	25.8	1 545.2	36.3	306.2	40.1	4.6	9.8	209.0	62.7	14.2	37.2
Southern Africa	986.3	36.1	9.8	20.0	28.2	0.8	16.8	3 804.9	3 417.3	26.0	1 954.5	54.4	493.5	70.5	10.5	10.7	314.0	72.9	14.7	47.7
Central Africa	294.9	30.2	17.5	6.1	5.2	0.2	12.5	1 555.8	1 210.3	16.0	422.9	10.0	387.0	35.6	6.2	15.5	790.0	64.2	18.9	32.7
West Africa	126.9	30.1	16.0	19.5	21.9	0.4	14.4	1 162.7	754.1	19.3	805.1	21.7	428.7	76.3	6.9	11.8	347.3	66.6	10.1	25.7
ADB Countries	1 750.5	82.4	9.4	24.8	54.8	1.5	25.3	4 494.4	4 179.2	66.5	4 929.6	115.5	808.9	148.7	9.9	10.0	213.9	85.0	16.8	68.0
ADF Countries	175.7	23.6	14.1	15.9	20.6	0.4	13.5	1 534.0	1 145.6	20.9	960.5	15.8	336.0	55.8	6.3	11.5	317.3	64.1	12.1	30.3
Fragile States	125.5	25.9	15.5	15.7	21.2	0.3	14.2	2 157.8	812.7	14.7	519.1	12.8	259.3	40.1	6.5	11.1	443.0	67.2	14.4	27.7
Oil Exporters	763.6	52.9	13.3	8.5	26.3	0.4	14.3	2 757.3	2 052.4	46.8	2 597.9	37.3	528.1	91.2	7.6	10.7	162.7	66.6	17.7	45.7
Oil Importers	496.4	31.8	13.9	21.3	29.2	0.6	14.3	2 244.7	1 881.8	27.3	1 660.0	41.2	427.3	74.9	7.3	11.2	318.8	69.7	11.6	37.6
Land Locked Countries	213.9	15.6	14.1	17.9	18.7			915.1	1 033.1	13.2	773.6	15.3	289.6	41.6	7.5	11.2	602.2	65.3	7.5	33.6
Coastal Countries	699.3	48.3	13.5	18.4	32.5	0.5	14.3	2 998.3	2 234.6	39.5	2 323.5	50.1	516.1	94.9	7.3	11.1	152.4	70.0	15.6	41.9

Chapter 4 :

PRIVATE SECTOR FINANCE IN AFRICA

Despite significant progress in terms of financial sector deepening and broadening, the African private sector remains financially underserved. The chapter documents the state of private sector access to finance in Africa and highlights characteristics of underserved groups as well as barriers preventing companies from receiving funding. Overall, access to finance in Africa remains undermined by inefficiencies related to the economic, political and legal characteristics of local economies, demand side factors related to the poor capacity and low capital levels of corporate Africa; and the structure of existing financial sectors which remain bank-dominated. Notably, the chapter documents a resource curse affecting African private sector access to finance. In order to alleviate the financing constraint, further efforts are needed to build capacity both from the supply and demand side, to address existing bottlenecks in terms of contract enforcement, asset repossession procedures, and information asymmetry. Innovative solutions leveraging on progress made in mobile phone technology could be a game changer.

Introduction

Finance is the private sector's lifeblood. Without adequate funding, private investments and working capital are stifled, new businesses cannot get started, existing ones struggle to expand and economic growth suffers. Yet access to finance remains problematic in Africa, particularly for MSMEs, which make up most of Africa's private sector (Chapter 1). There is an estimated 55 to 67 million such businesses on the continent, of which 70 % are financially underserved. Their funding needs are between US$ 385 and 455 billion[71]. Thus, the issue of limited access to finance needs to be addressed in order to unlock Africa's potential for a sustained and inclusive growth. The issue of access to finance encompasses both finance availability and funding characteristics in terms of cost and maturity.

The Financing Gap

Africa versus Other Developing Regions

Access to finance remains more challenging in Africa than in other regions at similar levels of economic development (Table 4.1). Although a third of Africa's large businesses face challenges to access finance, small companies struggle the most: almost half report that accessing finance is a major constraint – a proportion over three times as high as in developing Europe.

71 McKinsey & Company 2011.

Table 4.1: Percentage of Firms Identifying Access to Finance as a Major Constraint across Regions and by Size

Région	Small	Medium	Large
Africa	48,2	40,8	32,7
Developing Asia	26,3	24,5	21,6
Developing America	30,8	25,3	18,8
Developing Europe	14,0	13,7	15,3

Source: AfDB calculations using World Bank Enterprise Surveys data.

The World Bank Enterprise Surveys (WBES) document difficulties that African companies are facing for funding from formal financial institutions. Only 22 % of surveyed African companies hold a loan or a line of credit from a financial institution, compared to 31 % in developing Asia, 47 % in developing America, and 48 % in developing Europe (Table 4.2). This mainly reflects the inability of African companies to present bankable applications and sufficient collateral as well as credit rationing from banks. When it comes to borrowing from a financial institution, size matters in Africa even more than elsewhere: Africa's large companies are three times more likely to obtain a loan or a line of credit than small ones; in other developing regions, however, the gap is less than twice.

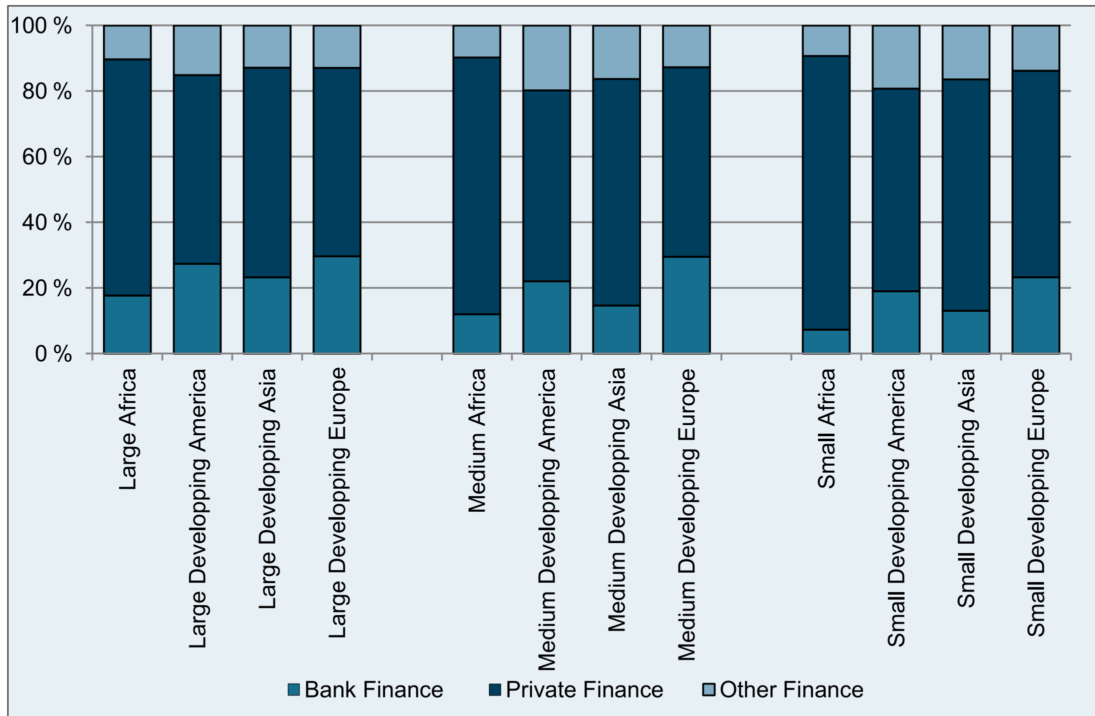
Table 4.2: Percentage of Firms with a Loan or Line of Credit across Regions and by Firm Size

Région	Small	Medium	Large	Average
Africa	16,1	31,8	47,7	22,2
Developing Asia	24,7	34,8	48,2	30,6
Developing America	38,9	53,6	67,7	47,0
Developing Europe	40,9	57,2	67,4	48,1

Source: AfDB calculations using World Bank Enterprise Surveys data.

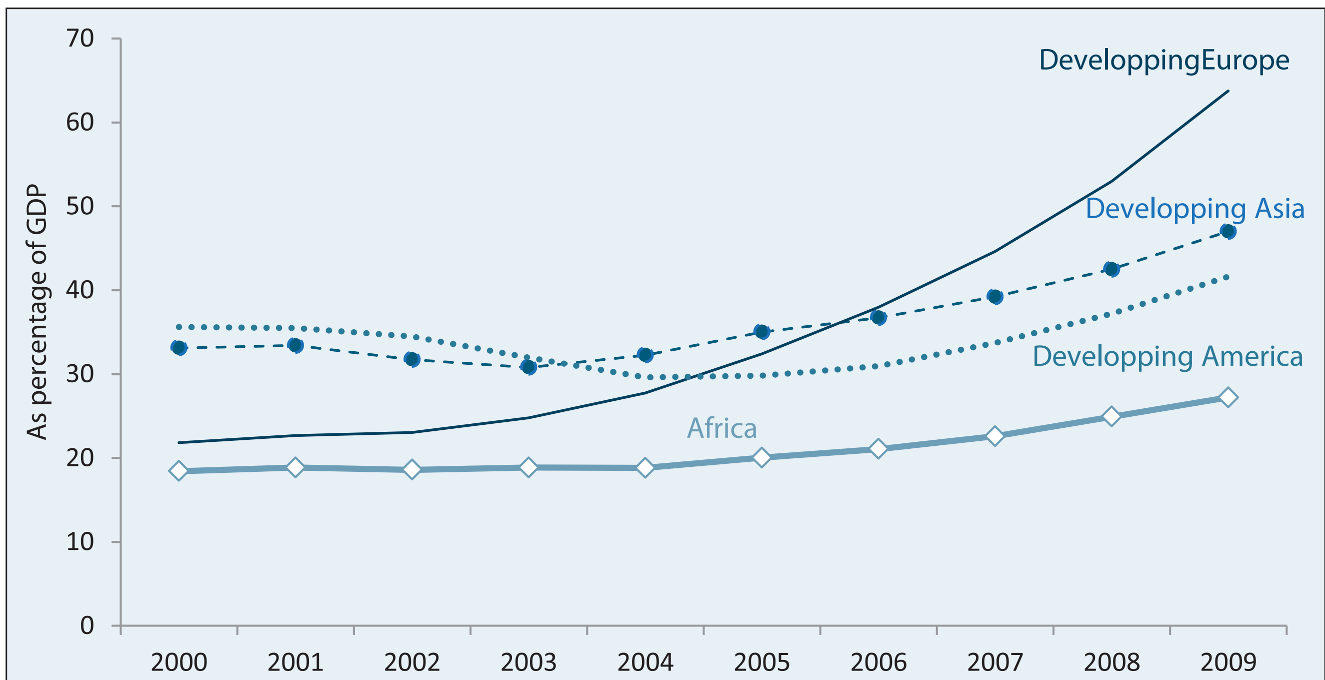
The scarcity of external funding forces African companies to rely heavily on internal sources of finance to meet their needs, making them the largest users of internal finance. This trend holds across all size groups (Figure 4.1). African companies that participated in the WBES reported that roughly 80 % of their investments were financed internally — a significantly higher proportion than in other regions. Similarly, banks are the main source of external formal financing for private sector investment in Africa. This reflects the lack of depth and breadth of African financial systems. Credit to the private sector, however, has been growing faster than the continent's GDP over 2005-2009 (Figure 4.2), though it remains below levels reported for other developing regions.

Figure 4.1: Sources of Investment Funding across Regions by Firm Size (Percentage)



Source: AfDB calculation using World Bank Enterprise Surveys data.

Figure 4.2: Credit to the Private Sector in Africa (Percentage of GDP)



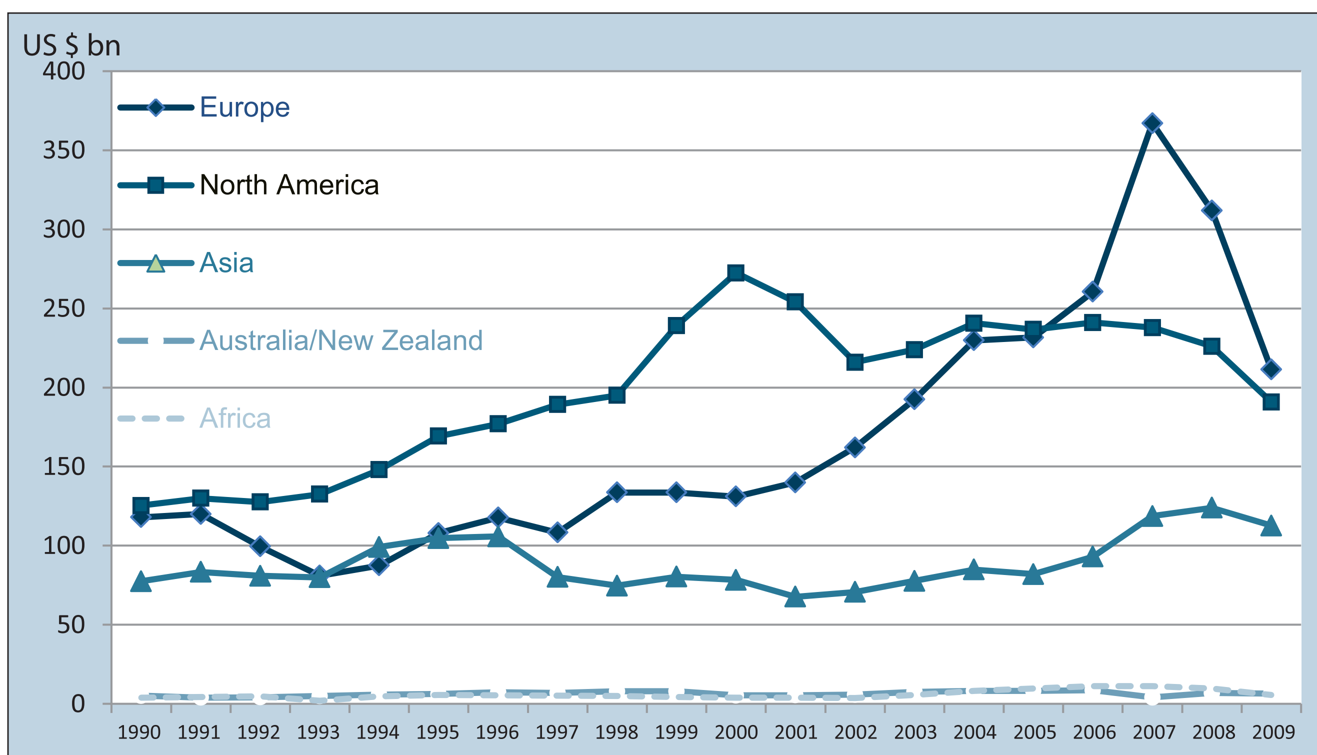
Source: Financial Structure dataset.

Almost 10 % of investment spending made by African companies is from banks, while the share ranges from 16 % to 26 % in other developing regions. Variations according to company size are more pronounced in Africa than elsewhere, with large companies relying most on bank credit to fund

investment. This supports the common belief that banks in Africa mainly cater to large corporations. Despite their heavier reliance on bank credit to fund investment compared to smaller businesses, large African firms still use less bank credit (18 %) than small firms in developing America (19 %) and developing Europe (23 %). This further highlights the severity of financing constraints on the continent.

Most alternative external sources of finance to bank credit such as stock exchanges, bond markets, leasing companies, and venture capital providers, remain underdeveloped in Africa. Leasing finance, for instance, accounts for less than 2 % of gross fixed capital formation of most African countries and remains underdeveloped compared to other regions (Figure 4.3). Similarly, bond and stock markets rarely exist and when they do, they lack liquidity. These low penetration rates result from the poor level of financial sector development, dominance of banks in the financial sector and companies' lack of familiarity with these sources of funding.

Figure 4.3: Leasing Volume across the World, 1990–2009 (US$ billion)



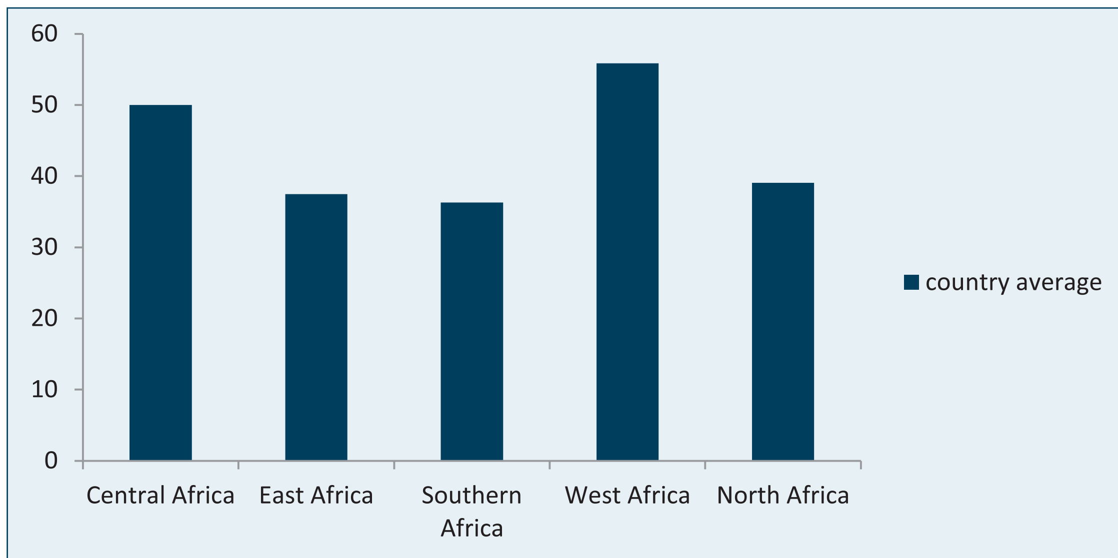
Source: White Clarke Group 2010.

Access to Finance within Africa

While the private sector in Africa significantly lags behind other developing regions when it comes to accessing finance, comparisons across African countries reveal significant variations. For instance, about 75 % of WBES respondents identified access to finance as a major constraint in Burkina Faso and DRC whereas less than 15 % did so in South Africa. Overall, the problem appears most acute in West and Central Africa, where about half the companies surveyed considered access to finance a major challenge (Figure 4.4). Available statistics also suggest that the size effect documented earlier is present across all countries. In most African countries SMEs have limited access to finance and when they do, they are required to pay higher nominal interest rates. For example, in Angola and Tanzania, SMEs pay nominal interest rates of about 16 %, and 14 % respectively whilst larger companies pay, on average, 15.6 % and 12 % respectively.

Access to finance is less challenging in Southern Africa (Figure 4.4). Banks in Botswana, Malawi,

Figure 4.4: Percentage of Firms Identifying Access to Finance as a Major Constraint



Source: AfDB calculation using World Bank Enterprise Surveys data.

Seychelles, and South Africa are well capitalized and offer a wider range of financial products to the private sector. This has been fostered by innovative approaches to improve financial inclusion in the region, often facilitated by flexible regulatory frameworks. For example, the South African Financial Sector Charter sets targets to improve small and micro enterprise and poor households' access to credit and other financial services. M-pesa in Kenya had also striking effects on financial inclusion. Conversely, financial systems in West and Central Africa, apart from Nigeria and to a lesser extent Ghana, remain underdeveloped, with banks extending credit mainly to large companies.

Table 4.3 shows a positive relationship between access to finance and level of economic development in Africa. Indeed 27 % of companies in ADB countries have access to credit against only 21 % in ADF economies. While one cannot ignore the virtuous effects of economic growth on financial sector development and credit availability, statistics in Table 4.3 are also consistent with a large body of the literature documenting a positive relationship between access to credit and economic growth. Indeed, even after controlling for reverse causality and country characteristics, countries that have higher levels of credit to the private sector seem to grow faster. It is estimated that Africa could have had a GDP that is 13 % higher, should it had the same growth rate of credit to the private sector, as a share of GDP, than East Asia[72].

Table 4.3: Percentage of Firms with a Loan or Line of Credit by Country Classification

	Small	Medium	Large	Country average
ADB Countries	19,5	31,1	42,7	26,8
ADF Countries	15,2	32,0	49,1	20,9
Africa	16,1	31,8	47,7	22,2
Oil Exporting ADB Countries	8,5	24,2	45,6	19,2
Oil Exporting ADF Countries	11,0	15,8	36,8	13,4
Fragiles states	13,0	22,4	36,5	14,9
ADF Countries except Fragiles States	16,4	36,9	54,8	23,9
Oil Exporting Fragile States	13,1	14,6	27,09	13,9

Source: AfDB calculation using World Bank Enterprise Surveys data.

72 Beck and others 2011.

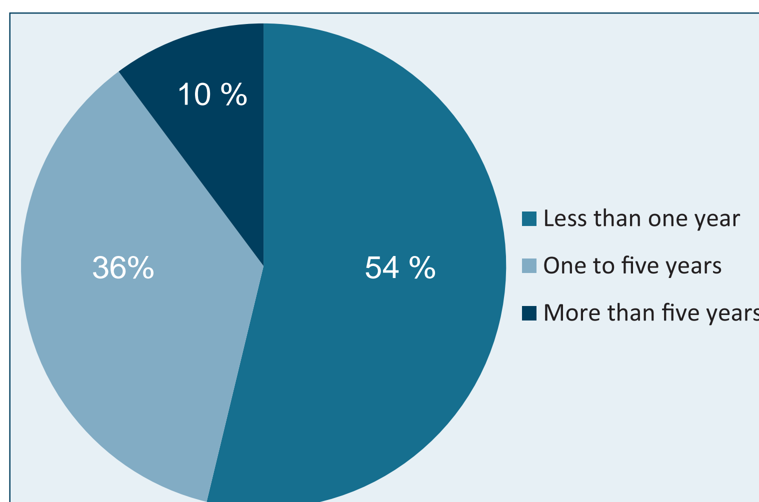
Interestingly, this conclusion does not hold across all size groups in Africa. Evidence suggests that financial institutions in ADF countries are more likely to extend credit to medium and large firms than those in ADB countries. Small businesses, on the other hand, face higher hurdles in ADF than in ADB countries (Table 4.3). Besides income level, lack of political stability also hinders access to finance: Fragile States report a significantly lower country average than ADF countries overall.

Notably, access to finance is more challenging in oil exporting countries, regardless of the level of economic development and political stability. While banks in oil producing countries tend to be liquid and well capitalized, they seem to extend less credit to the private sector. This trend suggests a resource curse whereby revenues accruing from the sale of natural resources reduce government incentive to build effective financial sectors to smooth consumption over time and make the sector less attractive for investment[73]. Often, this translates into inefficient intermediation systems. In Africa, it seems that resource abundance does not necessarily facilitate private sector access to credit.

Beyond finance availability, the issue of private sector access to finance encompasses finance affordability and quality. Africa Finance remains expensive. Beck and others (2011) document high interest rate margins and spreads in Africa. The interest margin for African banks is about 482 basis point compared to 334 for banks from the rest of the world. The high cost of finance, often attributed to the small size of local financial sectors and the high risk of borrowers, represents a barrier preventing the private sector from receiving finance, even when it is available. Related to issue of finance affordability are the excessive collateral requirements for African private sector companies, which are repeatedly cited as one of the main barriers preventing African firms from accessing finance. According to the WBES, collateral for African firms amount to 139 % of loan value on average, and as high as 155 % in ADF countries. Yet, these levels remain inferior or comparable to those observed in other developing regions. For instance, value of collateral represents 133 % of loan value in Eastern Europe and Central Asia and 192 % in Latin America & Caribbean. Notably, many African firms are poorly capitalized and therefore have few tangible assets to offer as collateral.

Perhaps the larger issue is access to long term finance. Local financial institutions are unable to extend loans with long maturities, given their limited access to long-term resources. Most bank credit is short term in Africa: almost 60 % of loans have maturities shorter than one year, while less than 2 % have maturities greater than 10 years (Figure 4.5). Scarcity of long term finance dampens private sector investments and growth potential.

Figure 4.5: Maturity Structure of Loans across Africa

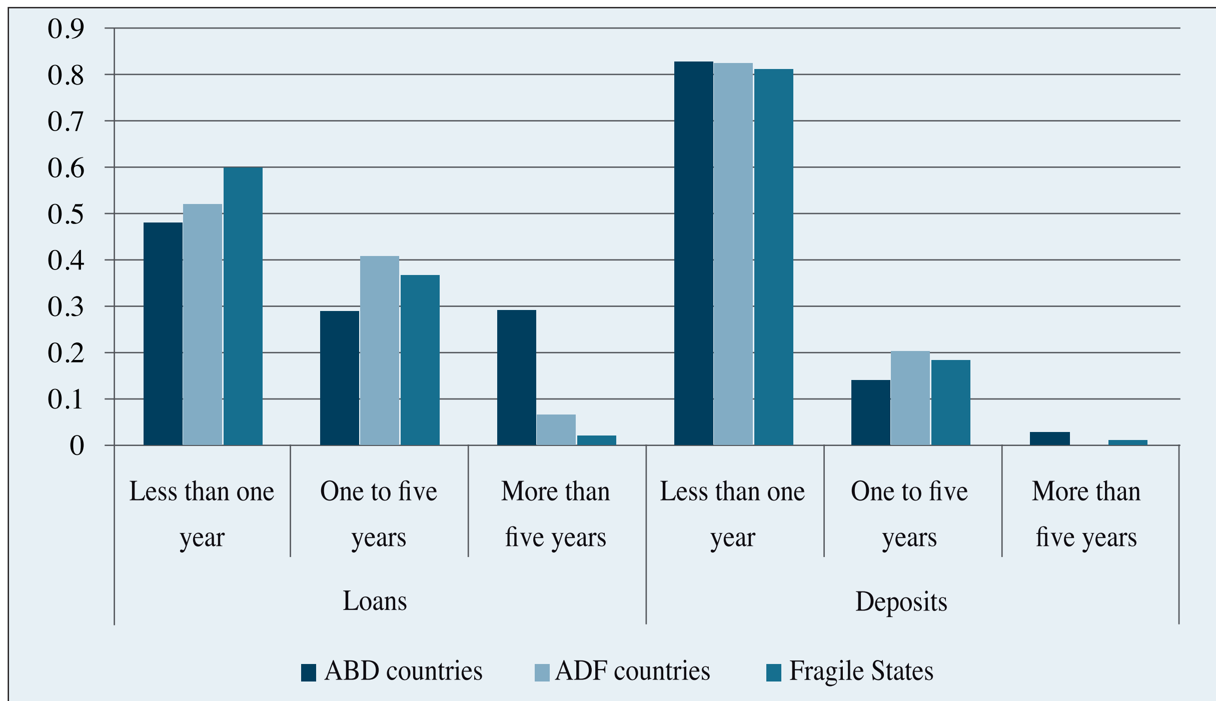


Source: Financial Structure dataset and AfDB/Making Finance Work for Africa database.

73 Beck 2010.

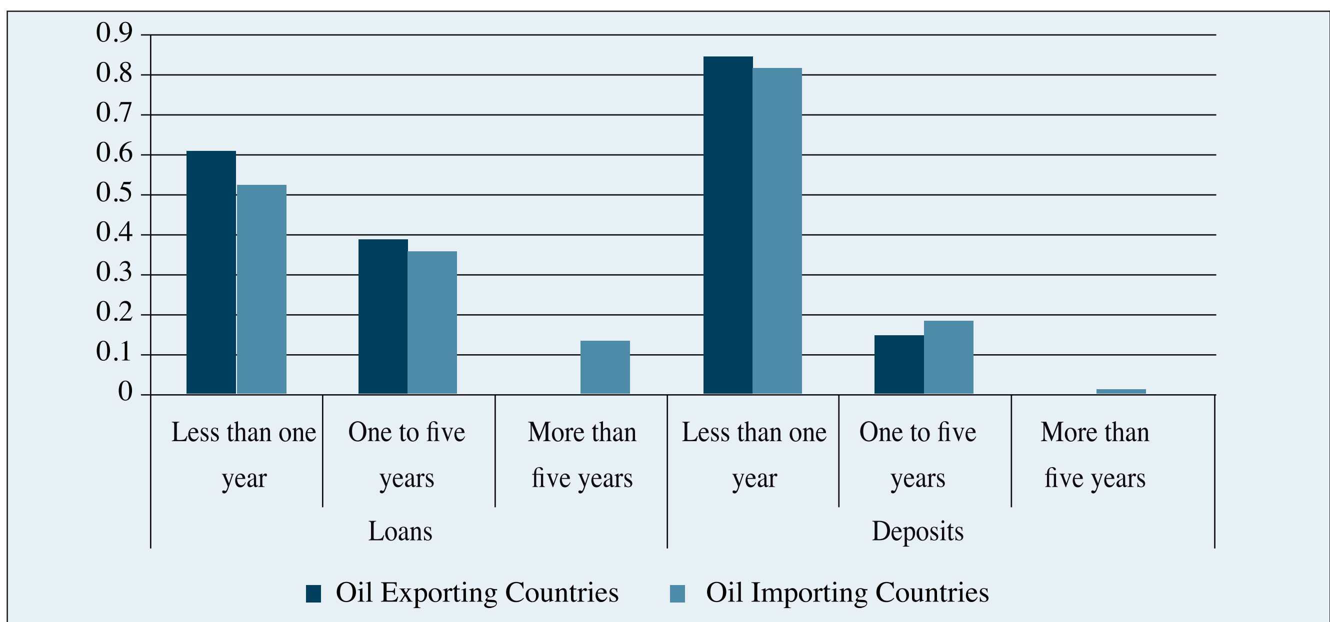
Financial institutions in Fragile States are less likely to provide long-term financing than in ADB and ADF countries (Figure 4.6). This suggests a positive relationship between economic development, political stability, and credit maturity. Oil exporting countries have almost no long-term credit or deposits (Figure 4.7), suggesting that oil revenues fail to facilitate long-term investments. This is consistent with the idea that resource abundance dampens financial sector development and leads to inefficient financial systems.

Figure 4.6: Maturity Structure of Loans and Deposits across Africa by Income Level



Source: Financial Structure dataset and AfDB/Making Finance Work for Africa database.

Figure 4.7: Maturity Structure of Loans and Deposits for Oil Importing and Oil Exporting African Countries



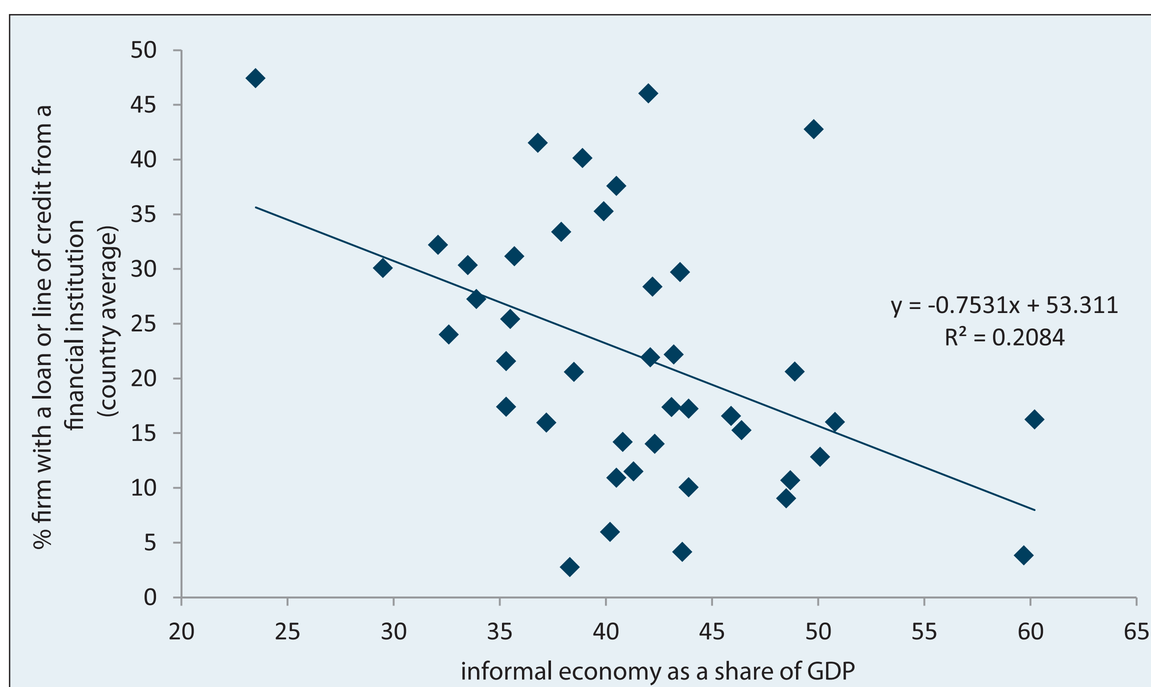
Source: Financial Structure dataset and AfDB/Making Finance Work for Africa database.

Challenges to Accessing Finance in Africa

The political, economic and legal environment, financial sector development and companies' own composition all weigh on businesses ability to access finance.

Political, Economic, and Legal Environment. The economic, political and institutional environments in which African companies operate undermine their capacity to access finance. Macroeconomic and political instability increases risks, which translates into both higher financing costs for financial institutions and a reluctance to lend to the private sector. Moreover, governments saddled with chronic budget deficits borrow frequently and heavily on local markets. Government borrowing often offers attractive returns at a low risk level, reduce banks' appetite to lend to the private sector. Furthermore, a large share of African companies operates in the informal sector (Figure 4.9), which limits their ability to obtain funding from formal financial institutions.

Figure 4.8: Informal Economy and Access to Finance in Africa



Source: AfDB calculation using data from Schneider and others (2010) and the World Bank Enterprise Surveys data.

The legal system seems also to affect the level of credit provided to the private sector. Private credit as a share of GDP has a median of 24 % in common law African countries as opposed to 15 % in civil law countries[74]. This reflects, among others, higher flexibility in common law systems which often allow for innovations that have the potential to improve access to finance. The M-Pesa experience in Kenya is a notable example.

Corruption, red tape, and inefficiencies in contract enforcement also impede financial intermediation and reduce companies' capacity to access finance. In many African countries, the judicial system is not functioning properly as well (Chapter 2), and financial institutions are discouraged to lend because of inefficient, lengthy, and costly asset recovery procedures.

Regulation can also discourage lending to the private sector, either by increasing financial institutions' capital cost or by reducing their desire or ability to cater to the private sector. For instance, Morocco requires microfinance institutions to

74 Beck and others 2011.

have a non-profit association status and limits the amount that MFIs can extend to US$ 3,530. This restricts their capacity to lend to SMEs. Regulatory barriers affect not only funding from financial institutions but also from capital markets. Box 4.1 describes such barriers in West Africa.

Box 4.1: Regulatory Barriers to Access the Bond Market in West Africa

In some cases, regulation is too conservative. For example, the West Africa stock market regulator, the The Regional Public Savings and Financial Markets Council (RPSFMC) requires private companies to offer a guarantee equal to 100 % of the issue value, covering interest payments and borrowed capital. The guarantee must be provided by a bank or the parent company of the issuer and could represent up to 2 % of the loan cost. This guarantee requirement undermines private companies' access to bond funding.

Similarly, the Inter-African Conference on Insurance Markets (CIMA) requires insurance companies in its 14 West and Central African member countries to hold at least 15 % of their regulated commitments in government bonds and no more than 40 % of their holdings in corporate bonds. This reduces the amount of resources that private companies can tap to from these institutional investors.

Source: BRVM authorities.

Financial Systems. Africa's financial systems also have a significant impact on the availability and cost of finance. First, African financial systems are dominated by banks which by nature do not provide equity funding and venture capital and stock markets are underdeveloped. This makes equity finance scarce and excludes de facto companies that are poorly funded and need equity rather than debt financing. Moreover, most African banks focus on asset-based lending and lack the skills to assess applications submitted by SMEs. This creates a missing middle which is too large to be served by microfinance institutions and is too small for banks. African banking systems report low intermediation ratios. On average, African banks transform only 74 % of their deposits into loans, while the intermediation ratio in non-African developing countries stands at 109 % of deposits[75]. Second, most African banking systems are concentrated. Figure 4.9 suggests that African countries with more concentrated banking systems have lower levels of credit to the private sector. Limited competition —not only among banks but also between banks and other financial providers such as leasing companies— is often attributed to high barriers to entry and the small size of African economies, which impedes economies of scale for new entrants. Low saving rates in the continent reduce further the space for potential entrants by limiting resources that banks can mobilize. Low saving rates can limit the banking sector capacity to sustain the economy even when the banking sector is competitive (Box 4.2). Banks are therefore in a position to charge interest rates well above actual costs, making credit unaffordable for many businesses.

Box 4.2: Funding the Economy when Banks Reach their Limits: The Case of Morocco

Bank credit in Morocco expanded by over 20 % a year over the period 2007-2010, driven by stiff competition in the banking sector and the dynamism of the local economy, which was growing by over 5 % per annum.

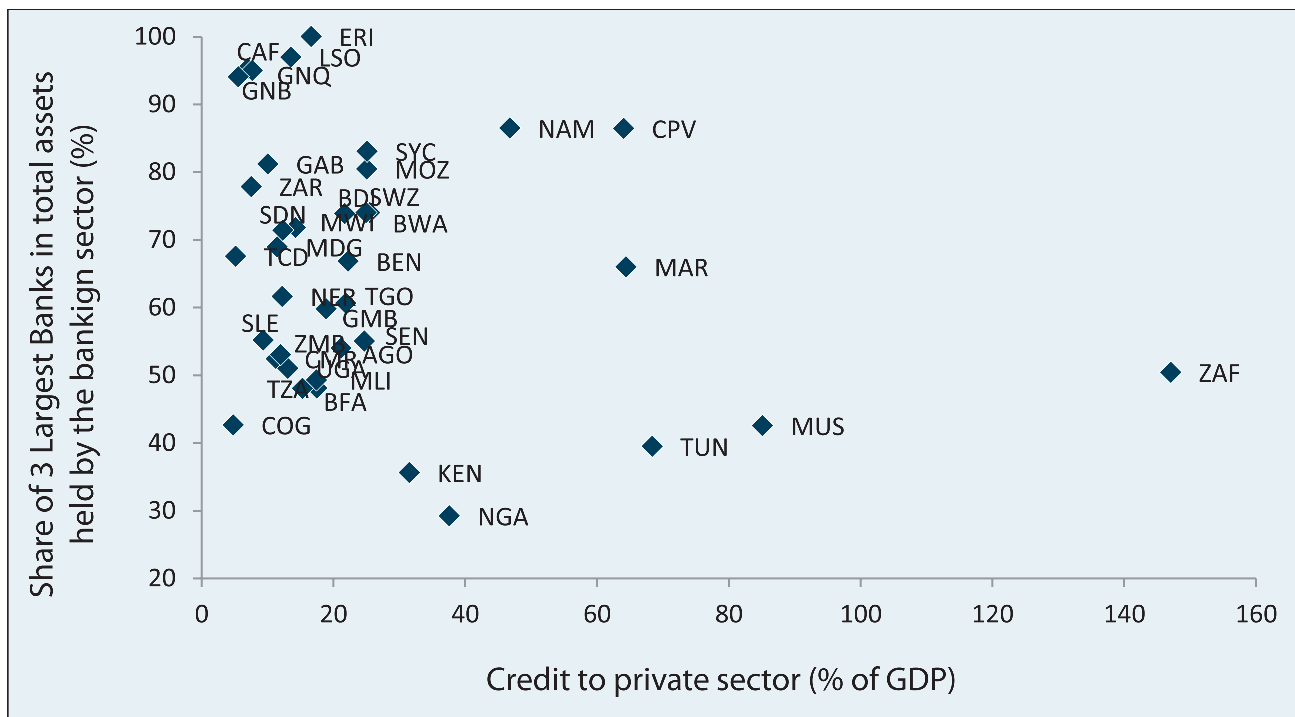
75 Beck and others 2011.

Fuelled by the large number of private and public projects, and the development of the mortgage market, banks are starting to have difficulties keeping pace with the increasing demand for credit. Despite a slowdown in 2009, when bank credit grew by 9.4 % compared to 23 % in 2008, bank loan portfolios continue to grow faster than their deposits. Liquidity was squeezed in 2008 when former state-owned banks were required to increase their solvency ratio from 8 % to 10 %. In response to the crunch, the central bank (Bank Al Maghrib) reduced the minimum reserves ratio several times up to 6 % in 2010. Following the global financial crisis, the central bank also injected significant amounts of liquidity into the system (MAD 15 billion per week) and lowered its base rate from 3.5 % to 3.25 % in March 2009.

In order to keep funding the economy, banks need to mobilize additional resources while dealing with four key ratios: the solvency ratio, the dividend payout ratio, the return on equity ratio, and the single obligor limit. A reduction in the payout ratio will help keep more internally generated funds for bank activities but will penalize shareholders. Improving the return on equity would also generate more funds but is very difficult to achieve given: (i) stiff competition that does not allow for increases in bank margins and (ii) increasing compliance costs, including those generated by Basel II requirements. The third option would be a relaxation of the solvency ratio, which is currently computed on the very conservative assumption that banks lose 30 % of their deposits. The central bank could also increase the limit on single obligor exposure —currently fixed at 20 %— or offer a guarantee structure to help free up part of banks' risk capital. Revising these two ratios without careful management, however, could potentially jeopardize the stability of the banking system.

Over the long term, banks are expected to increasingly rely on the stock and fixed-income markets to raise funds, and resort more frequently to capital increases. Non-bank financial institutions will also have to play a bigger role in funding the economy.

Figure 4.9: Bank Concentration and Credit to the Private Sector, 2009

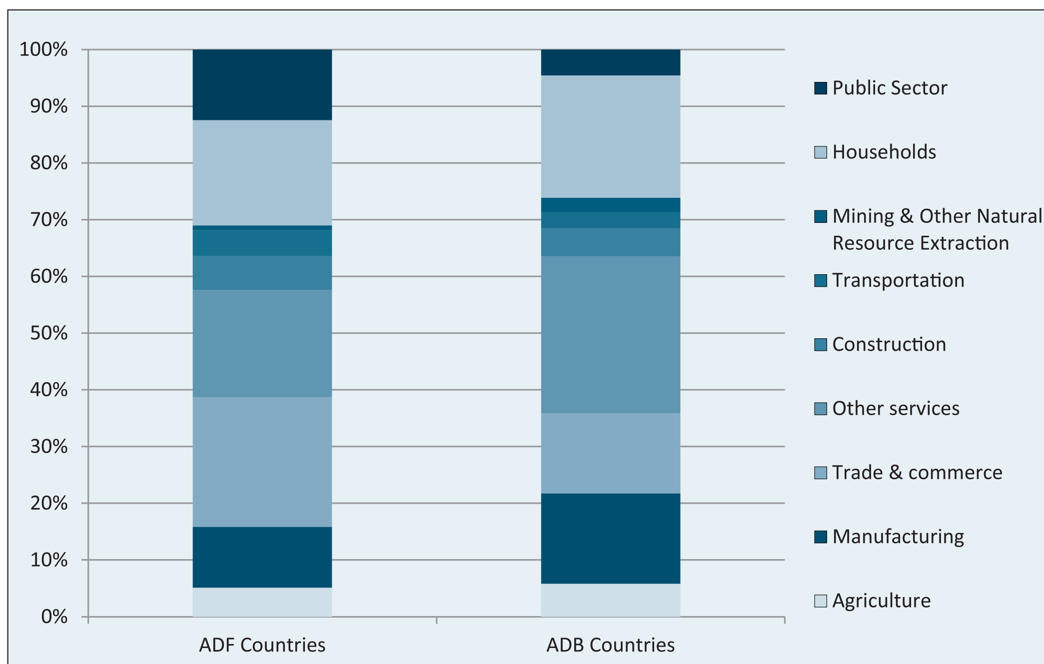


Source: Financial Structure dataset, AfDB/Making Finance Work for Africa database and World Development Indicators.

Company composition. Companies' age, size, ownership structure, sector of activity, and management quality also affect their capacity to access finance. In Africa, SMEs are the backbone of most economies (Chapter 1). These companies often have limited resources and capacity. Lack of management capacity affects companies' ability to translate business ideas into bankable projects and submit loan applications in a professional format. It also leads to poor management of resources which reduces further companies' capacity to repay. The poor quality of applications is related, among other things, to low literacy, the absence of entrepreneurship training (Chapter 7), and the scarcity of market intelligence and statistics. Capacity also affects companies' knowledge and understanding of financial products and their ability to make fully informed decisions. Only a minority of African companies, for instance, understands how private equity and leasing work.

Besides limited capacity, companies' access to finance is affected by their sector of activity. New data show that companies operating in the agriculture and transportation sectors are less likely to receive bank credit than those operating in the manufacturing, trade, services, and construction sectors (Figure 4.10). The severity of the financing constraint in underserved sectors reflects both systemic and specific inefficiencies. For example, agriculture is financially underserved because the sector remains dominated by small scale farmers, vulnerable to external shocks and suffer from unreliable and unclear land tenure and registration procedures which restrict the use of land as collateral. This situation hinders long-term investment in the agriculture sector despite its importance in terms of food security and employment generation.

Figure 4.10: Sector Distribution of Bank Credit to the Private Sector in Africa, 2005-09

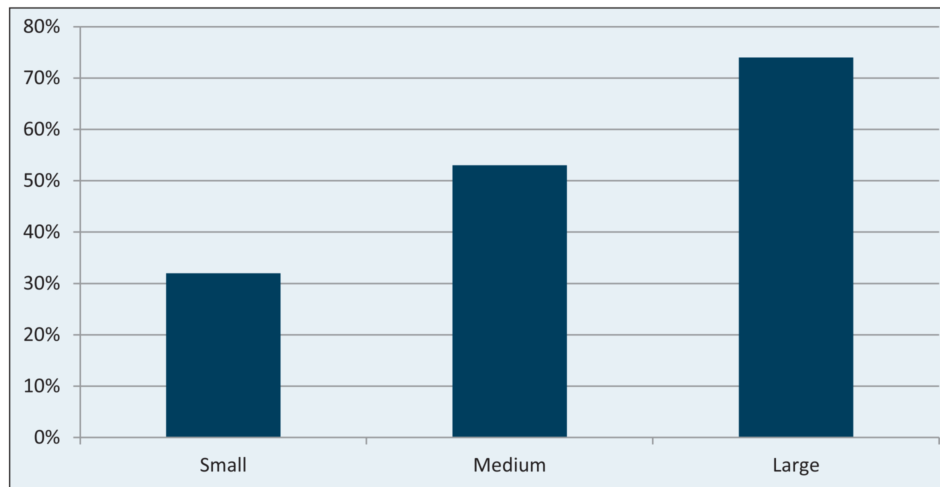


Source: Financial Structure dataset and AfDB/Making Finance Work for Africa database.

Additionally, weak accounting and auditing practices hinder banks' ability to assess applicants' financial situation. In Africa, it is common practice for companies to produce multiple versions of their financial statements for their bank, accountant, and tax authorities. Such practices undermine the credibility of companies' accounts, and therefore financial institutions' willingness to lend. Only one in three small-size firms in Africa produce externally audited financial statements, compared to three quarters of large companies (Figure 4.11). A recent study based on a sample of 14,000 companies in 42 African countries revealed a positive relationship between audited

financial statements and a softening of the finance constraint[76]. Weak accounting practices reflect in a large extent the high level of the informal sector in most African economies.

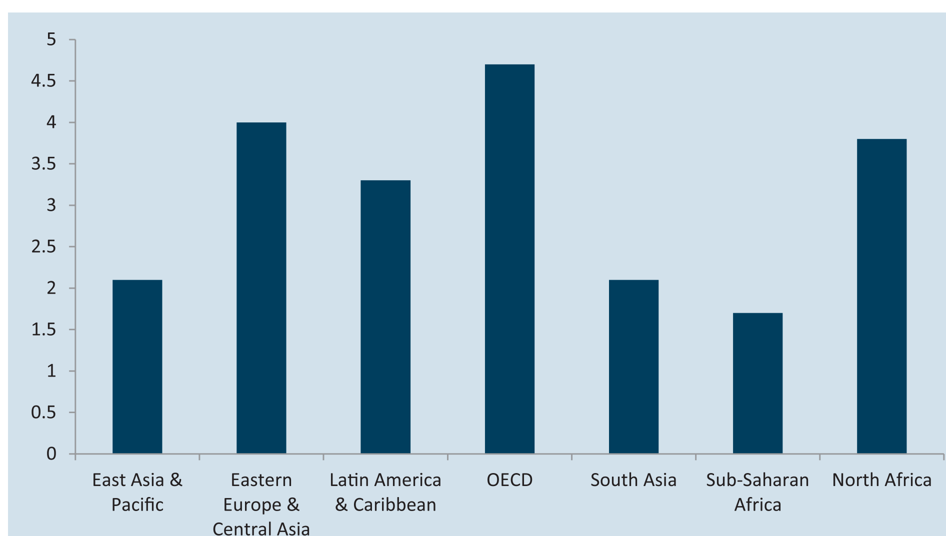
Figure 4.11: Share of Firms with Audited Financial Statements by Size Group in Africa (Percentage)



Source: AfDB calculations using World Bank Enterprise Surveys data.

Information asymmetry at the company level is exacerbated by inexistent or poor functioning credit information systems at the country level. Credit information systems act as information brokers and improve market transparency. Sub-Saharan Africa has the lowest quality of credit information (Figure 4.12). Creating credit information systems in Africa, particularly private credit bureaus, would therefore improve corporate access to finance[77].

Figure 4.12: Depth of Credit Information Index across Regions



Source: World Bank 2009.

76 Triki and Gajigo 2011.
77 Triki and Gajigo 2011.

Addressing the Private Sector's Financing Needs

The financing requirements of the private sector in Africa are enormous. Overall, these barriers revolve around three dimensions: companies' characteristics, the environment in which they operate and the structure of the financial sector that is expected to provide the financing. Hence, addressing the main constraints to accessing finance will require a holistic approach. However, while addressing bottlenecks across the entire value chain makes intuitive sense, African countries have different priorities and needs depending on their level of economic development, natural resource endowment, and political situation. A "one size fits all" approach does not exist and solutions must be adapted to the local context: what suits Tunisia does not necessarily suit DRC.

The lack of financial infrastructure and appropriate regulatory frameworks is more severe in ADF than in ADB countries. This is also the case for banks' capacities in terms of human capital, lending procedures, risk management and IT systems. The priority in ADF countries is create a well-functioning financial system by building an adequate financial infrastructure, shoring up institutions, organizing capacity building programs for both finance providers and regulatory authorities, and designing clear regulatory frameworks that foster competition and innovation within the financial sector. Reforms aimed at improving macroeconomic stability and creating a more conducive business environment for the real sector are also critical.

A well-functioning microfinance sector can support small businesses especially in Fragile States and in some ADF countries where the banking sector is not sufficiently developed. By providing funding to poor individuals and households, microcredit can be an efficient tool for improving access to finance. Sound microfinance institutions can also help address the problem of the missing middle in Africa. DFIs can assist Fragile States and ADF countries in the development of their microfinance sectors, through provision of financial support and technical assistance to microfinance institutions, central banks, and regulatory bodies. Developing microfinance activities could be done in collaboration with existing financial institutions. Initiatives seeking to improve private sector access to financial services that rely on local informal institutions can successfully contribute to easing the financing constraint for small companies (Box 4.3). Notwithstanding, microfinance institutions have been criticized for not reaching the poorest and for charging high interest rates.

Box 4.3: Barclays Microbanking- Susu Collectors Initiative

The Barclays Microbanking- Susu Collectors Initiative is a pilot program seeking to improve access to financial services for small informal businesses excluded from the banking system. Ghana's 4,000 or so informal Susu collectors gather deposits from small businesses daily or weekly. Accumulated savings are given back after about one month, minus a fee. Each Susu collector serves between 200 and 850 small businesses per day. Susu collectors are convenient for small businesses unable to afford high bank fees.

This initiative provides capital to Susu collectors, to be on-lent to small businesses. In addition, financial training is offered to collectors, but also to microfinance institutions and their clients, on topics such as Delinquency Management, Financial Management and Risk Management. In addition, a brainstorming and education platform gave Barclays Bank an opportunity to interact with end-users to help design products adapted to their needs. So far, Barclays has provided ¢2.4 billion (US$ 300,000) in investment capital to this program.

Source: Growing Inclusive Markets.

Beyond Banking. Improving access to finance requires a broader approach than the credit-led strategy conducted through microfinance institutions. This calls for innovative solutions. For

instance, advances in mobile phone technology can substantially enhance access to finance. What has started with the successful experience of M-pesa in Kenya could be a silver bullet for Africa. First, by reducing the required investment in physical branches, mobile technology can help financial institutions improve their outreach, especially in rural areas. This would lead to economies of scale and eventually lower cost of finance. Second, mobile technology offers small companies more flexibility to receive payments from clients and to make their orders which could translate into lower working capital needs. Third, mobile phones could be used to receive market information or managerial support. This is particularly useful for smallholders who often struggle to find information about prices for their crops. More recently, mobile phones have been used to improve access to risk management tools which have the potential to smooth companies' revenues and enhance their capacity to receive credit and repay. For instance, Safaricomm and UAP, a Kenyan insurance company, partnered to offer a "safe farming" contract to smallholders.

Developing financial products for SMEs would also help address the specific financing challenges that these business face. This can be encouraged for instance by pushing existing institutions down market. For example, South African banks, through the Mzansi account and Moroccan banks, namely Banque Centrale Populaire (BCP) and Attijari Wafa have embarked in low income banking experiences that helped improve their outreach to low income population and small businesses.

Non-bank financial institutions, such as leasing and factoring companies, also need to be supported. Since a large share of African private enterprises is financially constrained, leasing is a useful instrument to acquire machinery and equipment necessary for growth without requiring collateral. Leasing also reduces investment costs, which should help foster entrepreneurship activities. However, despite efforts led by DFIs and other donors, leasing activities remain embryonic in Africa. Similarly, factoring provides companies with immediate funds needed to finance either working capital or short-term investments, while reducing risk. The factoring company buys accounts receivables at a discount and takes on the firm's client-default risk. With the exception of a handful of African ADB countries, however, factoring activities are nonexistent in Africa (Table 4.4). Yet, developing the leasing and factoring sectors requires the implementation of clear regulatory frameworks, and programs to familiarize companies with the functioning and value added of these sources of finance. It would also require addressing bottlenecks in asset repossession, which might involve the establishment of non-court resolution systems.

Table 4.4: Factoring Activities in Selected African Countries in 2009

	Egypt	Mauritius	Morocco	South Africa	Tunisia
Number of Factoring Companies	4	2	6	5	3
Domestic Factoring Turnover (in Millions of EUR)	35	120	750	13,3	250
International Factoring Turnover (in Millions of EUR)	75	1	160	200	26
Total Factoring Turnover (in Millions of EUR)	110	121	910	13,5	276

Source: Factors Chain International.

Fostering the development of the contractual savings industry, private equity activities, and a business environment conducive to FDI would help increase long-term finance. Insurance companies, as well as pension and social security funds, are potential providers of long-term resources

not only for financial markets, but also for the real sector. In bank-based systems, contractual savings development is correlated with firms' debt maturity profile[78]. However, this would require concerted efforts to stabilize the macroeconomic environment through prudent monetary and fiscal policies and to revise the regulatory framework governing these institutions' activities.

Besides provision of long-term finance, private equity offers management assistance as well, which is critical for private sector development in Africa (Box 4.4). The development of the private equity industry requires regulatory reforms, fiscal incentives, and capacity building for regulators. Institutional investors could be encouraged to support the development of this sector. For example, regulation 28 of South Africa's Pension Fund Act recently increased the share of assets that South African institutional and retail investors could invest in private equity from 2.5 % to 10 %. This new regulation should boost the value of assets managed by private equity funds, as it applies to the US$ 167 billion managed by private pension funds and the US$ 151 billion in assets held in the Government Employee Pension Fund.

Box 4.4: Value Added of Private Equity Funds in Africa

Private Equity Funds (PEF) in Africa invest in SMEs with significant growth potential. Private equity funds can provide the capital and management expertise desperately needed for small African firms to thrive. Even though the private equity market is nascent in Africa, the deals to date have a positive impact on employment, sales growth, innovation, and profitability. As illustrated in Table A, PEF-backed companies have been growing, exporting, and creating jobs at a higher pace than other firms. Sales of firms funded by PEF grew by an average of 20 %, compared to 18 % in companies listed on the Johannesburg Stock Exchange (JSE).

Table A : Employment and Sales of SMEs funded by PEF

Indicator	Average	#	Country	Period	Benchmark performance
Panel A: Sales growth performance					
Total sales growth	20 %	90	South Africa	2005-2009	18 % (JSE listed businesses)
Annual sales growth	30 %	92	Morocco	1993-2008	NA
Annual sales growth	22 %	26	Tunisia	1997-2010	NA
Panel B: Employment Growth Performance					
Annual worldwide employment growth rate	9 %	37	South Africa	2005-2009	4 % (JSE listed businesses)
Annual domestic employment growth	10 %	79	South Africa	2005-2009	1 % (all businesses in South Africa)
Annual employment growth	17 %	92	Morocco	1993-2008	2.98 % (North Africa)
Annual employment growth	23 %	27	Tunisia	1997-2010	2.98 % (North Africa)

PEF also fosters innovation. Over two thirds of PEFs-backed companies introduced new products and/or services. Their research and development expenses also grew by 7 % a year from 2005-09, compared to 1 % in JSE listed companies. In addition, PEFs have been helping out underprivileged groups set-up viable and sustainable enterprises. The number of black-owned enterprises tripled post investment to reach 52 %. Similarly, in 2007, 69 % of total PEF funds had at least 5 % of black ownership.

78 Impávido and others 2001.

Employment and Sales Growth Performance of PEF- Backed Companies.

Returns reported on PEF deals in Africa show that these benefits do not come at the expense of profitability. A survey by the Moroccan Venture Capital Association, for instance, found that 26 exited deals made by private equity funds generated on average an internal rate of return of 26.85 %.

Source: AfDB calculation using data from different fund managers, De Beer and Nhleko 2007; AMIC, 2010; and ILO 2010.

The development of a thriving private equity industry would require efforts on the demand side as well. Initiatives to support the sector could prove to be unsuccessful if they are not accompanied with capacity building programs to help companies understand the benefits of private equity funds and how it functions (Box 4.5).

Box 4.5: The Small and Medium Industries Equity Investment Scheme (SMIEIS) in Nigeria

The Small and Medium Industries Equity Investment Scheme (SMIEIS) was set up in 1999 under the leadership of the Central Bank of Nigeria to increase access to finance for small businesses. It requires all banks reporting profits to set aside 10 % of their pre- tax profits to invest in SME equities. By doing so, the SMIEIS was expected to lower financial constraints faced by SMEs while harnessing the advisory, technical, and managerial skills of the banking sector. Firms from all sectors were eligible to benefit from the SMIEIS except those involved in trading, merchandising, and financial services. Eligible firms were also allowed to receive loans from commercial banks in addition to equity investment under the SMIEIS. Commercial banks unwilling to invest in SMEs were penalized by the Central Bank.

As of December 2005, the total amount set aside by banks under SMIEIS exceeded Naira 38 billion. However, only 27.5 % of funds set aside by banks had been utilized as of September 2005. Potential beneficiaries instead relied on personal savings, bank loans, relatives and friends to fund their startup capital or expansion. This reflects, among other things, lack of familiarity with the benefits of private equity financing.

Source: Central Bank of Nigeria and Abereijo and Fayomi 2006.

Bond and Stock Markets. In ADB countries, the development of corporate bond markets can provide an attractive source of long-term financing. This requires actions to address the limited and undiversified investor base, as well as the inefficiencies in bankruptcy and listing procedures that plague most African systems. The creation of credit rating agencies to assess the creditworthiness of private enterprises would also facilitate market activities and bond pricing. With governments and the private sector competing for the same pool of savings, reducing fiscal deficits would maximize potential credit to the private sector. Private enterprises in ADB countries and a few ADF countries (such as Nigeria, Ghana, Kenya, and Tanzania) could also rely on stock markets, which have helped finance the expansion of large African enterprises, to fund investmen[79]. Over the period 1995-2002, 12 % of total asset growth of listed companies in Ghana was financed through the stock market.

Additional measures beyond the privatization programs adopted in the 1990s would encourage the development of stock exchanges in ADB countries. For instance, efforts should be made to develop financial infrastructure, reduce listing fees, and

79 Yartey and Adjasi 2007.

develop the capacity of regulators. Market segments with relaxed listing rules can also be developed to help SMEs access funding (Box 4.6). Stock markets would also benefit from financial literacy programs helping companies understand the benefits of listing and from the promotion of institutions that drive stock markets liquidity, such as pension funds, credit rating agencies etc.

Box 4.6: Improving SMEs Access to Finance through Stock Markets

South Africa's AltX was set up in 2003 as a window within the JSE dedicated to small and medium-size companies with high growth potential. A registered advisor is designated to assist eligible companies through the listing process, the initial public offering and helps them maintain their status once listed. Along with AltX, the Directors' Induction Programme (DIP), a compulsory education program offered to managers of AltX-listed companies on issues such as corporate finance, management and governance, was set up.

Egypt's Nile Stock Exchange (Nilex) is a platform within the Cairo and Alexandria Stock Exchanges (CASE) launched in 2007 to facilitate SMEs access to stock markets. Yet trading only started in 2010. Nilex has relaxed listing rules compared to the CASE, including lower minimum capital and fewer share requirements. Similar to AltX, an advisor is nominated to help eligible SMEs prepare their financial statements, comply with the listing rules and complete the initial public offering of their shares. Advisors can be selected from financial consulting firms, investment banks and underwriters, private equity firms, etc.

AltX has been quite successful and allowed several SMEs access funding through the stock market. The Nilex initiative is too recent for its full impact to be assessed, and it has been affected by the recent political events in Egypt. Still, both experiences show that establishing stock markets with relaxed listing rules needs to be accompanied with capacity building programs for companies to understand the benefits and procedures of listing, and potentially with some financial support to help SMEs bear the cost of listing.

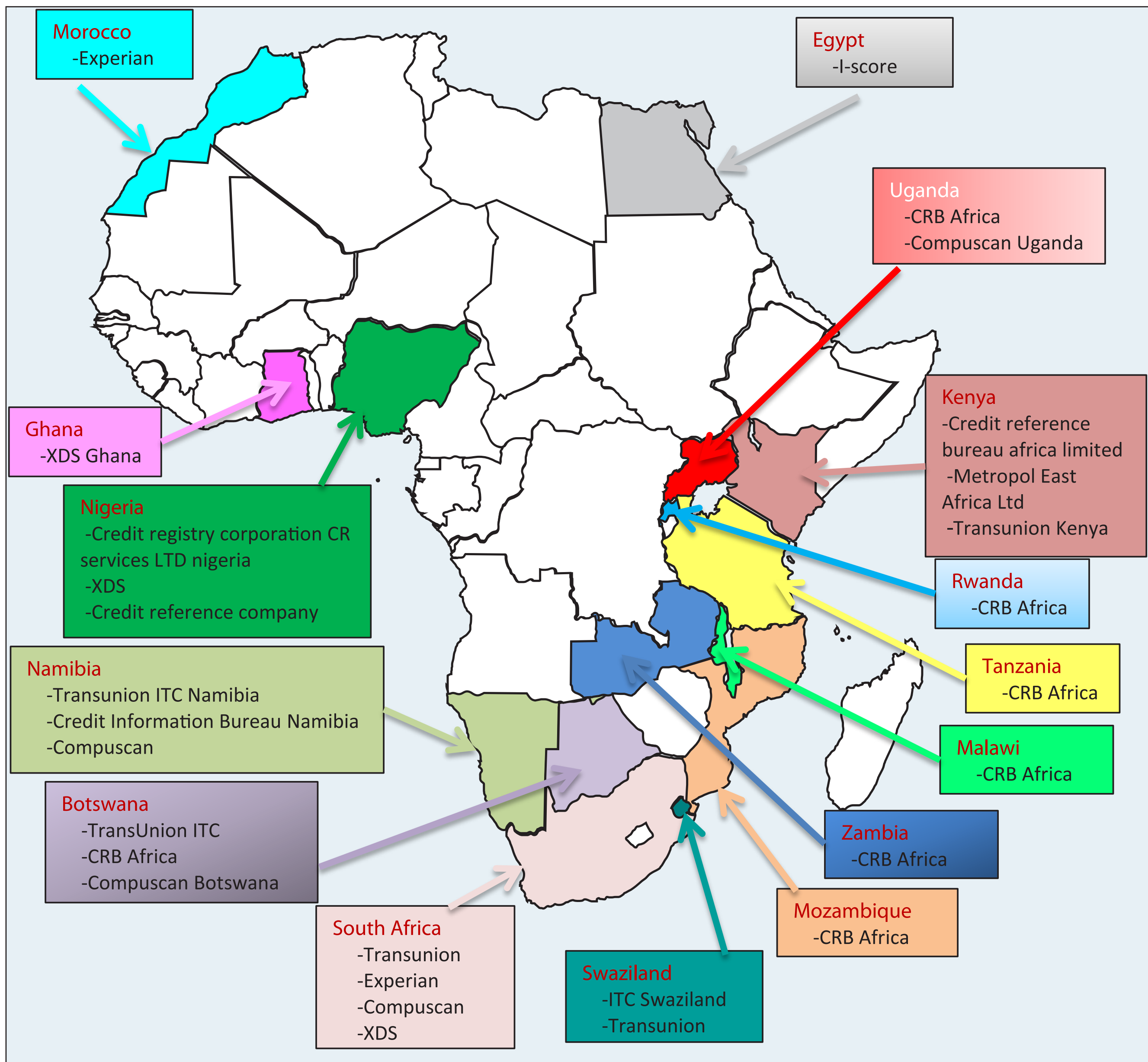
Source: EGX, JSE and Nilex.

Guarantees. Guarantee schemes also have the potential to enhance banks' appetite to lend to the private sector, especially to SMEs. Guarantee funds could help alleviate the collateral problem by shouldering the risk of default. Different categories of guarantee schemes have been developed in Africa, mainly as a result of governments' or Development Finance Institutions' initiatives. Such initiatives include the Guarantee Fund for Private Investment in West Africa (GARI), the African Fund for Guarantee and Economic Cooperation (FAGACE) and the Guarantee for Bank Loans of the French Development Agency (ARIZ). Guarantee schemes should be designed in a way that minimizes moral hazard while ensuring the highest coverage against credit risk. The effectiveness of these schemes depends on the quality on their management and their adaptability to local contexts.

Credit Bureaus. The issue of information asymmetry and collateral could be addressed through the creation of private credit bureaus (Figure 4.13). Progress has been made to set up private credit bureaus in Africa, but further efforts are needed. Empirical evidence and current initiatives supported by Bretton Woods' institutions seem to favor the private credit bureau model. Recent research indicates that public credit registries could help alleviate the financing constraint if their design includes certain features (Box 4.7)[80]. This is particularly attractive for small and fragile African countries which often fail to attract private initiatives. Yet, research shows that the financing constraint is less severe in countries with private credit bureaus compared to those with public credit registries.

80 Triki and Gajigo 2011.

Figure 4.13: Private Credit Bureaus in Selected African Countries



Source: AfDB compilation.

Box 4.7: The Benefits of Public Credit Registries and Private Credit Bureaus in Africa

Credit registries can facilitate the cost-effective exchange of accurate and timely credit information, which allows financial institutions to assess borrowers' creditworthiness. This should translate into lower barriers to access finance, especially for SMEs which often suffer from high levels of information asymmetry. Credit registries help potential borrowers use their reputation, rather than tangible assets, as collateral. Credit registries can be either private credit bureaus or public credit registries hosted within the central bank.

Access to finance is on average higher in African countries that established private credit bureaus, relative to countries with public credit registries or countries with neither institution. This finding could be explained by differences in the mandates of these

institutions. Indeed, while credit bureaus are private institutions created to address the problem of information asymmetry in credit markets, private credit registries are publicly managed initiatives designed to supervise systemic risks in the banking sectors and should therefore have limited effects on firm's ability to access finance. However, the positive relation between improved access to finance and the presence of a private credit bureau is not robust to control for the country level of economic development which suggests that financial sector development and the creation of a private credit bureau may be simultaneously determined.

On a related note, credit registries that collect positive and negative information on borrowers are more efficient in softening the financing constraint while provision of online credit information and reduction of the minimum cut-off for loan coverage improve credit registries' effect on access to finance only when the country has a high internet penetration rate and the registry collects both positive and negative information respectively.

Source: Triki and Gajigo 2011.

Conclusion

This chapter discusses access to finance by the private sector in Africa. It first compares Africa's performance to other developing regions and shows that Africa is still lagging behind despite progress made over the past decade. African firms continue to rely on internal financing sources to a much greater extent than their peers in other developing regions. Next, variations across the continent are highlighted based on aggregations by income level, endowment in oil resources and political stability. The chapter discusses the lack of depth and breadth in African financial systems, scarcity of long term finance and highlights a resource curse that is undermining private sector access to finance. The chapter also discusses barriers preventing private sector from accessing finance and argues that these barriers are related to 3 dimensions: the country institutional environment, the extent of financial sector development, and firms' characteristics. The institutional environment encompasses regulation, macroeconomic conditions and political stability. Financial sector development spans across the structure of the financial sector, the level of competition and concentration, and availability of financial infrastructure. Firm's characteristics that may discriminate against access to finance cut across size, age, ownership structure (both in terms of foreign ownership and gender), and its capacity to provide audited financial statements.

The problem of limited access to finance must be solved holistically to address bottlenecks across the entire value chain. Indeed, efforts are needed, not only, on the supply side but also on the demand side through capacity building and literacy programs. Moreover, sequencing of reforms and initiatives should be carefully thought. It is also necessary to avoid the "one size fits all" approach and to adapt solutions to the local context. Differences in access levels highlighted in the chapter build the case for such approach. Finally, innovative approaches and institutions should be encouraged. For instance, mobile technology could be Africa's silver bullet to improve private sector access to finance.

Chapter 5 :

HUMAN CAPITAL AND SKILLS DEVELOPMENT

Human capital and skills contribute to PSD through the initiation of ideas, the translation of ideas into goods and services, and the creation of value. This chapter examines the importance of human capital and skills development for PSD in Africa. It focuses on graduates and institutions in tertiary education, and whether these institutions are responsive to changes in knowledge, labor markets, and economic development. It also examines why the private sector suffers from skill shortages when unemployment is high among graduates, and the policies that can successfully address Africa's skills gap. It concludes that in the short run, human capital development should focus on providing short, practical courses to secondary and higher education graduates involving primarily on-the-job training. In the long run, there is a need to change the way students are trained, including curriculum reforms that favor science, technology, engineering, and mathematics. Emphasis should also be placed on critical thinking, problem solving, discovery, and experiential pedagogy rather than rote learning.

Introduction

Human capital—defined as the "stock of economically productive human capabilities"[81]—encompasses knowledge, health, skills, entrepreneurial talent, determination and other human traits that lead to success in endeavors. These capabilities are formed by combining innate abilities with investment in human beings. Human capital is obtained through general education and is transferable from one enterprise/endeavor to another. Skills are a subset of human capital specific to a particular task, job or enterprise and are obtained through specialized education or training, such as carpentry or dentistry.

Human capital and skills may play different but complementary roles in the growth and development of the private sector. General human capital may be used to generate ideas, form a company, and develop new products. Skills, however, are required to produce the product/service at competitive prices. This chapter focuses on the knowledge and skills aspects of human capital, including their acquisition, dissemination, and application to PSD in Africa.

Human capital is crucial to improve total factor productivity and to help countries adopt, and adapt to new technologies[82,83]. Up until the early 1990s, primary education was widely believed to have a greater impact on alleviating poverty than secondary and tertiary education, a belief that has since been challenged[84]. Higher education promotes economic development by enabling countries to catch up with technology. Thus, in today's knowledge-based global economy, the role of tertiary education should be emphasized in African countries' development strategies.

Knowledge and skills are central not only to make labor and capital more productive, but also to technical progress-the major source of private sector development and sustained growth.

81 McGraw Hill Encyclopedia of Economics 1993.
82 Miller and Upadhyay 2002.
83 See for example, Bartel and Lichtenberg (1987); Foster and Rosenzweig, (1995); and Kumar (2003).
84 Bloom and others 2006.

Higher technical and vocational skills enhance the competitiveness of economies and contribute to social inclusion, decent employment and poverty reduction. They can open doors to economically and socially rewarding jobs and support the development of informal businesses. These skills can also promote the re-insertion of displaced workers and migrants, and assist the transition to work for school drop-outs and graduates. Developing job-related competencies among the poor, the youth, and the vulnerable that are relevant to the private sector will contribute to inclusive growth and poverty reduction on the continent.

Human capital and skills contribute to PSD in three distinct ways: the initiation of ideas, the translation of these ideas into products and services, and the creation of value. Although human capital may be imported in the short run, domestic sources of human capital are necessary to sustain economic development. Human capital and skills can be developed formally through a country's educational system (especially through tertiary, technical, and vocational institutions) or informally through apprenticeships and learning by doing. The quality of human capital determines the productivity and, ultimately, the growth and development of enterprises. Companies that create, disseminate, and use knowledge (i.e., companies built on human capital) are the ones that survive and grow, while those that do not die[85]. Shortages of human capital and skills therefore place Africa at a significant competitive disadvantage.

Current Status of Human Capital and Skills in Africa

Tertiary Education Enrolment

In spite of the significant resources that have been invested in tertiary and vocational education, Africa suffers from crippling shortages of human capital and skills. Only 1 % of African adults had completed tertiary education by 2010, compared to a global average of 3.9 %. The gap was even more pronounced in sub-Saharan Africa (Table 5.1). Similarly, Africans spend less time in higher education than adults in other regions (Table 5.1).

Table 5.1: Tertiary Educational Attainment in Africa and the World

Country/Region	Percentage of adult population that has completed tertiary education	Average years of tertiary education attained
World		
Advanced Economies	3,9	0,20
South Asia	7,1	0,79
Latin America & the Caribbean	1,0	0,37
Middle East	3,0	0,39
Europe & Central Asia	3,2	0,47
East Asia & the Pacific	5,0	0,49
Africa	2,7	0,50
Sub-Saharan Africa	1,0	0,12
Egypt	0,8	0,08
Mauritius	1,2	0,31
Tunisia	0,9	0,09
South Africa	6,2	0,21
Kenya	0,6	0,09
Ethiopia	2,0	0,08
Botswana	0,4	0,02
Botswana	2,7	0,13

Source: Barro and Lee 2010.

85 Nonaka and Takeuchi 1995.

Table 5.2: Human Capital Indicators in Selected African Countries (2008, unless noted)

Indicators	*Angola*	Congo Rep.	Ghana	Mauri-tius	Nigeria	Sene-gal	South Africa	Tunisia	Algeria	Egypt	Mo-rocco
Life expectancy at birth, total (years)	47,0	53,6	56,6	72,6	47,9	55,6	51,5	74,3	72,4	70,1	71,3
Adult literacy rate (% age 15 and above)	69,6	--	65,8	87,5	60,1	41,9 [d]	89,0	78,0	72,6 [d]	66,4 [d]	56,4
Youth literacy rate (% age 15-24)	72,9	80,5 [a]	79,3	96,4	71,5	50,8 [d]	96,8	96,8	91,8 [d]	84,9	76,6
School enrolment, secondary (% gross), 2007	--	43,1 [c]	55,2	87,6	30,5	30,6	95,1	90,2	83,2 [a]	79,3 [b]	55,8
School enrolment, tertiary (% gross)	3,0 [d]	3,9 [c]	6,2 [e]	25,9	10,1 [a]	8,0	15,4	31,6	24,0	28,9	11,3
Scientific and technical journal articles, 2007	3,2	20,9	109,4 [e]	17,8 [e]	427,4	68,4 [e]	2 804,6	757	480,7	1 934,4	378

Note: a2005, b2004, c2003, d2006, e2007.

Source: World Bank data.

These averages mask substantial intra-regional variations and gender inequality in educational attainment. The stock of human capital and, in particular, tertiary education human capital in Africa is therefore low (Table 5.2).

Between 2003 and 2008, enrollment in African universities increased from 2.34 million to 4.14 million, a rise of 77 % compared with 53 % worldwide over the same period. Yet in spite of this increase, Africa gross enrollment ratio (GER) was only 6 % in 2008, much lower than the global average of 26 %[86]. GER in Sub-Saharan Africa's tertiary education rose faster than any other region, with growth rates averaging 8.6 % per annum between 1970 and 2008 compared to the global average of 4.6 %[87]. Variations within the region are substantial: although nine countries in sub-Saharan Africa exceeded the regional average in 2009, 10 countries recorded very low GERs. In addition, most tertiary education students are enrolled in the humanities and social sciences, and few study Science, Technology, Engineering and Mathematics (STEM).

Successes and Challenges in Education. The successes and challenges in the education sector are highlighted below, with special reference to tertiary education enrolments in selected African countries.

Access to tertiary education in Botswana has significantly improved, with student enrolment increasing by 139 % from 20,011 in 2003/04 to 47,889 in 2008/09. Enrolments increased dramatically in 2007/08 following a decision by the Government to sponsor students' participation in local private tertiary institutions registered by the Tertiary Education Council.

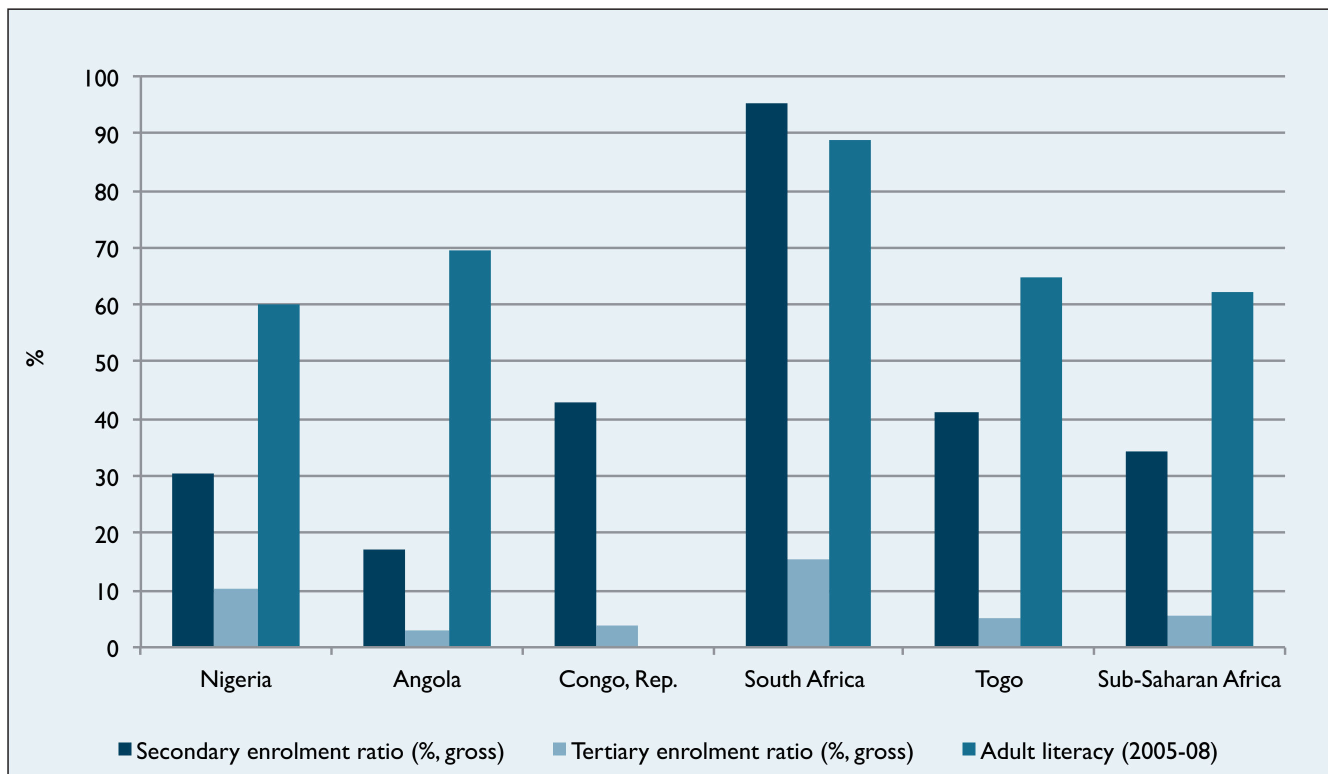
Mauritius outperforms regional educational indicators by substantial margins. The tertiary enrolment rate in Mauritius is 26 % compared to 6 % for sub-Saharan Africa[88]. The country's main challenge is upgrading its tertiary education

86 UNESCO Institute for Statistics 2010 (a).
87 Ibid.
88 UNESCO Data Centre.

system in order to become a knowledge hub for the region[89]. Mauritius has achieved universal primary education, and its education system is strong by regional standards. Its literacy and net enrollment rates were 87 % and 97 %, respectively, in 2008. The gender parity index is 1.0 at the primary level. It had a gross tertiary education enrolment rate of 41 % in 2008. In Mauritius, tertiary education is provided by 7 public universities/ institutes, 55 private institutions, and 76 awarding bodies, involving programs mostly in information technology, law, management, accountancy and finance.

Namibia's tertiary education enrolment rate is 9 % compared to an average of 6 % for Sub-Saharan Africa. Youth literacy rates stand at 93 % relative to 71.2 % for Sub-Sahran Africa[90]. Although Nigeria's secondary enrolment and literacy ratios are below the regional average, tertiary education enrolment ratios—while low relative to international norms—are significantly higher than the average for Sub-Saharan Africa (Figure 5.1). This is mainly due to cumulative number of students who every year have to wait to enter tertiary institutions, the recent surge in the number of private universities, and large population of foreign students from other African countries. With women representing about 40 % of total tertiary enrolments, Nigeria also outperforms many other African countries on gender parity.

Figure 5.1: Enrolment and Adult Literacy Average Rates in Selected African Countries, 2001-09*



Source: UNESCO Institute for Statistics 2010 (a).

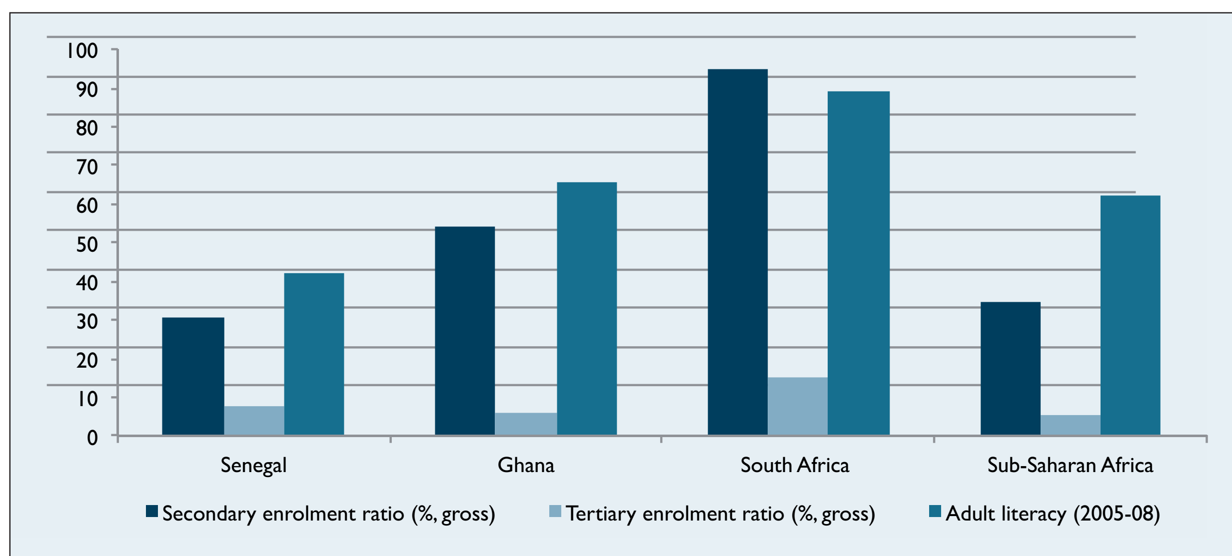
* Data on tertiary education for South Africa are for 2007.

Although South Africa's tertiary education enrolment ratios are relatively low vis-à-vis international standards, they are higher than the average for sub-Saharan Africa, Senegal and Ghana (Figure 5.2).

The higher education sector in South Africa went through major changes in the past decade as a result of institutional mergers and the creation of universities of technology. South Africa now has

89 AfDB 2009.
90 UNESCO Data Centre.

Figure 5.2: Senegal, Ghana and South Africa – School Enrolment (2001/2009) and Adult Literacy (2005/2008)



* Data on tertiary education for South Africa are for 2007.
Source: UNESCO Institute for Statistics 2010 (a).

23 public institutions, including 11 universities, six comprehensive universities, and six universities of technology. An estimated 761,090 students were enrolled in public higher education in 2007, representing 1.6 % of the population[91].

South Africa's tertiary GER stands at 15.4, compared to 43.5 for upper middle-income countries. Yet, South Africa spends marginally more on public education (5 % of GDP) than other economies with a similar income level. The South African participation rate – measured by the total headcount enrolment as a proportion of the total population between the ages 20 to 24 – stands at 15.9 %, below the 20 % target. Participation rate declined between 2004 and 2007, despite the growth in the number of headcount enrolments across the system (from 744,489 in 2004 to 761,090 in 2007). This is partly explained by the fact that the capacity of the public higher education institutions is limited by the availability of staff and infrastructure, falling enrolments in some disciplines such as computer science and the decline in the proportion of the national budget going to higher education. Access is still heavily skewed by race, with relatively high participation rates for people classified as white and Indian, and relatively low participation rates for people classified as African and colored.

Tunisia has made investing in human capital an integral part of its economic and social policies[92], and higher education has been a priority in the country's development and growth strategies for several decades. While tertiary enrolments increased in all four North African countries over the period 1980-2008, the increase in Tunisia was more pronounced compared to the other countries in 1990-2008 (Figure 5.3): the tertiary Gross Enrolment Rate (GER) more than doubled between 1990 and 2000, and increased by 75 % in 2000-2008.

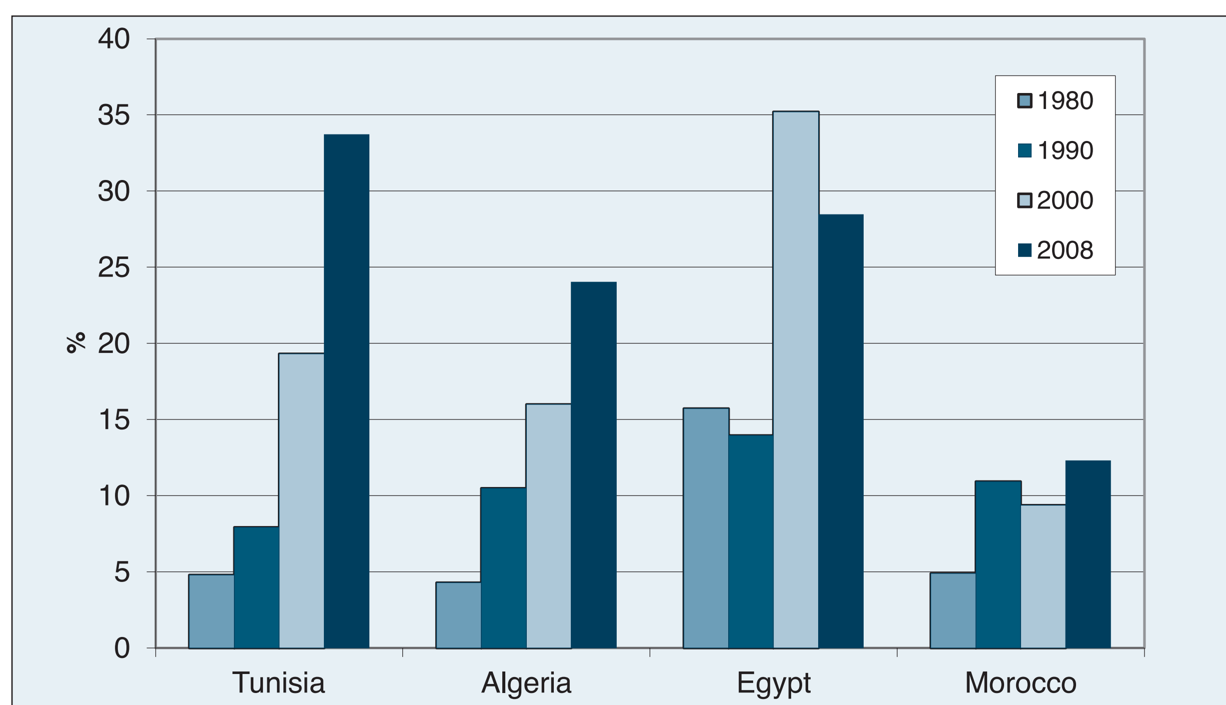
Tertiary Education Expenditure

Spending on tertiary and vocational education in Africa has been significant when compared to other regions. In 2006, Africa spent 0.8 % of GDP in these areas, compared to 0.7 % in other developing economies, 1.2 % globally and 0.8 % in OECD countries[93]. The ratio of expenditure per student to GDP per capita was much higher in Africa (2.9 in 2007) than in the rest of the world (1.2) and in OECD countries (0.3)[94].

91 CHE 2009.
92 Baliamoune-Lutz 2009 (a).
93 World Bank 2010 (a).
94 Gyimah-Brempong and Ondiege 2011.

Table 5.3 shows public education expenditures in selected African countries to demonstrate the high shares of expenditures that these countries are allocating on education. For instance, Botswana's spending on public education (8.1 % of GDP) is amongst the highest on the continent (Table 5.3). Much of the public education expenditure is absorbed by secondary and tertiary education – 48 % and 32 %, respectively – unlike most of sub-Saharan Africa, where the bias tends to be towards primary education.

Figure 5.3: Tertiary School Enrolment in North African Countries* (Percentage gross)



* The years for Egypt are 1980, 1990, 1999 and 2008 and for Algeria are 1980, 1990, 2001 and 2007.

Source: AfDB 2011.

Table 5.3: Public Education Expenditure in Selected African Countries, 2008*

	Botswana	Mauritius	Namibia	South Africa	Tunisia	Algeria	Egypt	Morocco
As % of GDP	8,1	5,1	6,5	5,1	7,2	4,3	3,8	5,7
As % gov. expenditure 2008	21,0	12,7	22,4	16,2	22,4	20,3	11,9	25,7

* Tunisia data are for 2007.

Source: World Bank, World Development Indicators database.

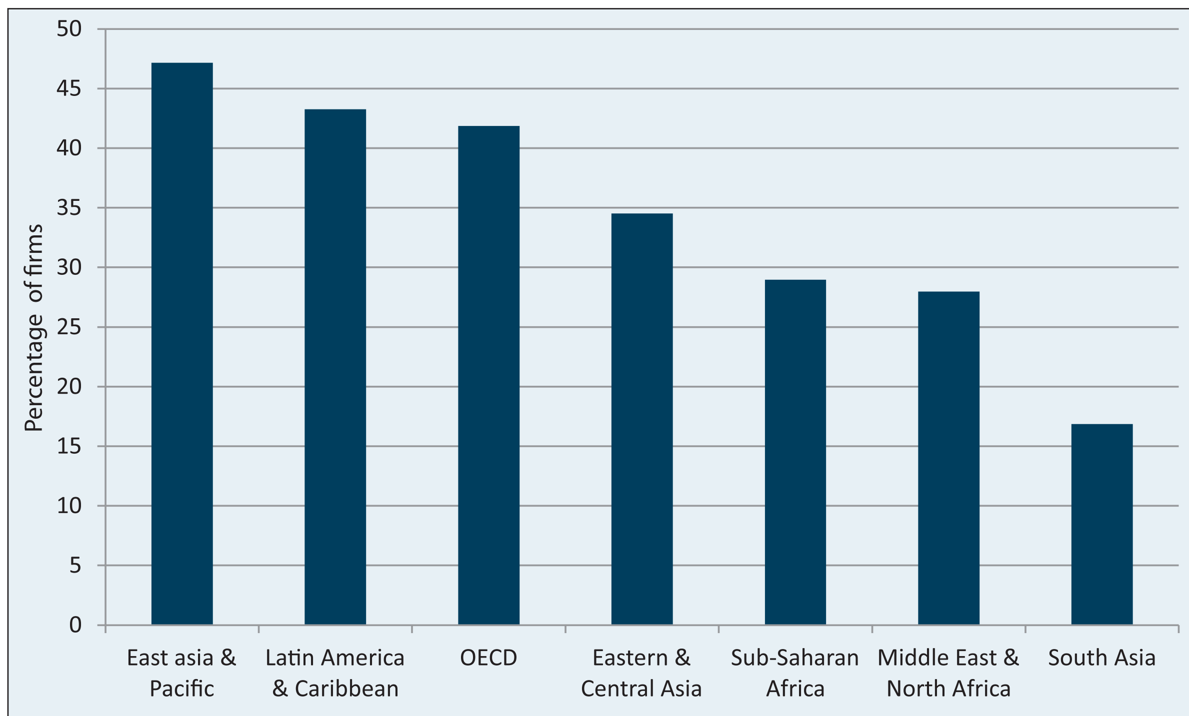
Quality and Relevance of Tertiary Education

Africa's significant spending on tertiary and vocational education has been inefficient. Overall, it has failed to generate an adequate and relevant stock of human capital, and Africa is trailing behind the fast-growing economies in other developing regions when it comes to skills. Tertiary education systems do not appear to effectively generate the types of graduates and applied research needed to support PSD and raise Africa's competitiveness. While African businesses complain about the lack of skilled workers, large proportions of graduates

go unemployed for long periods of time or are forced to work in the informal sector.

Africa has one of the lowest shares of firms offering formal training programs in the world (Figure 5.4). African businesses European and Japanese firms, for instance, devote 6 % and 10 % of their payrolls to training, respectively, while South African businesses spend only 0.5 %[95].

Figure 5.4: Share of Firms that Have Formal Training Programs



Source: Uy 2010.

According to the Global Competitiveness Reports (GCR), Africa is at a competitive disadvantage in all indicators measuring performance in higher education and training, health and primary education, and technology readiness. Average scores (on a scale of 1-7)[96] on higher education and training, which reflect the importance of vocational and continuous on-the-job training, as well the quality of educational systems, are presented tables in 5.4a and in 5.4b. Africa scores lower on quality of educational systems than China and East Asia, but better than Latin America, including Brazil; similar results are observed in mathematics and science education. Africa also trails behind most other regions when measuring local availability of research and training services, as well as staff training. A few countries have higher scores in these areas, however. ADB countries have slightly better scores than ADF countries, except when measuring the quality of education. Fragile States' relatively good performance is heavily influenced by Zimbabwe's and Cote d'Ivoire's high scores.

95 Lynham and Cunningham 2004.

96 Scores are on a scale of 1(being the lowest) to 7 (being the highest). Lower scores reflect a country competitiveness disadvantage, while higher scores reflect a country competitiveness advantage. This is based on 29 out of 35 African countries surveyed in WEF (2010).

Table 5.4a: GCI Scores on Higher Education & Training in Africa and Other Regions, 2010-11 (Scale 1-7)

Region/ Country	Quality of Educational System	Quality of Math & Science Education	Availability of Research & Training Services	Extent of Staff Training
Africa	3.5	3.5	3.6	3.8
North Africa	3.0	3.7	3.7	3.6
East Africa	3.9	3.5	3.3	3.6
Southern Africa	3.6	3.4	3.4	4.0
West Africa	3.7	3.5	3.9	3.7
East Asia	4.6	4.7	4.5	4.6
South Asia	3.6	3.7	3.6	3.6
Latin America	3.2	3.0	4.3	4.1
China	4.0	4.7	4.4	4.1
Brazil	3.1	2.7	4.7	4.2

Source: World Economic Forum 2010.

Table 5.4b: GCI Scores on Higher Education & Training in African Country Groupings, 2010-11 (Scale 1-7)

Category	Quality of Educational System	Quality of Math & Science Education	Availability of Research & Training Services	Extent of Staff Training
ADB Countries	3.2	3.5	3.7	4.0
ADF Countries	3.7	3.5	3.5	3.7
Fragile States	3.8	3.5	3.2	3.7
Coastal Countries	3.4	3.5	3.7	3.8
Land Locked Countries	3.7	3.4	3.2	3.7
Oil Exporters	2.8	3.3	3.6	3.6
Oil Importers	3.7	3.5	3.6	3.8

Source: World Economic Forum 2010.

The Mauritian education system enjoys adequate infrastructure, especially at the pre-primary, primary, and secondary levels, where both private and public schools operate. At these levels, the priority is to improve turnout and reduce high repetition rates at the end of each cycle, while improving the transition from one level to the next. However, Mauritius still faces a number of hurdles at the tertiary level if it is to become a knowledge hub for the region. These include: improving access, capacity and the supply of higher value-added human capital, as well as fostering skills in existing and emerging economic sectors. In addition, the quality and focus of education is poorly matched with the needs of the economy[97].

According to GCR, Nigeria had competitive disadvantages in all indicators measuring higher education and training, health and primary education, and technology readiness. Nigeria's key challenges are the low output and quality of education including higher education (particularly S&T) – inadequate infrastructure, and low levels of governance and institutional quality. These three challenges combined undermine the country's ability to diversify its economy by developing a solid manufacturing base, vibrant

97 AfDB and World Bank 2009.

Table 5.5: GCI Scores on Higher Education & Training in Selected African Countries, 2010-11 (Scale 1-7)

Country	Quality of Educational System	Quality of Math & Science Education	Availability of Research & Training Services	Staff Training
Algeria	2.9	3.6	3.4	3.5
Benin	4.2	4.2	3.9	3.5
Botswana	4.1	3.7	3.4	4.2
Burundi	4.2	3.1	2.2	2.9
Cameroon	3.5	3.7	3.5	3.7
Côte d'Ivoire	3.1	3.6	4.2	4.3
Egypt	2.5	2.7	4.1	3.3
Gambia	4.5	3.6	4	4.4
Ghana	3.7	3.9	3.5	3.8
Kenya	4.5	4.2	4.3	3.9
Lesotho	3.6	3.4	3.2	3.8
Libya	2	3.1	2.7	3.4
Malawi	4	3.7	3.7	4
Mali	2.7	2.4	3.3	3
Mauritania	2.3	3.2	2.6	2.6
Mauritius	4	4	3.8	4.4
Morocco	3.1	4	4.2	3.7
Mozambique	3.5	2.9	3	3.4
Namibia	3	2.8	3.2	4
Niger	3.8	2.9	3.7	3.9
Rwanda	3.9	4.1	3.2	4.4
Senegal	3.6	3.9	4.5	3.3
South Africa	2.5	2	4.4	4.7
Swaziland	3.2	3.5	2.3	3.6
Tanzania	3.2	2.7	3.4	3.4
Tunisia	5	5.6	5	4.8
Uganda	3.6	3.3	3.4	3.6
Zambia	4	3.8	3.8	3.8
Zimbabwe	4.2	3.8	3.3	3.9

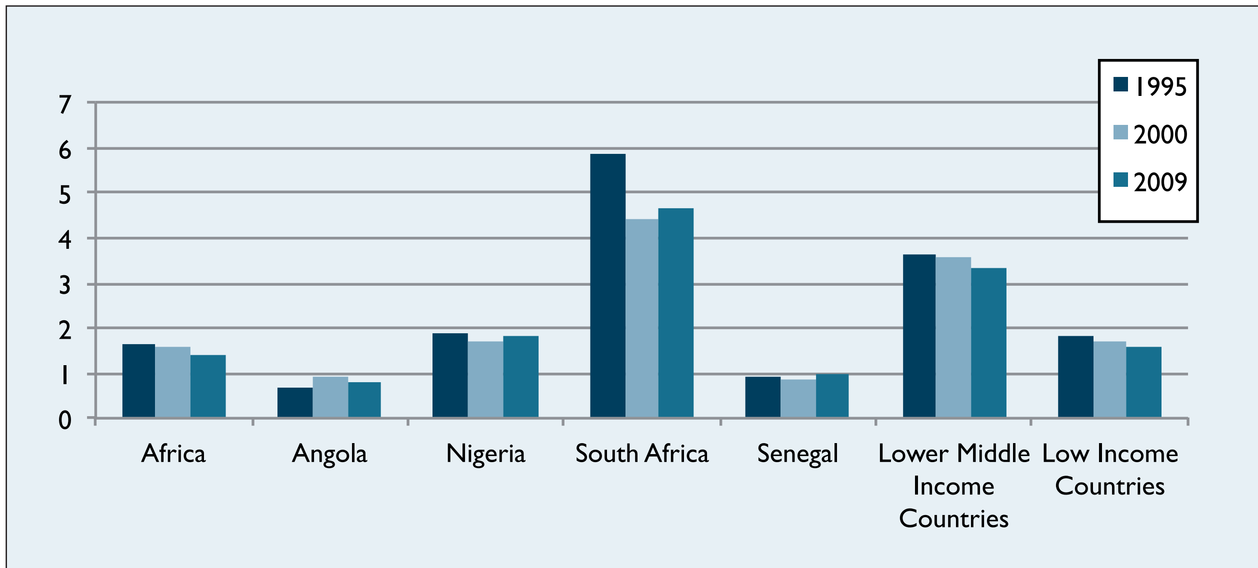
Source: World Economic Forum 2010.

entrepreneurship, a private sector capable of undertaking large investments, and innovative and knowledge-based businesses (Figures 5.5-5.6).

Senegal, on the other hand, recorded competitive advantages in education expenditure, availability of the latest technology, firm-level technology adoption, quality of math and science education, quality of management schools, and local availability of research and training services. In 2010, Senegal ranked 51st (out of 139) in university-industry collaboration in R&D, and the country had competitive advantages in quality of scientific research institutions, company spending in R&D, and government procurement of advanced technology products[98]. Yet Senegal's adequate innovation capacity failed to translate into vibrant entrepreneurship, suggesting a poorer performance in other factors contributing to competitiveness such as health and primary education and market size, among others. Figure 5.7 shows the performance of Africa and selected countries on the World Bank's KAM innovation index.

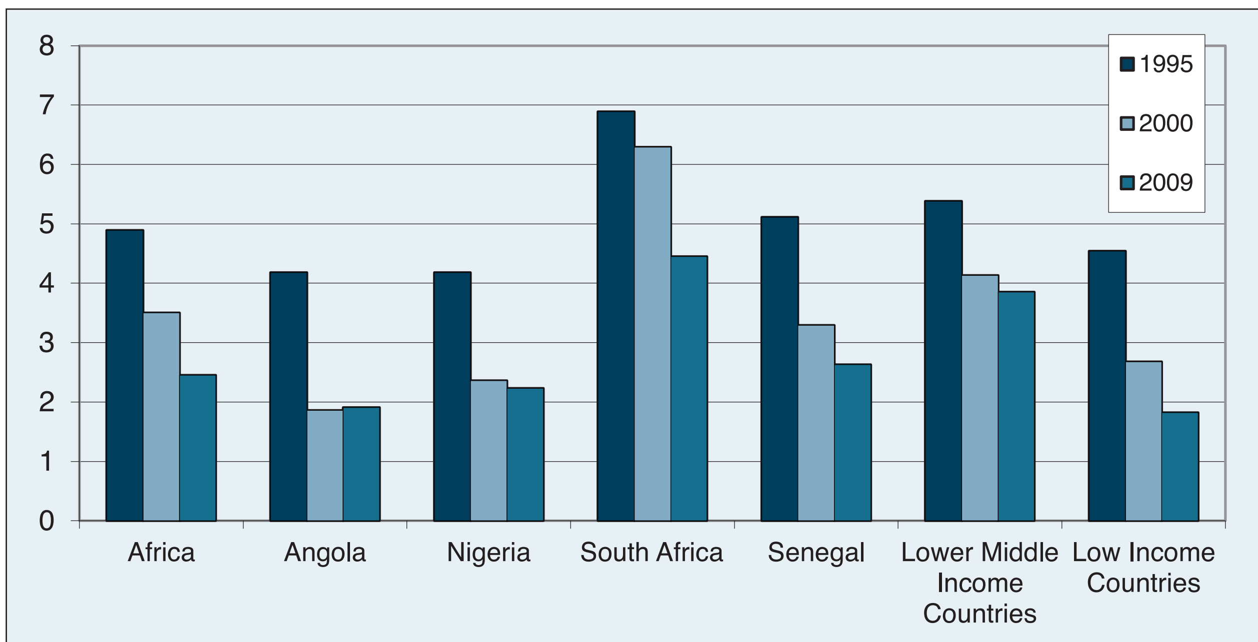
98 WEF 2010.

Figure 5.5: Education Index



Source: World Bank 2010 (a); and World Bank 2010 (b).

Figure 5.6: Knowledge Economy Index



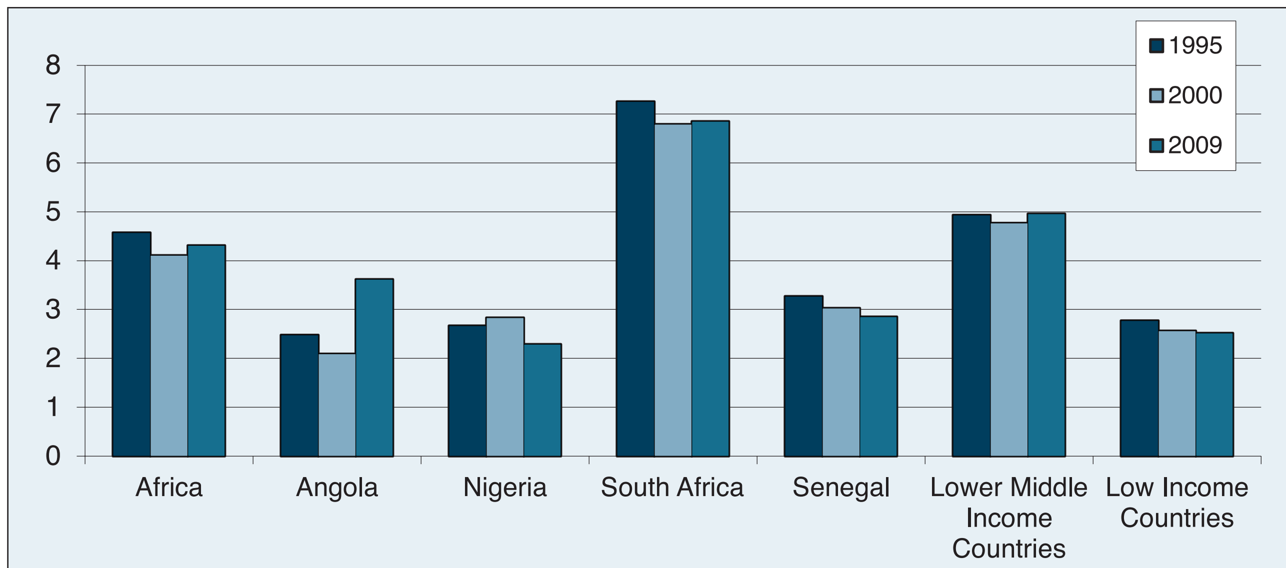
Source: World Bank 2010 (a); and World Bank 2010 (b).

Tunisia ranks 30th (out of 139) in competitiveness in higher education and training[99] Its rankings in the quality of math and science education, educational system and management schools are excellent (8th, 20th, and 22nd, respectively). Tunisia is Africa's top performer in higher education and training, significantly ahead of Mauritius (70th), South Africa (75th), Botswana (94th), Egypt (97th), Algeria (98th), and Morocco (102nd). Also, Tunisia has the highest female tertiary education rates (exceeding 40 % in 2008) on the continent. In fact, Tunisia's female enrolment rates in university and higher education institutes are higher than male enrolment rates (40.5 % vs. 27.2 % in 2008).

99 WEF 2010.

At the same time, unemployment is significantly higher among young Tunisians with a tertiary education (20 %) than the country's average (about 14 %).

Figure 5.7: Innovation Index in Selected Years



Source: World Bank 2010 (a); and World Bank 2010 (b).

Enrolments and Investments in Science and Technology

The proportion of tertiary education students enrolled in science and technology in Africa is low compared to other regions of the world (Table 5.6): about 27 % of students in African tertiary institutions were enrolled in science, engineering, and technology subjects in 2008, compared to over 50 % in Korea, China, and Taiwan; and less than 10 % of students in secondary school in Africa ever take any vocational and technical subjects[100]. In addition, there are few high-quality technical and vocational training institutions in Africa. High enrolment rates in the arts and social sciences results in a severe shortage of scientists and technicians-human capital necessary for private sector development.

Table 5.6: Science and Technology Enrolment Ratios in Africa and Other Regions

Country	Science &Technology Enrolment Ratio
OECD	48.9
East Asia	38.8
South Korea	56.3
Costa Rica	59.1
Africa	26.9
Sub-Saharan Africa	22.2
Botswana	17.7
Ethiopia	14.4
South Africa	23.9
Tunisia	36.8

Source: UNESCO 2009.

100 UNESCO 2009.

As a result, the number of technicians and researchers per 1,000 workers in Africa is very low compared to, for instance, China (Table 5.7). Moreover, the number of technicians and researchers in Africa are not growing fast enough for the continent to catch up with international standards. In addition, these researchers operate in areas that do not directly accelerate private sector growth. For example, in Burkina Faso and Ethiopia, almost all researchers work for the government. In South Korea, China, and India, on the other hand, 75 %, 70 %, and 48 % of researchers are employed in the private business sector, respectively[101]. This suggests that the little scientific human capital available in Africa does not directly contribute to developing the private sector.

Table 5.7: Technicians and Human Resources in R&D (Per 1,000 workers)

Technicians			
	1997	**2002**	**2007**
African average	0.59	0.27	0.63
China	30.18	31.02	42.81
Researchers			
African average	0.19	0.36	0.99
China	1.86	2.42	4.76

Source: UNESCO Institute for Statistics 2010 (b).

In Tunisia, the number of graduates in the field of science and technology (as well as in general fields) has increased rapidly over the last eight years. Yet, although the number of researchers per million people is the highest in the region and higher than Chile's, it is still low compared to countries such as Finland and South Korea[102].

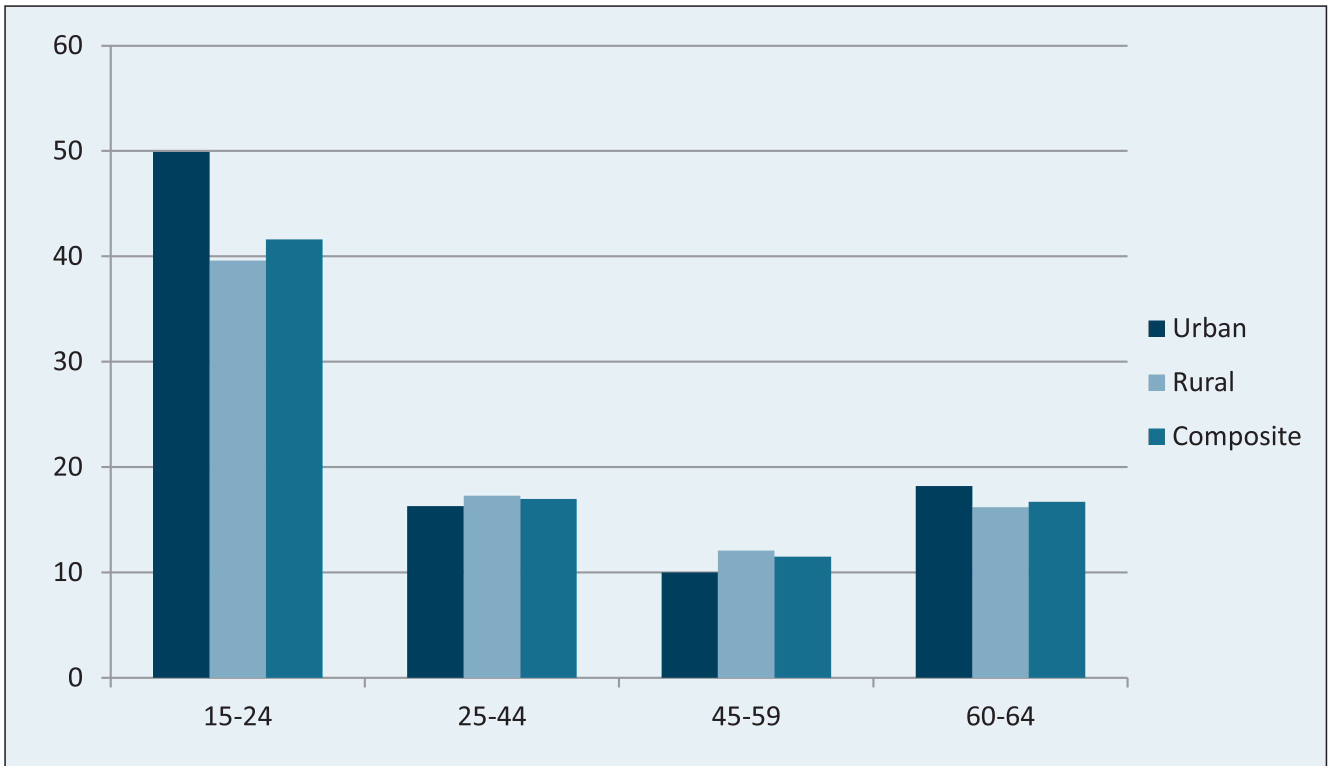
The Incidence of Youth Unemployment

The scale of unemployment for the population between 15 and 24 years of age varies considerably from one region to another. In 2005, 13.5 % of the global 1.1 billion youths were unemployed, significantly higher than the 4.6 % recorded for adults. The highest youth unemployment rates were in the Near East and North Africa (27.7 %) and in sub-Saharan Africa (18 %), while the lowest were in East Asia (7.8 %) and South Asia (10 %)[103]. Africa's low transition rates from primary to secondary education partly contribute to youth unemployment: indeed, two thirds of all countries with secondary GER of 40 % and below are in Africa[104]. Youth unemployment issues in selected African countries are highlighted below.

Nigerians aged 25-44 suffer most from unemployment (47.5 %), followed by the youth (32 %) (Figure 5.8). This seems to be broadly consistent with ILO global data for these groups of 47.4 % and 46.7 %, respectively. Yet the unemployment rate for those with a secondary and post-secondary education is higher than the national average (19.7 %) (Figure 5.9).

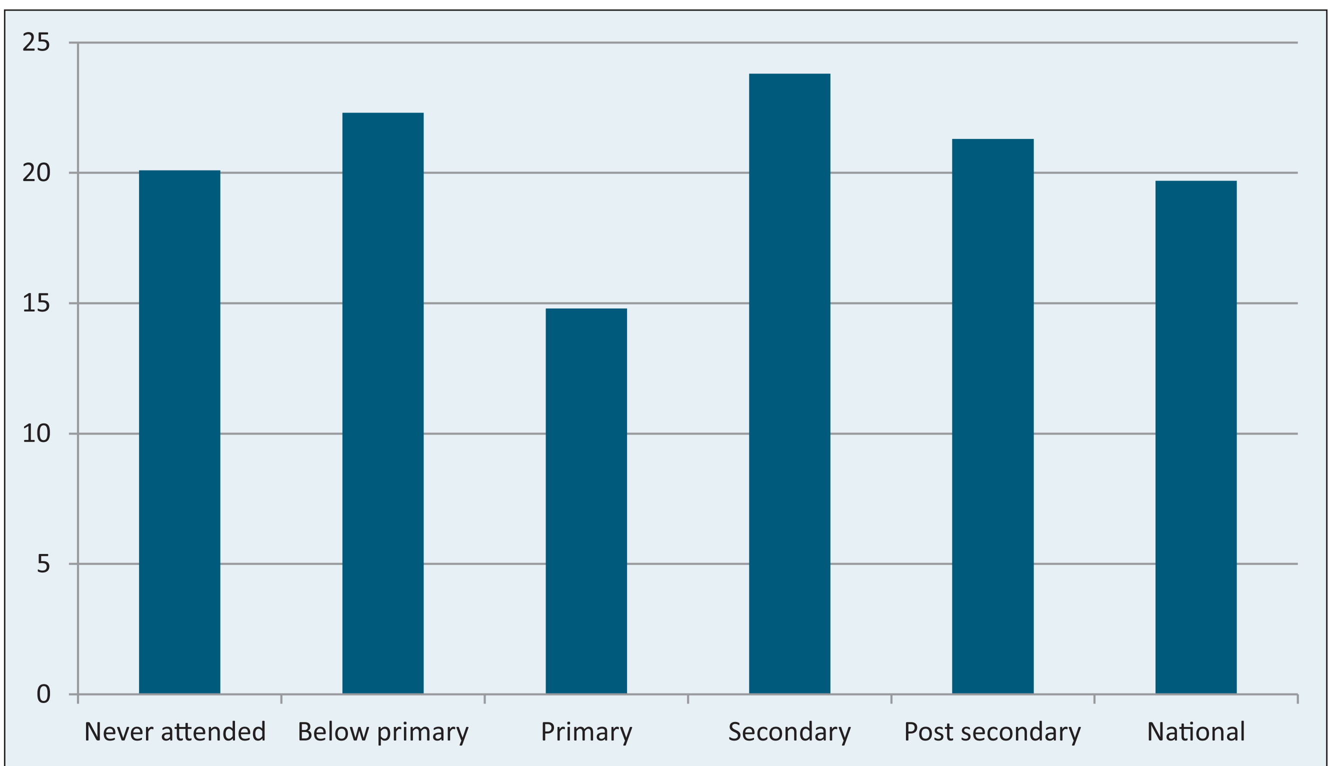
101 UNESCO Institute for Statistics 2010 (b).
102 UNESCO Institute for Statistics 2010 (b).
103 Borode 2011.
104 APHRC 2007.

Figure 5.8: Unemployment in Nigeria by Age Group, March 2009 (Percentage)



Source: Nigeria National Bureau of Statistics (NBS) 2010.

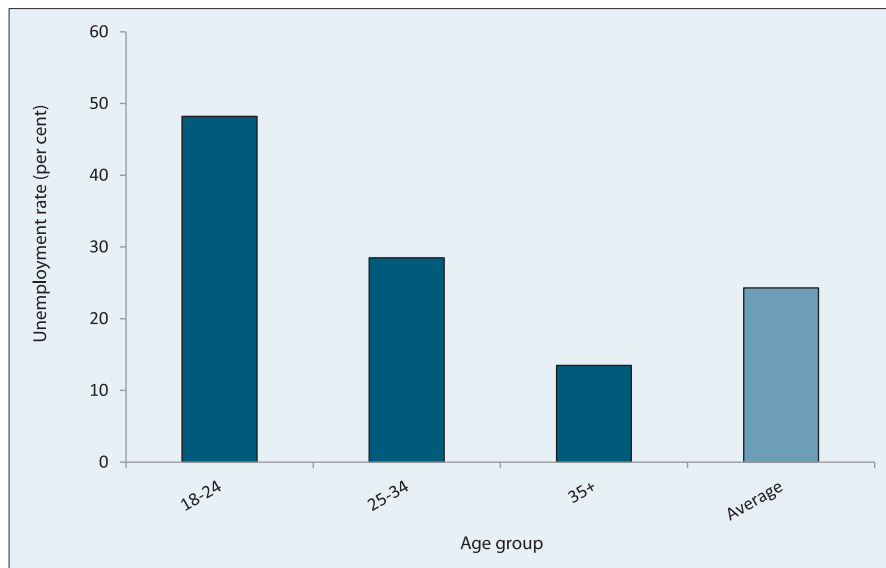
Figure 5.9: Nigerian Unemployment Rates by Educational Level, March 2009



Source: Nigeria NBS 2010.

Youth Unemployment. Unemployment in South Africa is particularly concentrated amongst young people. Nearly half of those aged 18-24 is unemployed, compared to 13.5 % for the population older than 35 and a national average of 24.3 % (Figure 5.10). South Africa stubbornly high unemployment rate combined with high economic growth demonstrate how quickly bottlenecks appear in the labor market: skill shortages developed during 2004 through 2007 while the economy was growing at around 5 %. These shortages affected both professionals and the highly skilled, as well as artisans and technicians. This reflects a structural problem in the labor market, which cannot be solved on the demand side alone (Box 5.1).

Figure 5.10: South Africa Unemployment Rate by Age Group, December 2009



Source: South Africa National Treasury 2010.

Box 5.1: Skills Mismatch and Youth Unemployment in South Africa

Although unemployment fell from close to 30 % in 2004 to 21 % in 2007, low-skilled South Africans did not benefit. The South African education system is not producing the sort of skills that the economy is demanding, and this mismatch is unlikely to disappear without education reforms.

The structure of the economy has changed drastically over the past four decades, with a move away from the primary sector (unskilled and labor intensive) to the services sector (more skill intensive). Matriculation pass rates have fallen from 73.3 % in 2003 to 60.6 % in 2009, while the pass rate was a paltry 29 % for mathematics and 21 % for science. The quality of the public education system, which has seen enrolments rise sharply without concomitant improvements on the quality side, is also being questioned.

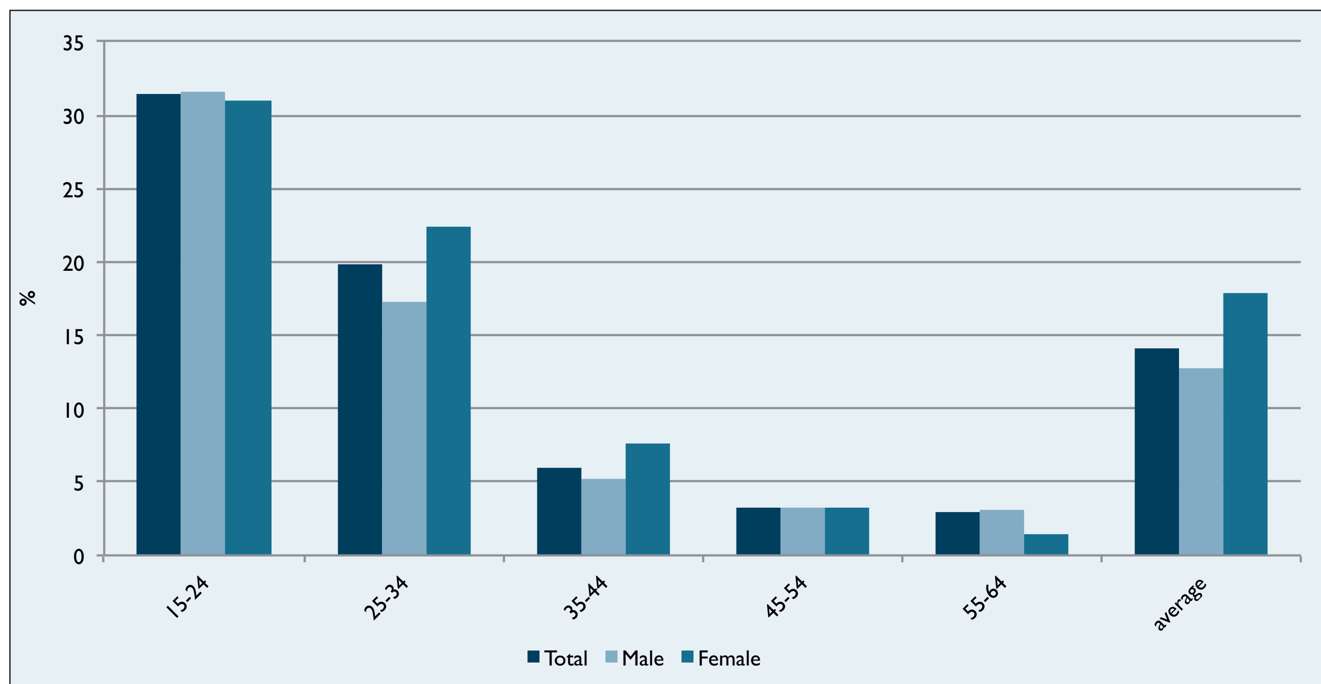
South Africa may need to experiment with more innovative ways to deliver education through hybrid models of state-funded but privately delivered schooling.

The excess supply of labor, especially at the unskilled level, reflects a real wage (relative to productivity) beyond the market clearing level. Real wages have been downwardly rigid. Labor market flexibility is poor, as reflected in the World Bank's Doing Business reports. This is likely to result in unemployment particularly for the youth, as employers are wary of employing candidates without experience given the costs associated with retrenchments.

Source: AfDB 2011.

Educated Unemployed. Tunisia's persistently high unemployment rate among young higher education graduates remains a serious challenge. The country's labor market is highly rigid, which contributes to high unemployment. Young people (ages 15-24) are by far the worst affected by unemployment (Figure 5.11). Unemployment in this age group, as well as in the 45-54 age group, seems to affect both men and women equally.

Figure 5.11: Tunisian Unemployment by Age Group and Gender, 2007



Source: European Commission 2010 (b).

The enduring high unemployment among the educated seems to be a general feature of labor markets in African countries, including those in North Africa (Figure 5.12) where high youth unemployment helped to trigger the recent revolution. Such high unemployment suggests a persistent mismatch between the demands of the economy and skills offered by recent university graduates[105]. In Tunisia, the unemployment rate for higher education graduates (19 %) is much higher than for those with lower education levels. The situation is similar in Algeria, Egypt and Morocco.

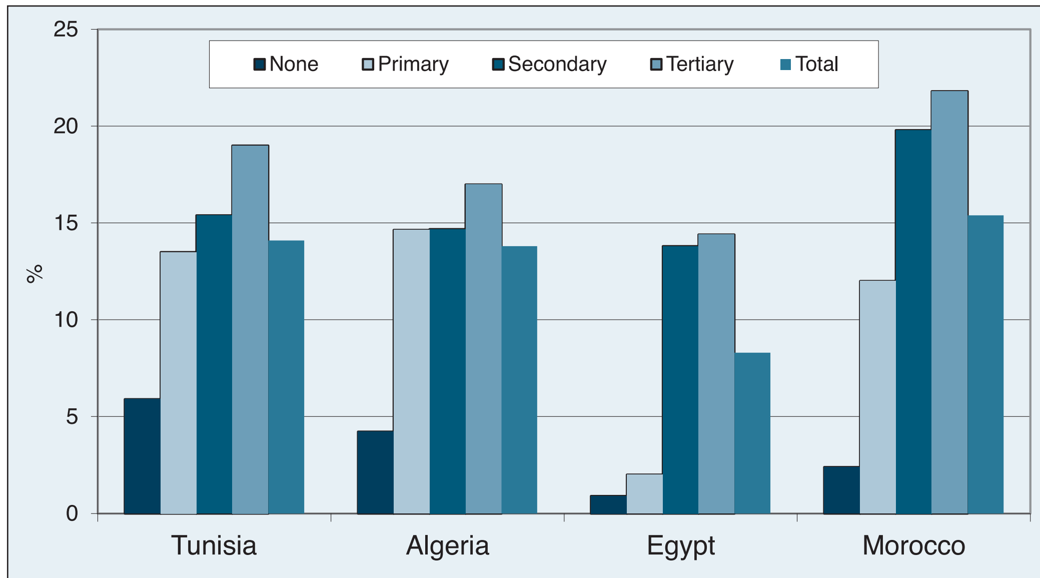
Although Tunisia's total unemployment declined little from 1994 to 2007 (from 15.8 % to 14.1 %), the pattern of joblessness by level of education changed dramatically (Figure 5.13). The rate of unemployment among Tunisians holding a higher education degree ballooned from 3.8 % to 19 %. Joblessness also worsened for high school graduates, although by a much lesser degree. On the other hand, unemployment among illiterate workers declined by about two thirds (from 16.8 % to 5.9 %), and unemployment for workers with only primary education also declined significantly (from 19.2 % to 13.5 %). The explanation may be the possession of some practical skills by these two groups.

Tertiary Education Graduates and Emigration

Unable to find employment at home, an increasing numbers of African graduates from both tertiary institutions and Vocational and Technical Training Institutes (VOTECs) are emigrating (legally or otherwise) to OECD and Gulf countries. This has an impact on Africa's development, especially PSD,

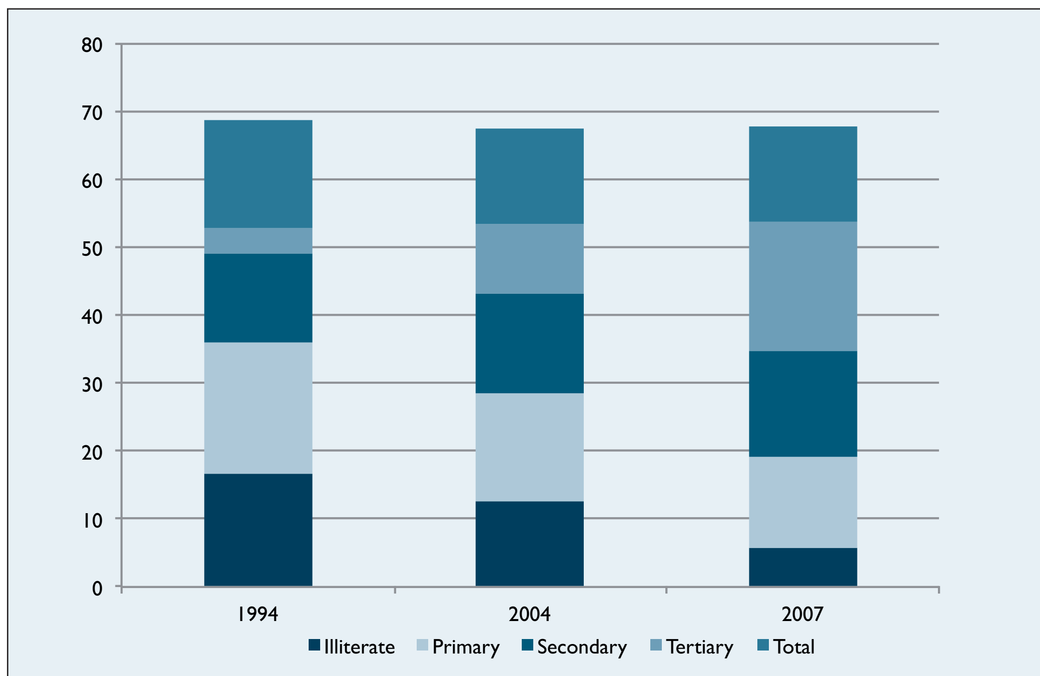
105 Ghali and Mohnen 2004; and Baliamoune-Lutz 2009.

Figure 5.12: North African Unemployment by Level of Education, 2007



Source: European Commission 2010 (a).

Figure 5.13: Tunisian Unemployment Rates by Educational Level, Selected Years



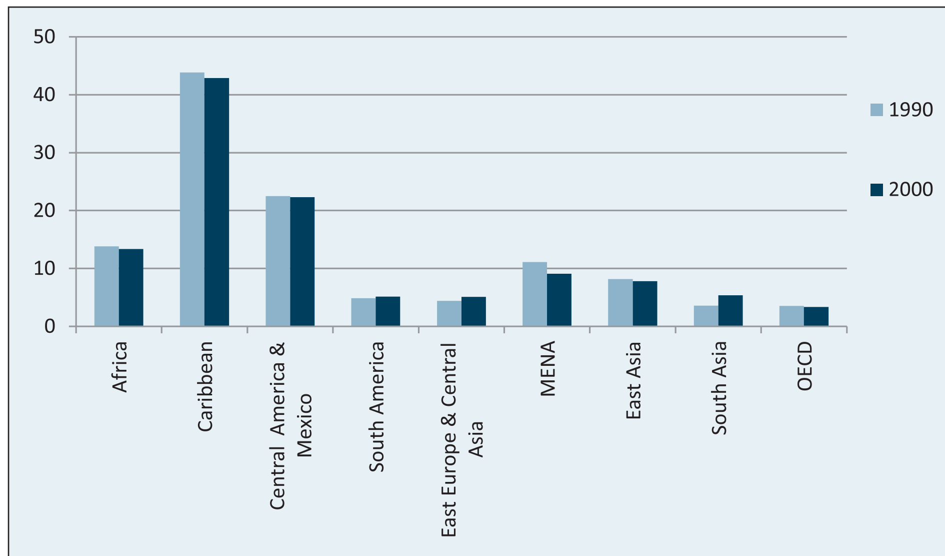
Source: European Commission 2010 (b)

principally because, among those who emigrate, are highly qualified and skilled professionals like health workers (especially medical doctors and nurses), teachers, scientists and engineers and who incidentally are those needed by the continent. These category emigrants seek better opportunities abroad for higher salaries, better working conditions, more stable politics etc. Indeed, more than half the physicians trained in Ghana since 1980 are working in OECD countries. Similarly, a large proportion of South African skilled workers, especially in ICT and banking, are emigrating to OECD countries. In recent years, over 10 % of tertiary-educated Nigerians have emigrated, and 10.8 % of physicians trained in Nigeria have left the country[106-107].

106 AfDB and World Bank 2011.
107 Bhargava and others 2010.

A recent study on migration and remittances concludes that migration of skilled African labor is resulting in serious developmental challenges for the continent[108]. Skilled emigration affects the supply of critical services, particularly health and education, as well as productivity spillovers to both high- and low-skilled workers. It is also reducing the potential for innovation, which supports long-term growth. The study further estimates that in 2000, one out of every eight Africans with a university education lived in OECD countries, a rate which is higher than those of other developing regions, except the Caribbean, Central America, and Mexico (Figure 5.14).

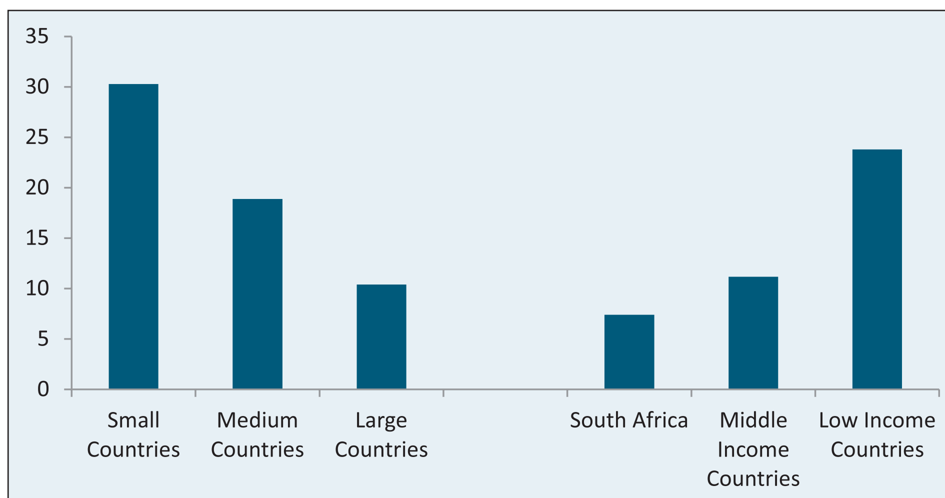
Figure 5.14: Migration Rate among Tertiary Educated Workers



Source: AfDB and World Bank 2011.

Skilled emigration rates vary considerably across Africa, ranging from 3 % in Burkina Faso to 82 % in Cape Verde. Emigration rates in countries of less than 3 million people are three times higher than in large countries with a population of 30 million and above[109]. Similarly, high-skill emigration rates averaged almost 25 % in low-income countries, more than double the rate in middle-income countries (Figure 5.15).

Figure 5.15: High-Skill Migration Rates in Africa



Source: AfDB and World Bank 2011.

108 AfDB and World Bank 2011.
109 Ibid.

Constraints

Africa's human capital and skills shortages undermine economic development and the development of the private sector. As the result, the continent's economy still heavily relies on activities that mostly require low-skilled labor (such as agriculture or natural resources), which, by stunting the demand for human capital and skills, perpetuates the low accumulation of human capital. If Africa's private sector and economy are to grow at a faster rate and be competitive globally, the continent needs to address the mismatch between the skills of vocational and tertiary institutions' graduates and those required by the private sector. There are several reasons for this mismatch. Among these are history, misguided funding policies, labor market policies, lack of collaboration between the private sector and educational institutions, and immigration policies.

Most educational systems in Africa are relics of the continent's colonial heritage. Systems were set up to supply low-level officials for the colonial administration and manual labor, not build a robust private sector. Education systems have not been radically restructured to focus on innovation and problem solving, largely due to inadequate financial and human resources. The lack of resources has been exacerbated by centralized management structures, thus making it difficult for educational institutions to respond to changing conditions and skill needs.

Misguided government funding policies for higher education also contribute to this mismatch. Instead of focusing on priority skills, African governments tend to support any student admitted to a tertiary education institution without regard to the field of study. Together with wage practices that set remunerations based on academic qualification without regard to the contribution to output (especially in the public sector), this policy fails to properly signal private sector needs to students.

Besides failing to channel students into fields that are economically more valuable, inappropriate reward structures also result in a brain drain of graduates with these valuable and scarce skills. In a global labor market, many of these graduates choose to pursue better opportunities abroad, depriving Africa of the human capital and skills it needs to build a vibrant private sector.

In addition, the lack of collaboration between the private sector and educational institutions contribute to the mismatch. Educational institutions are often unaware of what skills businesses currently need or may need in the future, while businesses assume that academic institutions focus on theory and have nothing to offer.

The shortage of human capital and skills in African countries may be due to the lack of effective demand for human capital or the thinness of the market for skills in Africa.

Labor market policies also influence skilled emigration. Skills needed in Africa are also needed globally. In such a globalized labor market, skilled labor will migrate to where it is appropriately compensated commensurate with the value of its marginal product. Restrictive labor market policies that do not pay African skilled labor appropriately will result in the emigration of such skilled labor.

Finally, human capital and skills gaps can be filled through immigration policies. Several OECD countries have tailored their immigration policies to attract immigrants with skills these countries need. These include the US Diversity Visa Lottery and the Canadian Skilled Workers (Professional) Program. Unfortunately, with the exception of a few countries such as Botswana, most African countries have not developed coherent immigration policies to meet their skill needs.

Addressing the Challenges for Private Sector Development

Growth strategies based on tertiary education rely on adequate human capital, skills, and knowledge to succeed. They therefore require policies promoting the generation of the appropriate volume and quality of graduates. To ensure that skilled tertiary education graduates get adequate returns on their education, the private sector should be encouraged to climb the technology value chain.

Supporting the development of human capital and skills involves both short- and long-term strategies. Short-term strategies involve upgrading the skills of adults who are already working and of secondary school or university graduates, who attained a good level of general education but lack

specific work skills. In the long term, education systems need to be revamped.

In the short run, human capital development should focus on providing short, practical courses to secondary and higher education graduates. For example, a general engineering graduate could be trained in construction engineering, a graduate in mathematics could be trained to become an accountant for the electronics software industry, and English majors could be trained to work in call centers. These courses should involve primarily on-the-job training and require cooperation between the government and the private sector; businesses are indeed critical not only to provide funding, but also internships and facilities for such training. Singapore, for instance, adopted such a strategy starting in the 1960s to rapidly turn its low-skilled work force into one of the most qualified in the world. Public-private internship mechanisms placing tertiary education graduates in firms, particularly SMEs, would also promote much-needed practical training. In addition, incentives for tertiary institutions and firms to collaborate on research, design, and testing or product development need to be put in place.

In the long run, increasing the supply of human capital and skills will involve changing the way students are trained–-a process that will require changes in the education system, labor markets, government policies, and the interaction among all three. These educational reforms should: (i) focus on increasing the skills and productivity of workers, (ii) train graduates to be entrepreneurs and thus create and develop enterprises to employ themselves (Chapter 6), and (iii) create a class of skilled researchers who can develop new ideas and products. Entrepreneurship skills and the ability to manage small businesses are critical for private sector development in Africa, since small private companies dominate Africa's private sector (Chapter 1).

The educational system needs to favor science, technology, engineering, and mathematics, which will require major curriculum reforms. The curriculum should also focus on the specific problems facing Africa such as poverty, unemployment, inequality, low entrepreneurship as well as low scientific and technological know-how. In addition, critical thinking, problem solving, discovery and experiential pedagogy skills need to be developed rather than the current reliance on rote learning. A number of African countries (including Botswana and Kenya) have embraced such an approach (Box 5.2).

Box 5.2: Addressing the Skills Mismatch and Private Sector Needs

Botswana's Vision 2016 recognizes the role of education in enhancing national productivity, innovation and competitiveness. It also acknowledges past failures. For example, the National Development Plan (NDP) 10 (Republic of Botswana, 2009: 93) states that "The mismatch between opportunities in the labor market and the skills of graduates contributed significantly to youth unemployment". During NDP 9, the Education sector focused on increasing access and equity, improving the quality and relevance of education and providing competent human resources necessary for achieving the nation's economic diversification strategy.

The sector's key objectives for NDP 9 included the provision of a universal 10-year basic education; increasing access to senior secondary education; expanding vocational and technical training; promoting lifelong learning; increasing access and equity at tertiary education level; and improving access to education services for children with special needs. The greatest challenge facing Botswana's education system is improving the quality and relevance of education, since the society and the economy have evolved in new directions, making fresh demands in terms of attitudes, skills and abilities. During NDP 10, a key subsector strategy will focus on quality and relevance of education. The National Human Resources Development Strategy lays the basis for improving the processes for human resource development so as to match the education sector with the requirements of the economy, focusing on: the relevance and quality of education and

training; employability and skills; creation of employment opportunities and acquisition of knowledge, skills and experience by citizens; the development of "education and innovation hubs"; enhancement of R&D capacity; enhancement of utilization of ICT; and increased access to early childhood and tertiary education levels.

Kenya's Vision 2030 seeks to provide globally competitive quality education, training and research for national development. One goal is to increase the transition rate to technical institutions from 3 % to 8 % by 2012, and raising the quality and relevance of education. Others are: expanding access to university education to 20 % from 3 % emphasizing S&T programs and revising the curricula for universities and technical institutes. Specific strategies include strengthening the partnerships between education and training institutions on the one hand and the private sector on the other, to be responsive to the needs of industry and agriculture and to support the activities described under Vision 2030's economic pillar.

Source: AfDB 2011.

The most effective way for the private sector to communicate its needs to the educational system is through strong, effective, and constant linkages with universities. For example, the private sector could be represented on governing and academic boards of educational institutions to participate in curriculum development, as well as on national policy-making bodies for the education sector. This will also make it easier for the private sector to fund education through joint research as well as research work of relevance to them, and the provision of scholarships and school equipment. Securing private sector involvement would also foster better understanding of the needs of, and constraints, on the educational system, which may promote industry's support in budgetary matters.

Curricula and pedagogical changes also require changes in the governance structure of the education system to allow flexible implementation by local authorities. Local education authorities should have the discretion to decide how to combine inputs (such as school materials, facilities, and teachers) to achieve objectives set out at the national level. Local education leaders should also be given the freedom to collaborate with the local industry to promote experiential learning for students, as well as raise additional funding.

Addressing the shortage of skills will entail increasing the supply of human capital and skills in Africa through labor market and industrial policies that will also generate demand for such skills. Since most African businesses are SMEs that cannot afford to employ skilled personnel or professionals several companies need to come together to create joint skill pools. An Association of Small Retailers, for instance, could establish and pay for a pool of accountant and marketing consultants that members could access when needed. Similarly, regional pools of skilled workers allowed to work across borders would generate economies of scale. Engineers in Ghana, Nigeria, and Senegal, for instance, could form a consortium for the ECOWAS region.

The development of knowledge-intensive industries, both domestic and foreign, and the creation of science parks in the vicinity of leading universities would enhance competitiveness and generate demand for high skills. This may require regional coordination and development partners such as the AfDB to help achieve a critical mass of skills and a desirable scale of market opportunities. Providing incentives for tertiary institutions and firms to collaborate in garnering technological capability could also foster much-needed applied research in a few strategic areas. The creation of mechanisms to disseminate and commercialize such research would further support these efforts. In addition, the provision of seed capital for high-tech start-ups could be encouraged through financial incentives for R&D in public and private companies, appropriate institutional and fiscal measures that encourage the provision of such financing, and stronger support for research by public and private entities through research endowments and other forms of institutional research grants.

Besides cooperating with education institutions, Africa's private sector could contribute to improving skills by training its workers. Perhaps the private sector can increase the proportion of payroll it devotes to employment training. Lessons from South Korea could be emulated by African countries. (Box 5.3).

Box 5.3: Lessons from South Korea's Experience

South Korea's most significant development attribute has been its ability to develop its skills and innovation base aligned with private sector needs. The government played a major role in effectively making a transition from being a regulator to an architect of the economy, making strategic decisions on guiding the country toward strengthening different sectors at various times in the country's development.

South Korea invested heavily in R&D, but only after building up the required knowledge capacity and technical base through years of assimilation and imitation of foreign technologies. The government encouraged the private sector to finance a large portion of education expenditure, especially at the higher education levels, thereby leveraging scarce public resources. One tool was the government-sponsored Informatization Promotion Fund to develop IT connectivity, science, culture, and literacy levels, thereby lessening the digital divide.

Source: Radwan and Pellegrini 2010.

Vocational and Technical Training institutions are in short supply and the quality and relevance of skills produced by these few institutions is inadequate to fill the skills gap in the private sector. The capacity of VOTECs needs to be extended, and their quality improved. In most African countries, vocational and technical skills are mostly acquired through informal apprenticeships. While these arrangements may work to ease skill shortages, they leave large knowledge gaps in the training of apprentices. Filling these gaps would require linking these informal apprenticeships to formal VOTECs training institutions.

Ensuring that skills are appropriately rewarded will help slow down, or even reverse Africa's brain drain, as demonstrated by the recent experience of changes in working conditions of medical staff in Ghana. However, the issue of brain drain should be addressed holistically. Apart from the issue of monetary incentives such as inadequate salaries, other pertinent issues to address include: poor working conditions (including the lack of basic instrumentation and technical support, particularly in science and technology); low importance attached to research work by society; limited prospects for belonging to research groups that are recognized by, and well connected to, the worldwide science and technology community; low probability of attaining a sense of self-fulfillment (scientific, cultural, or financial); weak integration of basic science and technology with public or private enterprises; little or no research and development in public and private enterprises; and highly uncertain political and socioeconomic conditions for the future.

Conclusion

This chapter has examined the importance of human capital and skills development for PSD in Africa. It focused on graduates and institutions in tertiary education, and whether these institutions are responsive to changes in knowledge, labor markets, and economic development. It also examined why the private sector suffers from skill shortages when unemployment is high among graduates, and the policies that can successfully address Africa's skills gap. Education, training and skills development are important for PSD in Africa given their importance in attaining higher productivity and competitiveness. These in turn lead to higher incomes not only for businesses but also for the employees as well as more job creation, economic growth and poverty reduction.

While insufficient demand for workers remains a problem in many African countries, persistently high (especially youth) unemployment rates are partly a function of skills mismatches. This means that workers are inadequately equipped for the demands of employers. This is due to both insufficient education (especially qualitatively) and the fact that the education and training did not provide the skills that employers want. Things are complicated by the increasing emigration of the few highly skilled and professional workers particularly to OECD countries where they go to seek better salaries, working conditions, and opportunities. Addressing these will require building job-relevant skills which employers demand; encouraging entrepreneurship and innovation; matching the supply of skills with the demand by facilitating labor mobility and job matching; public-private sector partnership, including greater education-industry collaboration; and providing relevant and adequate incentives not only to retain locally-trained and skilled professionals but also to encourage brain-gain.

Chapter 6 :

ENTREPRENEURSHIP DEVELOPMENT

Entrepreneurship supports economic growth and development through market innovations and there is a bi-directional relationship between entrepreneurship and economic growth and development. Key constraints include the cost of starting a business and minimum paid-in capital requirements, with women entrepreneurs facing additional hurdles. Moreover, most of Africa's entrepreneurs are "necessity driven" rather than "opportunity driven". RMCs should promote the development of "high-growth entrepreneurship" and strengthen the quality of the entrepreneurial environment for firms. By doing so, they would support a cultural and regulatory environment that encourages people to develop original ideas, recruit the right expertise, and grow.

Introduction

Africa's private sector suffers from low innovation and productivity, which contributes to the low level of economic development in many RMCs[110]. Entrepreneurship supports economic growth and development through the introduction of innovations that add value to the economy. Innovation can take several forms, such as the generation of new products or services, new processes or ways of using existing factors of production more efficiently, and/or the implementation of technologies previously developed by others but not yet introduced in the local market[111].

At first glance, Africa appears to be ripe with entrepreneurs given that 90 percent of the total number of businesses are micro and small enterprises, the bulk of which are in the informal sector. The reality, however, is that these enterprises are generally run by "necessity-driven entrepreneurs" or individuals who start firms because they have no other viable opportunities for gainful employment. They rely on these activities in order to survive or to supplement their in-kind earnings from subsistence farming.

What Africa needs more are "opportunity-driven entrepreneurs" or individuals who innovate in order to take full advantage of market opportunities. While RMCs need to support appropriate education and training for the continent's business managers and professionals (as discussed in Chapter 5), they also need to develop opportunity-driven entrepreneurs. At the same time, governments need to facilitate necessity-driven entrepreneurs from the informal sector to become productive workers in the formal economy.

Defining Entrepreneurship and Entrepreneurship Development

Entrepreneurship can be defined in many ways, emphasizing the different attributes, contexts, motivations, roles, and contributions of these individuals vis-à-vis society (Box 6.1). The seminal definition of an entrepreneur is attributed to Schumpeter, who argues that innovation is demonstrated in one of five different ways: new products, new production processes, new markets, new inputs, and re-organization of an industry[112]. Schumpeter's entrepreneur causes disruptions in the marketplace through the process of "creative destruction".

110 World Economic Forum and others 2011; Gebreeyesus 2009; Onyeiwu 2011; and Yoshino 2011.
111 Stam and van Stel 2009.
112 Schumpeter 1951.

Box 6.1: A Typology of Entrepreneurship

Necessity-Driven versus Innovation/Opportunity-Driven Entrepreneurs

Necessity entrepreneurs start a firm because there are no other viable opportunities for gainful employment. They generally use old, existing, marginally productive technologies and processes, and do not have innovative ideas or high growth prospects. They are not true entrepreneurs.

Opportunity entrepreneurs pursue profit and independence. They innovate and have strong growth motivations, including expanding beyond local markets, products, and services.

Unproductive/Destructive Entrepreneurs

Not all entrepreneurs are welfare-improving. Unproductive entrepreneurship is characterized by activities that redistribute wealth from one part of society to the entrepreneur. These are rent seeking activities. Destructive entrepreneurship diminishes the welfare of the society as a whole and includes criminal activities such as smuggling, drug trafficking, prostitution, and illegal mining, trading, and poaching.

Social and Corporate Entrepreneurship

There are two other categories of entrepreneurial activity in addition to starting and growing a business – social and corporate entrepreneurship. Social entrepreneurship is embedded in a social purpose. Nonprofit organizations of all forms, including government agencies, have applied entrepreneurial activity to successfully compete for clients and scarce resources to solve social problems. Corporate entrepreneurship or intrapreneurship, as distinct from commercial entrepreneurship, is entrepreneurial activity within the context of a large firm. Many large firms want to capture the excitement, innovation, and renewal found in entrepreneurial firms. They do this by creating an environment where entrepreneurship can flourish.

Source: Global Entrepreneurship Monitor (GEM), several years; Austin, Stevenson and Wei-Skillern 2006.

Kirzner's entrepreneur is a person who perceives profit opportunities that are not apparent to others and engages in an arbitrage to affect the market's equilibrium with a view to gaining a profit[113]. While these two concepts differ with regard to the entrepreneur's effect on market equilibrium, the outcome is the same: knowledge is both harnessed and created in the pursuit of profit.

Leibenstein focuses on entrepreneurs in developing countries, where markets are not well defined nor smoothly operated and the production function is not known[114]. In such cases, he sees the entrepreneur as having four principal roles: a gap-filler, an input-completer, a connector of different markets, and a creator of firms. The developing country entrepreneur must therefore fill in for market inefficiencies, find inputs for production, and connect markets.

Each of the above definitions considers the entrepreneur to be a creative and alert person who surveys the economic horizon and uses knowledge and information to pursue profit. They also include entrepreneurial activity within existing firms (i.e., intrapreneurship) and entrepreneurial activity in non-profit institutions (i.e. social entrepreneurship). Human capital (i.e., knowledge and training) and access to information and markets are preconditions for the entrepreneur's success. Although in some cases the entrepreneur may also manage the firm, in most cases he is the innovative spark that creates a market opportunity that others can then take forward.

113 Kirzner 1997.
114 Leibenstein 1968.

Entrepreneurship development is the process of enhancing entrepreneurial skills and knowledge through structured training and institution-building programs. It aims to enlarge the base of entrepreneurs to speed up the pace at which new ventures are created. The focus is on the individual who wishes to start or expand a business, with concentration on growth potential and innovation.

Entrepreneurship in Africa

A major constraint to assessing entrepreneurship in Africa is the lack of comprehensive data on the size and breadth of entrepreneurial activities. There are many gaps in the existing data sets that attempt to measure entrepreneurship and innovation. The Global Entrepreneurship Monitor is a perceptions based survey which covers attitudes and activities of entrepreneurs (Box 6.2). However, it is highly subjective and only covers 6-7 countries per year. The WBES has broader country coverage and its variables are more objective. However, the variables used in the survey change from year to year, which makes trend analyses and inter-temporal comparisons problematic. While both surveys give an idea of the types of entrepreneurship in RMCs (i.e., necessity-driven versus opportunity-driven), neither quantify the number of entrepreneurs on the continent.

Box 6.2: The Global Entrepreneurship Monitor

The Global Entrepreneurship Monitor (GEM) was established in 1999 and is a research program centered on an annual harmonized estimation of entrepreneurial activity in countries around the world. GEM currently conducts surveys of adults (ages 18 to 64) in 59 countries in both OECD and non-OECD countries in order to better describe the "world's entrepreneurs and their role in economic development." Specifically, the surveys capture country differences in entrepreneurial attitudes, activity at various stages of the entrepreneurial process, and aspirations. At least 2,000 adults per country are interviewed using random sampling. The individual country survey results are then harmonized into a master dataset.

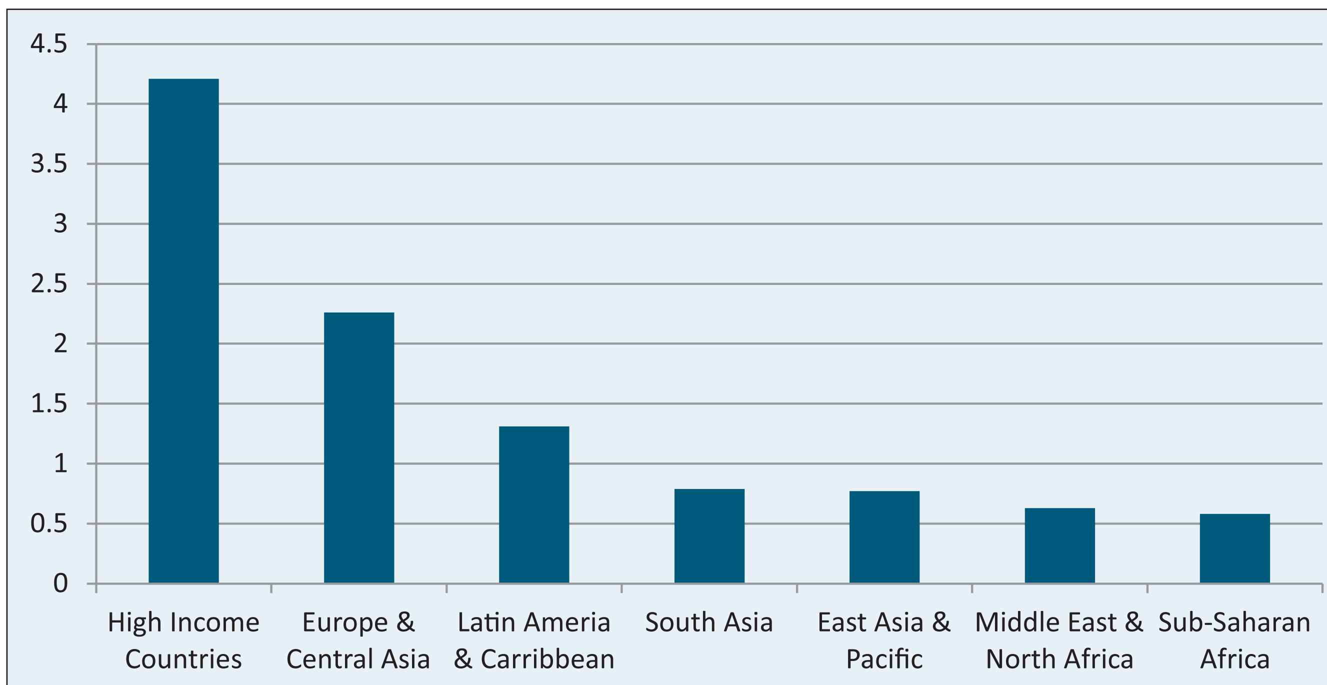
GEM distinguishes between opportunity-driven and necessity-driven entrepreneurship. Questions covered in the survey include whether the respondents believe they have the knowledge and skills needed to start a business, perceive good business opportunities in their country, see entrepreneurship as a good career choice, and perceive high status associated with successful entrepreneurs. GEM also measures the rate of nascent entrepreneurship (i.e., the percentage of survey responders who are currently setting up a business for which they will have (partial) ownership but have not begun to make any kind of payments, such as salaries, wages, etc.), and young entrepreneurship, (i.e., the percentage of respondents who own and manage a business that pays salaries and wages and has been in operation for more than 3 months, but less than 42 months). These two types of entrepreneurship are combined to give the rate of total early-stage entrepreneurial activity (TEA) in all surveyed countries.

GEM has its limitations in measuring entrepreneurship in Africa. First, its definition of entrepreneurship excludes the concept of innovation. Opportunity entrepreneurship covers only whether the firm's owner started the business because of a perceived business opportunity and/or because he wanted to be financially independent. Second, since it is a survey, the answers are subjective and there is no way to verify the responses. Lastly, each year, the GEM only surveys 6 or 7 out of the 54 African countries each year, and the countries surveyed change from year to year.

Source*:* Global Entrepreneurship Monitor 2011.

An important indicator for gauging new firm creation is entry density – the number of newly registered limited liability companies per 1,000 working-age people (those ages 15–64). As Figure 6.1 shows, between 2004 and 2009, there was large variation in entry density, across both regions and income levels. On average, about four new limited liability firms registered annually per 1,000 working-age people in industrialized countries; between one and three in Latin America and the Caribbean and Europe and Central Asia; and less than one new firm registered in other regions of the world. Sub-Saharan Africa has the lowest entry density of 0.58. The new entry densities translate roughly into national averages of 55,000 newly registered limited liability firms a year among industrialized countries and about 35,000 in Latin America, 14,000 in South Asia, and 9,000 in Sub-Saharan Africa[114]. Figure 6.2 indicates the fluctuation in new firm entry density for twenty African countries with consistent data for the period, 2004 to 2009.

Figure 6.1: New Firm Entry Density by Region, 2004-2009



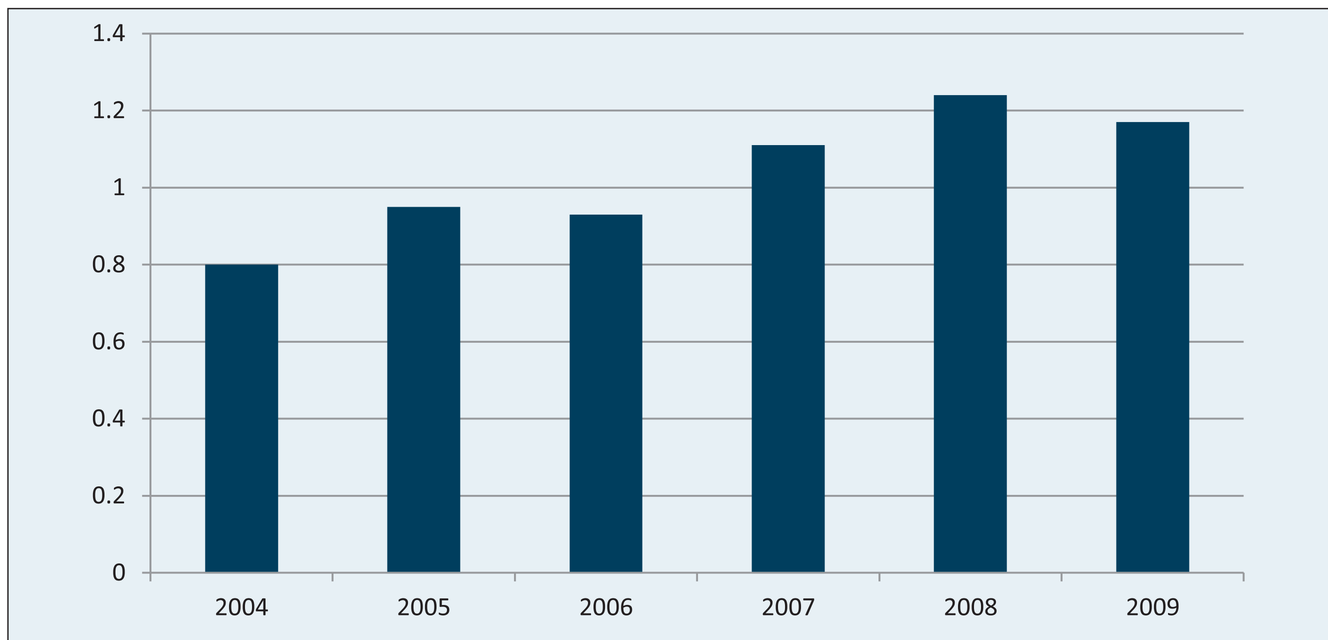
Source: Global Entrepreneurship Monitor 2011.

Recent evidence on the ground, however, indicates that entrepreneurship is increasing in Africa, powered in part by the influx of returning skilled workers.

Just as waves of expats returned to China and India in the 1990s to start businesses that in turn attracted more outside talent and capital, there are now signs that an entrepreneurial African diaspora will help transform the continent. Some reports indicate that about 10,000 skilled professionals returned to Nigeria in 2010 while the number of educated Angolans seeking jobs back home rose 10-fold, to 1,000, in the last five years. For example, Bartholomew Nnaji gave up a tenured professorship at the University of Pittsburgh to move back to Nigeria in 2005 to run Geometric Power, the first private Power Company in Sub-Saharan Africa. The company's US$ 400 million, 188-megawatt power plant will come on stream late 2011 as the sole provider of electricity for Aba, a city of 2 million in southeast Nigeria. In the same vein, Afam Onyema, a 30-year-old graduate of Harvard and Stanford Law, turned down six-figure offers in corporate law to build and run a US$ 50 million state-of-the-art private hospital with a charitable component for the poor in southeast Nigeria.

114 Klapper and Love 2010.

Figure 6.2: Average New Entry Density for 20 African Countries, 2004-2009



Source: World Bank Entrepreneurship Surveys data.

The Nigerian Aliko Dangote is a good example of a successful entrepreneur on the continent. He transformed a small trading farm founded in 1977 into a billion dollar conglomerate present in at least 5 African countries. The Dangote Group is now one of the main suppliers of sugar and cement in West Africa. One of the most successful African hi-tech start-up entrepreneurs is Mo Ibrahim. After few years of experience in the telecommunications industry, Mo Ibrahim created Celtel, which later became a 24 million mobile phone subscribers company, sold afterwards for US$ 3.4 billion.

Entrepreneurship and Economic Growth

There is a bi-directional relationship between entrepreneurship and economic growth/ development. Some maintain that entrepreneurship leads to economic growth, while others believe that economic development leads to more entrepreneurship[115].

Entrepreneurship's Impact on Economic Development

In addition to introducing innovations to the market, entrepreneurs also create opportunities for others to profit from their discoveries and innovations. This continuous process of innovation engenders technological change, which contribute to economic growth. The presence of entrepreneurs varies across countries, and this variation in part explains differences in economic growth rates[116].

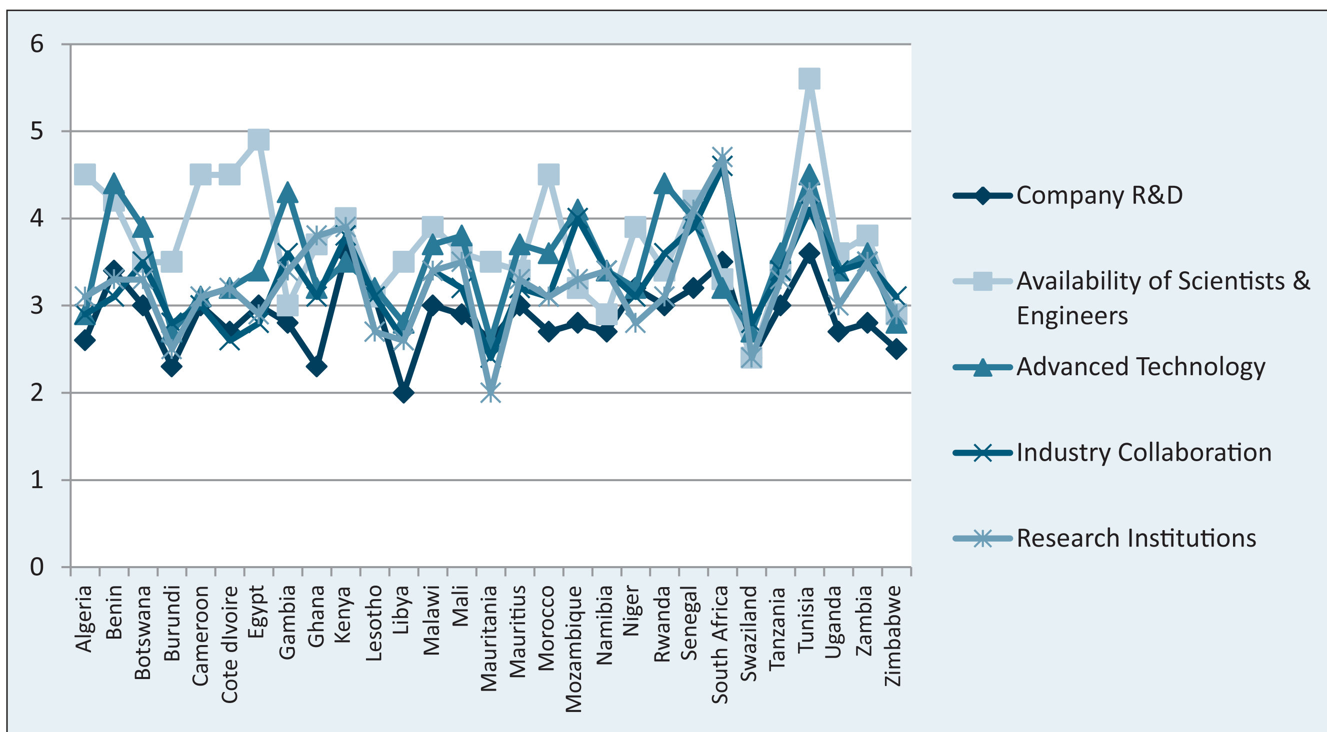
However, empirical evidence supporting the claim that entrepreneurship leads to economic growth and development is mixed. This is not surprising because of the various definitions used for entrepreneurship and the many contexts in which entrepreneurship occurs. Variations in entrepreneurship rates across countries have been found to account for a third to a half of the economic growth rates in some economies[117]. These studies conclude that entrepreneurship in transition and high-income countries leads to strong economic growth. But other studies maintain that

115 Kilele 2011.
116 Baumol 1968.
117 Reynolds and others 1999; and Zacharakis and others 2000.

entrepreneurship does not have any effect in low-income countries, such as in Africa, and that the role of entrepreneurs in developing countries is different from the role of their role in developed economies[118]. While entrepreneurs in developed countries are focused on cutting edge innovation and research and development, entrepreneurs in developing countries are largely engaged in producing goods for the local market that available in the world market place, but at a lower cost[119].

For Africa, it can be argued that entrepreneurship has not played a key role in growth to date. As indicated in Chapter 1, the high growth rates that Africa has recently experienced are largely the result of structural reforms at the macro level and not productivity-driven at the micro-level. Moreover, as underscored in the 2011 *African Competitiveness Report*, there are only four African economies (i.e., Kenya, Senegal, South Africa, and Tunisia) that rank high on the innovation index, comparing favorably with Italy and India (Figure 6.3)[120]. African economies are still not well-diversified, their share of world trade remains low, and they suffer from low skills and capacity to absorb new technologies (Box 6.3)[121].

Figure 6.3: Innovation in Africa (Scale 1-7)



Source: Data from World Economic Forum 2011.

118 Stam and van Stel 2009.
119 Rodrik 2007.
120 World Economic Forum and others 2011. The African Competitiveness Report measures innovation differently from how we have described it here. Its innovation index includes measures of capacity for innovation, quality of scientific research institutions, company spending on R&D, university-industry collaboration in R&D, government procurement of advanced technology products, availability of scientists and engineers, utility patents, and intellectual property protection.
121 World Economic Forum and others 2011.

Box 6.3: Global Competitiveness Index and Innovation in Africa

Africa gets low scores in the GCI innovation pillar of competitiveness (12th pillar) compared to other regions. Africa and its sub regions lag behind in the areas of company spending on R&D, availability of scientists and engineers (except for North Africa), university-industry collaboration in R&D, and the quality of scientific research and institutions. These have implications for PSD and competitiveness of African economies.

	GCI Scores on Innovation in Africa and Other Regions (Scale 1-7)				
Region/ Country	Company Spending on R & D	Availability of Scientists & Engineers	Governement Procurement of Advanced Technology Products	Univer-sity - Industry Collaboration in R & D	Quality of Scientifi Research Ins-titution
Africa	2,9	3,7	3,5	3,3	3,2
North Africa	2,8	4,4	3,3	3,0	3,0
East Africa	2,9	3,6	3,5	3,4	3,2
Southern Africa	2,9	3,2	3,4	3,5	3,3
West Africa	2,9	3,9	3,7	3,2	3,4
China	4,1	4,6	4,5	4,6	4,3
Brazil	3,8	4	3,9	4,3	4,2
East Asia	3,9	4,6	4,2	4,4	4,2
South Asia	3,1	4,1	3,5	3,3	3,4
Latin America	3,1	3,8	3,6	3,7	3,6
	GCI Scores on Innovation Within African (Scale 1-7)				
Category	Company Spending on R & D	Availability of Scientists & Engineers	Governement Procurement of Advanced Technology Products	Univer-sity - Industry Collaboration in R & D	Quality of Scientifi Research Ins-titution
ADB Countries	2,9	3,9	3,4	3,3	3,3
ADF Countries	2,9	3,7	3,5	3,3	3,2
Fragile States	2,5	3,6	2,9	2,8	2,9
Coastal Countries	2,9	3,9	3,5	3,3	3,4
Land Locked Countries	2,8	3,4	3,4	3,2	3,0
Oil Expoters	2,7	4,4	3,1	2,8	3,0
Oil Importers	2,9	3,6	3,6	3,4	3,3

Source: Data from World Economic Forum 2011.

Economic Development's Impact on Entrepreneurship

In addition to entrepreneurship affecting economic growth and development, entrepreneurship rates vary from country to country depending on their level of economic development[122]. Studies reveal that there is a U-shaped relationship between these two variables (Figure 6.4). At low and high levels of economic development (as measured by GDP per capita), there are high rates of total early-stage entrepreneurial activity (TEA). TEA declines, however, at the middle level of economic development[123].

Figure 6.4: Total Early-Stage Entrepreneurial Activity and Per Capita GDP, 2010

Note: Bolivia and Vanwatu are not showed in this figure, because their TEA rates are outsiders.

Source*:* Global Entrepreneurship Monitor (GEM) Adult Population Survey (APS) and MF World Economic Outlook Database.

It is important to note, however, that the TEA is composed of both necessity and opportunity entrepreneurship. As the level of economic development increases, the prevalence of opportunity or innovation-driven entrepreneurship rises (Figure 6.5)[124]. In contrast, the rate of necessity entrepreneurship declines as the level of economic development increases (Figure 6.6)[125]. This explains why there is a U-shaped relationship between the entrepreneurship rates and the level of economic development in a country[126].

122 Wennekers and Thurik 1999; and Wennekers and others 2005.

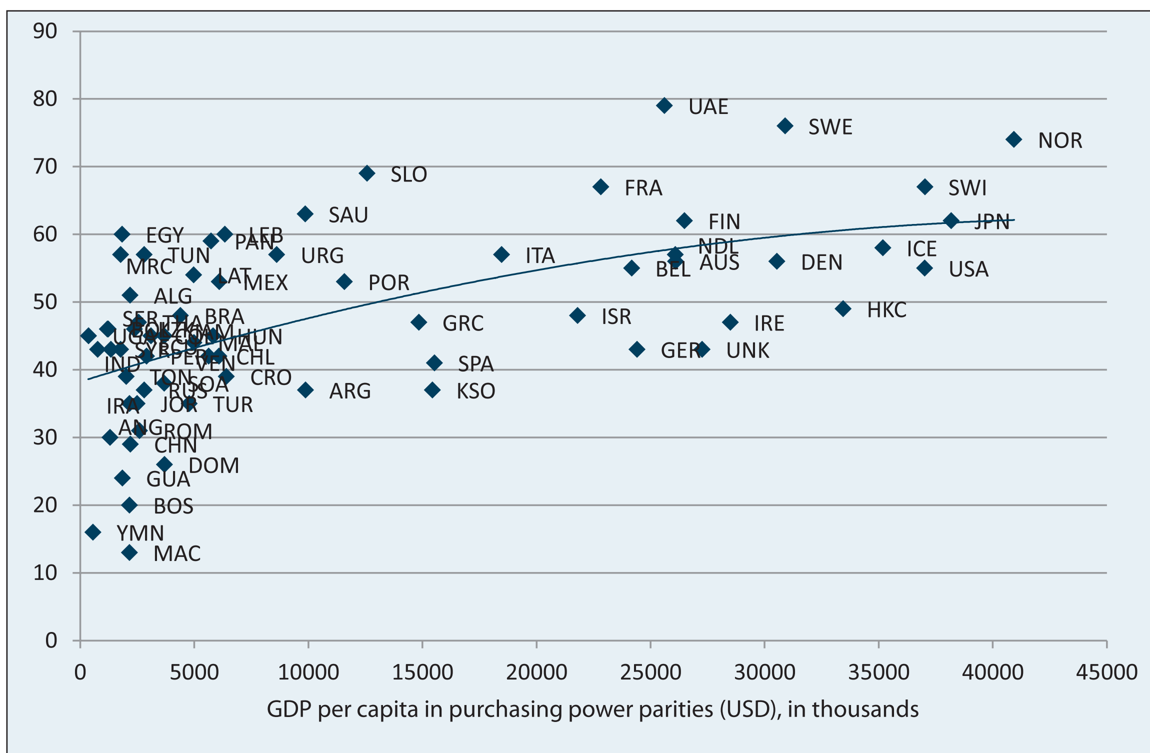
123 The correlation coefficient is -0.49, indicating a moderate, negative relationship between the TEA rate and the level of economic development.

124 The correlation coefficient is 0.582, which suggests a moderate and positive association between the amount of opportunity entrepreneurship and the level of economic development.

125 The correlation coefficient is -0.62, which implies that there is a negative relationship between the rate of necessity entrepreneurship and the level of economic development.

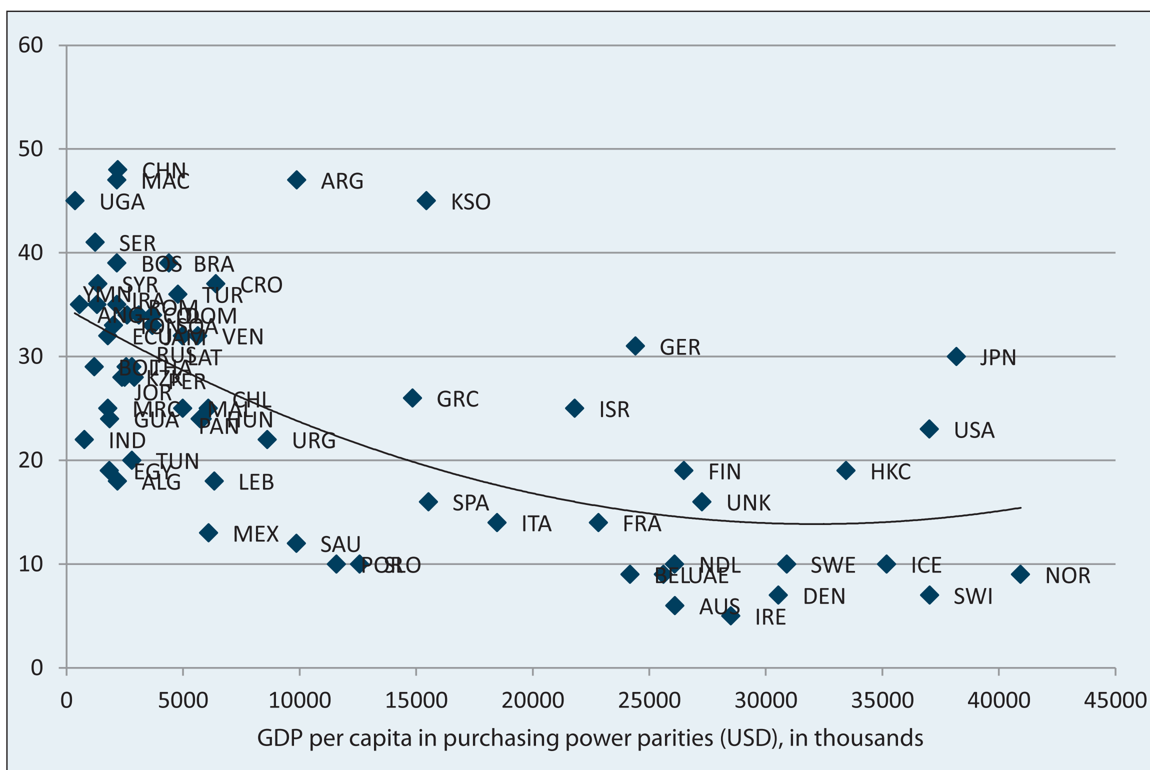
126 Although there is an association between these two variables, determination of causality will require further research and analysis.

Figure 6.5: Rate of Opportunity Entrepreneurship versus GDP per Capita for 67 Countries, 2007-09



Source: GEM APS and IMF World Economic Outlook Database.

Figure 6.6: Rate of Necessity Entrepreneurship versus GDP per Capita for 67 Countries, 2007-09



Source: GEM APS and MF World Economic Outlook Database.

Constraints

Doing Business indicators on starting a business show the impact of the business environment and barriers to entry on new firm registration in the countries surveyed. Table 6.1 compares these constraints for Africa and the global average during the periods, 2004-11 and 2011 only. It shows that while the procedures of starting a business and the length of time involved are worse in Africa than the global average, there are two most important constraints to new firm creation in Africa. The first is the cost of starting a new business (all official fees and fees for legal and professional services involved in incorporating a company, measured as a percentage of the economy's GNI per capita). Between 2004 and 2011, Africa's average was 194 compared to the global average of only 72. The second key constraint is the paid-in minimum capital requirement as a percentage of income per capita: between 2004 and 2011, this averaged 202 in Africa against only 126 globally. In addition, women entrepreneurs face even greater constraints. For example, in a recent study on Women, Business and the Law, the World Bank Group surveys of 28 sub-Saharan African countries show that all countries except Botswana have unequal rules for men and women in at least one of the following areas: accessing institutions, using property, getting a job or dealing with taxes.

Table 6.1: Constraints of Starting a New Business

	Procedures (number)	Time (days)	Cost (% of income per capita)	Paid-in Min. Capital (% of income per capita)
2004-2011				
Africa	10	54	194	202
World	9	43	72	126
2011 Only				
Africa	9	45	100	138
World	8	36	43	63

Source: Data from World Bank Doing Business Surveys.

Other major constraints to entrepreneurship development in Africa include (i) lack of education and training in entrepreneurial skills; and (ii) lack of access to information particularly relevant to entrepreneurial activities. African firm owners and managers need more training concerning how to successfully start and run a business is needed in Africa.

In a managerial training experiment that was held in industrial clusters in Ghana and Kenya, trainers found that firm owners in the clusters did not engage in bookkeeping, organizing of their files, marketing, and other crucial business management activities[127]. This lack of business know-how severely stifles the growth of firms and therefore the African private sector.

Access to information is also a problem for firm owners/ managers in Africa and other developing regions[128]. Potential firm owners may not know all of the steps required to start a business. For example[129], they may not know who the proper authorities are. Firm owners and managers in Africa might also not even be aware that there are government programs that exist to help them to run more productive businesses.

Addressing the Challenges to Entrepreneurial Development

Given the major constraints identified above, ease of entry matters in Africa hence more firms will enter into countries with lower business start-

127 Yoshino 2011.
128 Leibensteign 1968; and Drine and Grach 2010.
129 Fadahunsi and Rosa 2002.

up costs. Better financial support schemes to increase business credit should be developed while providing greater equality of economic rights for men and women entrepreneurs.

African countries will also need to promote "high-growth entrepreneurship", that is, enterprises with average annualized growth in employees greater than 20 % per annum, over a three year period, and with more than 10 employees in the beginning of the observation period. To do this, and depending on where each country is in its path of general economic development, it might need to strengthen the conditions for and improve the quality of entrepreneurial environment for firms, including the rule of law, labor market flexibility, infrastructure, financial market efficiency and management skills. These conditions are necessary to attract FDI that will provide employment, technology transfer, exports and tax revenues.

Governments need to make a strong commitment to education at all levels but especially at both the secondary and tertiary levels. African countries need to strengthen their "basic requirements" (institutions, infrastructure, macroeconomic stability, health and primary education) to transition to culture of innovation and entrepreneurship. Policies focused at firms, should include financial assistance, management assistance, training and reducing regulatory burdens.

A cultural and regulatory environment that encourages people to develop their original ideas, recruit the right expertise, and grow is imperative. Among the policy changes needed, are for focusing SMEs on quality, not just quantity; nurturing high-growth entrepreneurship, rather than self-employment; fostering clusters and ecosystems for growth, rather than scattering entrepreneurial seeds at random; recognizing the role of big companies in entrepreneurship – both as the nucleus of clusters, and as sources of talent; training people for global growth; ending market fragmentation; and educating potential entrepreneurs out of their risk-aversion.

In addition, entrepreneurial levels should be improved through commitment to entrepreneurial sensitization in order to instill a mindset of entrepreneurship; governments at all levels should support innovative and viable business creations with patent rights so as to limit duplication; and governments at various levels should also encourage research and technological developments by giving tax exemptions or holidays, where necessary. It is essential that RMCs, DFIs, universities, and other stakeholders gather data and study African entrepreneurs and firm owners. An example of this is the OECD's Entrepreneurship Indicators Programme[130]. This program is a coordinated effort to gather comparable data on entrepreneurship and business demographics in OECD nations in order to better formulate policies to nurture entrepreneurs and businesses. Once governments know exactly what they desire for their private sectors, they can enact policies to promote them. More work also needs to be done to refine the use the term entrepreneur for the purpose of policy making. As noted earlier, simply owning or managing a firm does not make a person an entrepreneur and there is a difference between necessity-driven and opportunity-driven entrepreneurs.

Conclusion

RMCs need to implement policies to encourage necessity-entrepreneurs to become productive workers in formal sector rather than remaining in marginally productive informal activities. African governments should provide viable work opportunities for their citizens through sound economic policies and improving the enabling environment for business as has been argued throughout this report. In the absence of such policies, necessity-entrepreneurs will continue to establish small, limited productive firms that contribute only marginally to economic growth.

For opportunity-entrepreneurs, governments, DFIs, and other development partners should put in place systems that provide entrepreneurs with market information and facilitate linkages with formal firms, both domestic and international, with a view to increasing their knowledge, innovation, and competitiveness. Promotion of FDI, clusters, incubators would be particular helpful[131].

130 OECD website.
131 Yoshino 2011; and Akçomak 2009.

Chapter 7 :

CORPORATE GOVERNANCE

There is a positive link between good corporate governance (CG) and good performance at the level of the firm. CG seeks to balance the interests of a company's shareholders with those of other stakeholders and stresses corporate social responsibility. For RMCs, good CG can be a source of competitive advantage while for the firm it facilitates access to external finance. African Heads of State have been promoting good CG and there has been good progress in most African countries. The main challenges include good economic governance, an enabling legal and regulatory environment, strong supervisory institutions with enforcement powers, a capacity for self-monitoring of compliance, a strong and well balanced Board of Directors, and timely and accurate disclosure of information. RMCs should ensure that appropriate regulatory bodies have been put in place to oversee CG standards consistent with the national company codes, and that they have sufficient enforcement powers, including the imposition of sanctions for noncompliance. Moreover, these national codes and standards need to be streamlined and simplified to take into account the limited capacity of small size firms.

Introduction

Corporate Governance (CG) is absolutely necessary for PSD in Africa. In launching the New Partnership for Africa's Development (NEPAD) in 1992, African Heads of States recognized that poor CG had resulted in missed opportunities for the continent's private sector to mobilize financial resources from both domestic and international capital markets and to operate in a transparent and socially responsible manner[132]. As such, they included CG as one of the four thematic areas that participating countries were obliged to integrate into national programs of action that would be reviewed periodically under the APRM. NEPAD subsequently requested that AfDB play a lead role in providing assistance to RMCs in implementing the APRM's recommendations and in identifying appropriate indicators and benchmarks to measure progress in CG. This, together with support from other development partners and a concerted effort aimed at addressing the other constraints to PSD identified in previous chapters, would allow the private sector in Africa to fully emerge as the engine of growth and development on the continent.

Definition and Objective of Corporate Governance

Although there is no single definition, CG can be defined as the institutional, legal, and regulatory framework that governs the relationship between the managers and investors in a firm, whether it be private, publicly traded, or state-owned[133]. It involves the pursuit of objectives by the board of directors and senior management that represent the interest of a company and its shareholders, including their effective monitoring of performance and the efficient use of corporate resources. Defined more broadly, CG implies that companies not only

132 Organization of African Unity 2001.
133 AfDB 2007.

maximize shareholder wealth, but balance these interests with those of other stakeholders, including the firm's employees, customers, suppliers, as well as the community within which they operate. The Bank adopts this broader "stakeholders" approach regarding its support to CG, stressing the importance of corporate social responsibility (i.e., social and environmental responsibility to a wider set of stakeholders)[134].

The need for CG arises because of the separation of management and ownership. This so called principal-agent problem occurs when the management of a company pursues activities or takes decisions which are not in line with the interests of the shareholders or investors in the firm and/or of the broader society. The absence of an overarching legal and regulatory framework with strong institutions involved in monitoring and enforcement as well as internal corporate procedures that ensure transparency, disclosure, and accountability could result in such outcomes. A system of good CG would therefore safeguard these interests and thereby mitigate the principal-agent problem.

The Importance of Corporate Governance for Private Sector Development

From the RMC's perspective, the objective of good CG should be to foster efficient, effective, and sustainable corporations that contribute to the welfare of society by creating wealth, generating employment, and providing solutions (or at least doing no harm) to the environment and other social challenges. The expectation is that these corporations would recognize and protect stakeholders' rights through an inclusive approach based on democratic ideals. From a company's perspective, the objective of CG is to facilitate access to external financing by ensuring that its board and management acts with integrity and probity, while being held accountable and responsive to the concerns and interests of its shareholders and employees.

There is a positive link between good governance and good performance at the level of the firm, as confirmed by a review of the literature carried out by the Global Forum on Corporate Governance[135]. The channels include increased access to external financing, lower cost of capital and associated higher firm valuation, better allocation of resources and management, reduced risk of financial crisis, and improved social and labor relationships. Moreover, the empirical evidence documents these relationships at the level of the country, the sector, the firm, and the investor[136].

For RMCs, good CG can be a source of competitive advantage. If the business environment is sound and predictable and there is a good CG regime in place, it increases the chances that companies will consider establishing themselves, relocating, and/or expanding their operations or activities in that country. In turn, this would improve economic performance at both the corporate and national level. Poor CG, on the other hand, could undermine a country's competitiveness and attractiveness to outside firms, which would in turn constrain the country's economic growth potential.

For firms, good CG attracts critically needed external finance by gaining the confidence of foreign and domestic investors and lenders. As discussed in Chapter 4, private equity capital (in ADF countries) and portfolio investment (in ADB countries) is potentially a key source of investment financing. In both cases, international investors are reluctant to hold shares in companies that do not meet minimum CG standards. Moreover, institutional investors have indicated a willingness to pay a premium for shares in a well governed company. With recent advances in communication technology, detailed information about individual corporations and their national CG framework is readily available and subject to public scrutiny. Good CG ensures these investors that their funds are being used in an efficient, transparent, and accountable manner.

CG is equally important for access to bank finance. As also noted in Chapter 4, African firms at present rely more on internal sources of funds and bank loans for financing their working capital and

134 Ibid.
135 Claessens 2003.
136 It is important to note that some of the studies suffer from endogeneity issues.

investment than on equity financing. One of the key constraints in banks extending credit to firms is the lack of credible, externally audited financial statements. Good CG, including the preparation of externally audited returns, should go a long way in facilitating bank credit to these firms.

Progress in Corporate Governance

As mentioned at the beginning of this chapter, CG has been mainstreamed by African Heads of States in NEPAD, through the APRM. This has provided participating African Union members with the opportunity to have other African countries review and assess their policies in the area of democracy and good political governance, economic governance and management, socio-economic development, and corporate governance (Box 7.1). As of January 2011, there were 30 member states participating in the APRM[137]. Between January 2006 and January 2011, 14 member countries have been reviewed[138].

Box 7.1: The African Peer Review Mechanism

NEPAD is an integrated strategic framework for Africa's socio-economic development that was adopted by the Organization of African Unity in 2001. It focuses on the linkages among economic growth, socio-economic development and political rule, and emphasizes the importance of good governance in all of these aspects. African leaders proclaimed the Declaration in Democracy, Political, Economic, and Corporate Governance at the inaugural AU meeting in 2002.

The NEPAD declaration was of particular importance because it acknowledged the many similar but un-integrated declarations and frameworks for Africa's way forward that had been made for two decades. The NEPAD declaration integrated them and made good governance its central plank. It placed new emphasis on certain preconditions for Africa's progress including the rule of law; human rights; regular elections; fighting corruption; ensuring transparency in monetary, financial and budgetary matters; providing an independent and effective accounting, auditing and banking system; making corporations responsible and accountable; providing peace and security; ensuring human and physical development; and promoting gender equality.

To enforce NEPAD commitments, the African Peer Review (AFRM) was formally launched by the Heads of State and Government in 2003. The peer review is a mechanism voluntarily agreed upon by African states themselves to monitor progress in governance and good practices in four thematic areas, namely democracy and political governance, economic governance and management, corporate governance and socio-economic governance. These thematic areas incorporate the critical preconditions for progress highlighted by the NEPAD declaration, but include many other aspects of governance that are to be evaluated. The objective of the evaluation is to make policies and practices of member states of the APRM, and eventually all African states, conform to commonly accepted African and Global governance standards. Following evaluation, experiences of the participating African countries will be shared; deficiencies pointed out, best practices encouraged, and needs addressed.

Source: NEPAD 2007.

137 These are: Algeria, Angola, Benin, Burkina Faso, Cameroon, Republic of Congo, Djibouti, Egypt, Ethiopia, Gabon, Ghana, Kenya, Lesotho, Liberia, Malawi, Mali, Mauritania, Mauritius, Mozambique, Nigeria, Rwanda, Sao Tome & Principe, Senegal, Sierra Leone, South Africa, Sudan, Tanzania, Togo, Uganda, and Zambia.

138 These are: Algeria, Benin, Burkina Faso, Ethiopia, Ghana, Kenya, Lesotho, Mali, Mauritius, Mozambique, Nigeria, Rwanda, South Africa, and Uganda.

The focus with CG has been on the promotion of ethical principles, values, and practices that are in line with the country's broader social and economic goals to benefit all citizens. In particular, the APRM focuses on:

- Rules providing the framework for the regulation of and support to economic activities;
- Rules and actions to ensure that business entities act responsibly with regard to human rights, social goals, and environmental sustainability;
- Fair and just treatment of all stakeholders (i.e., shareholders, employees, communities, suppliers, and customers);
- Reporting, disclosure, and accountability of directors; and
- Effective accounting and auditing of corporations.

There has been mixed progress on implementing good CG practices in African countries (Table 7.1, Box 7.2, and Annex 7.1)[139]. First and foremost, CG in Africa is undermined by the lack of progress in economic and political governance. RMCs are still plagued by deficiencies in their court systems whereby property and contractual rights are not protected and the resolution of commercial and employee disputes are slow and costly. Second, despite the good progress to date in developing a regulatory framework for CG, the implementation of these rules and regulations is deficient due to the lack of enforcement. Third, SMEs continue to face difficulties in accessing capital due to their underdeveloped and non-transparent accounting practices. This is also complicated by poorly defined property rights which impede their ability to meet collateral requirements. Finally, the existence of large informal sectors impedes fair competition with formal firms. This, in turn, often discourages firms in the formal sector from engaging in business practices that are compatible with good CG.

Table 7.1: Status of Corporate Governance Reforms in Selected African Countries

	CG Code in line with International Standards	Implementation of CG Codes	Compliance by SMEs	Financial Disclosure	Enforcement & Compliance Oversight	Accpountability of Management and Directors	Corporate Social Responsibility	Private Assoc. and Institutions	Minority Shareholder Protection	Weak Judiciary
Algeria	+	+	+/-	+	+	+	+	+		
Benin	+	-	-	-	-	-	-	-		
Burkina Faso	+	-	-	-	-	-	-	-		
Ghana	+	-	-	-	-	-	-	-		
Kenya	+	-	-	-	-	-	-	-		
Lesotho	+	-	-	-	-	-	+	+		
Mali	-	-	-	-	-	-	-	-		
Mozambique	+	-	-	-	-	-	-	-		
Niger	+	-	-	-	-	-	-	-		
Rwanda	+	-	-	-	-	-	-	-		
South Africa	-	-	-	-	-	-	-	+		
Uganda	+	-	-	-	-	-	-	-		

Source: NEPAD Africa Peer Review Mechanism (APRM) Country Reports.

139 APRM reviews have been conducted for 12 African countries, including Algeria, Benin, Burkina Faso, Ghana, Kenya, Lesotho, Mali, Mozambique, Nigeria, Rwanda, South Africa, and Uganda. APRM reviews have also been conducted for Ethiopia and Mauritius, but were not publicly available at the time of this report.

Box 7.2: Corporate Governance in Selected African Countrie

South Africa is amongst the best performers in corporate governance in Africa. Tremendous progress has taken place in implementing CG rules and standards, a process which culminated with the promulgation of the King I, II, and III reports. However, most stakeholders believe that more can be done, particularly in terms of updating the regulatory framework governed by key legislation, such as the 1973 Companies Act. Similarly labor laws are perceive by many to be too restrictive and constraint job creation. There are also shortcoming with regard to the plethora of oversight institutions, particularly in financial services supervision, which creates problems in terms of compliance and enforcement due to the multiple reporting obligations.

Mozambique is at the other extreme and is still in its embryonic stage. Public awareness of CG is still low and best practice is a new concept in most businesses except for foreign-based organization. However, following recent reforms in the financial sector, the concept is catching on rapidly and steps are being taken to prepare a National Code on Corporate Governance. Financial accountability is generally low, the implementation of the 2005 commercial code and the requirement to adopt International Financial Reporting Standards on publication of financial records of financial institutions and listed companies should greatly improve the situation over the medium to long term. Small and medium size businesses have low levels of transparency, complicated by lack of acceptable records.

Kenya's performance in CG is somewhere between that in South Africa and Mozambique. It has ratified and adopted the most significant international standards and codes for CG, but needs to extend them to the SME sector as well. Enforcement has been patchy, as the institutional capacity of regulators and supervisors has been limited. The legal framework governing accounting and financial reporting, professional education and training, professional associations, and enforcement mechanisms also need to be improved. Kenya's CG framework does not provide for the pooling of voting rights of minority shareholders. It has, however, effectively pursued a public awareness campaign on business policies and is collaborating with local business associations and non-government organizations to develop codes of ethics for businesses.

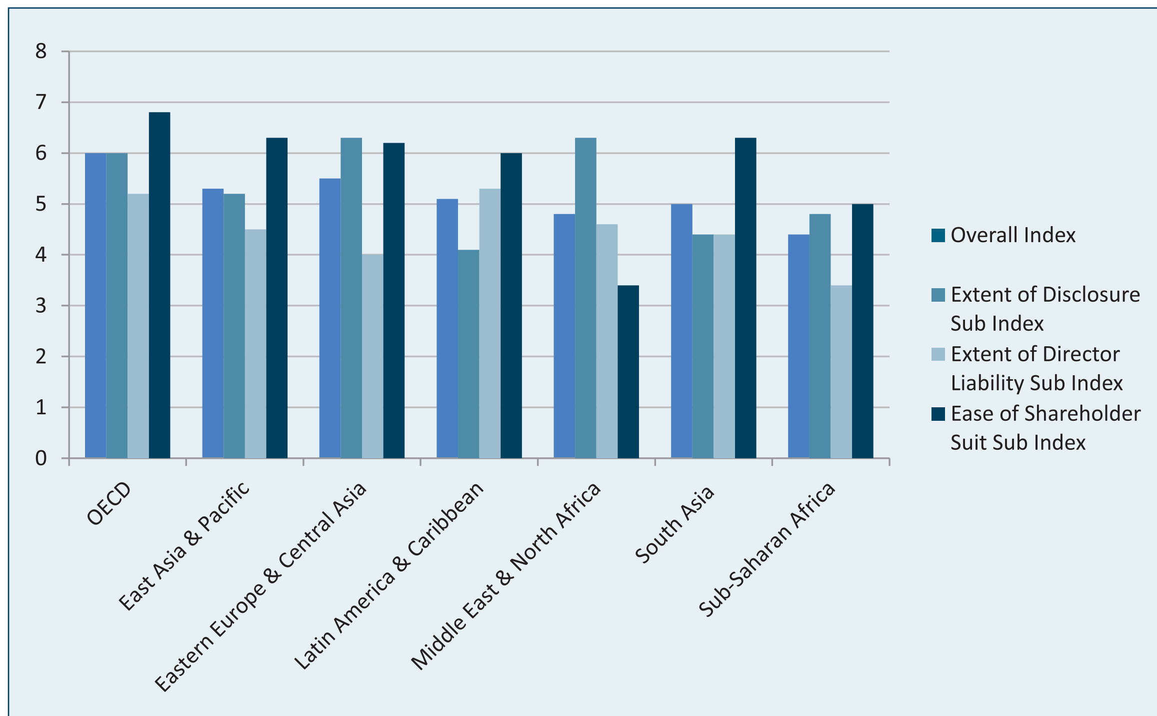
Source: NEPAD APRM Country Reports.

Measuring CG. It is difficult to measure and quantify CG because there are few objective indicators that are systematically collected across firms within a country, let alone across countries. The World Bank began to publish an "Investor Protection Index" as part of its *Doing Business Report*[140]. The index measures the strength of minority shareholder protection against misuse of corporate assets by Directors for their personal gain. It is an average of three sub-indices which are measures of the transparency of transactions, the liability for self-dealing by Directors, and shareholder's ability to sue officers and directors for misconduct. Although it is limited in scope and does not capture the full breadth of CG issues, it nonetheless provides a useful snapshot of a core aspect of CG that is comparable across countries.

Relative to other developing regions of the world, sub-Saharan African countries have the lowest overall level of investor protection next to the Middle Eastern and North African countries as measured by this index (Figure 7.1). It ranks lowest for the sub-index on the extent of director liability and second and third from the bottom for the ease of shareholder's suit and extent of disclosure sub-indices, respectively.

140 The Index measures and compares regulations relevant to the life cycle of small to medium-sized domestic businesses in 183 countries, with the most recent round completed in June 2011.

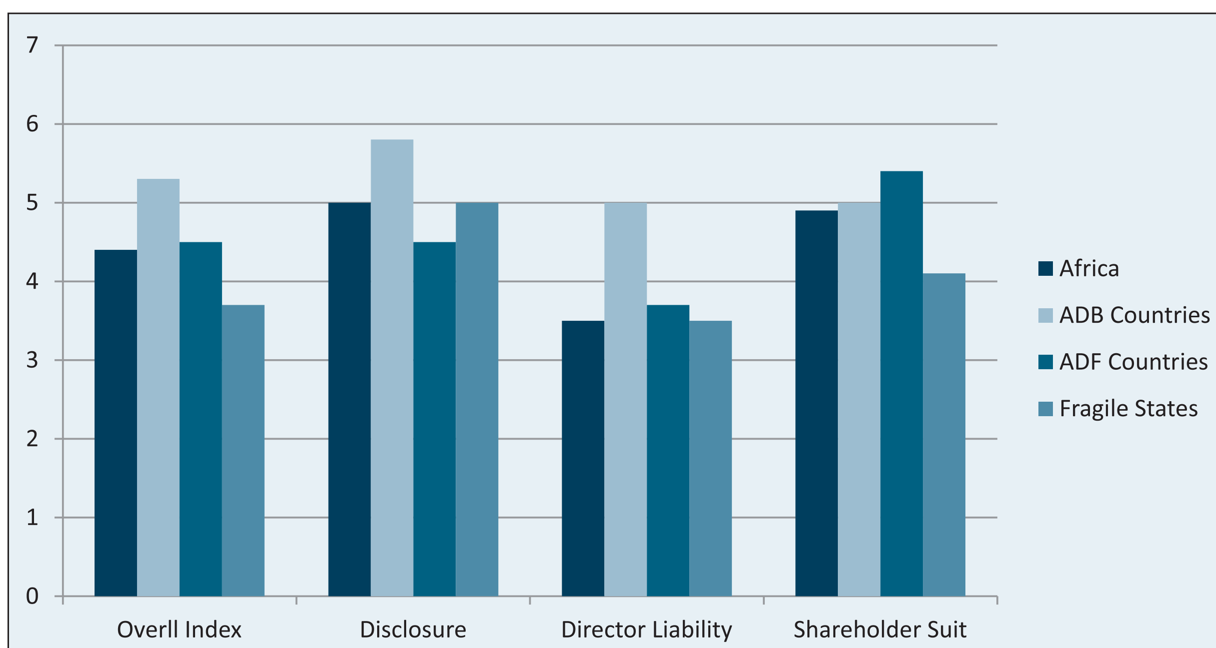
Figure 7.1: Strength of Investor Protection Index and Sub-Indices



Source: World Bank Doing Business database 2011.

Investor protection varies widely across African countries. ADB countries have the highest ratings across all indices with the exception of that for ease of shareholder suits (Figure 7.2). In the case of the latter, the strong performance of countries like Mauritius, South Africa, Swaziland, and Tunisia are offset by the relatively lower performances of countries such as Morocco, Botswana, and Gabon.

Figure 7.2: Strength of Investor Protection by African Country Groupings



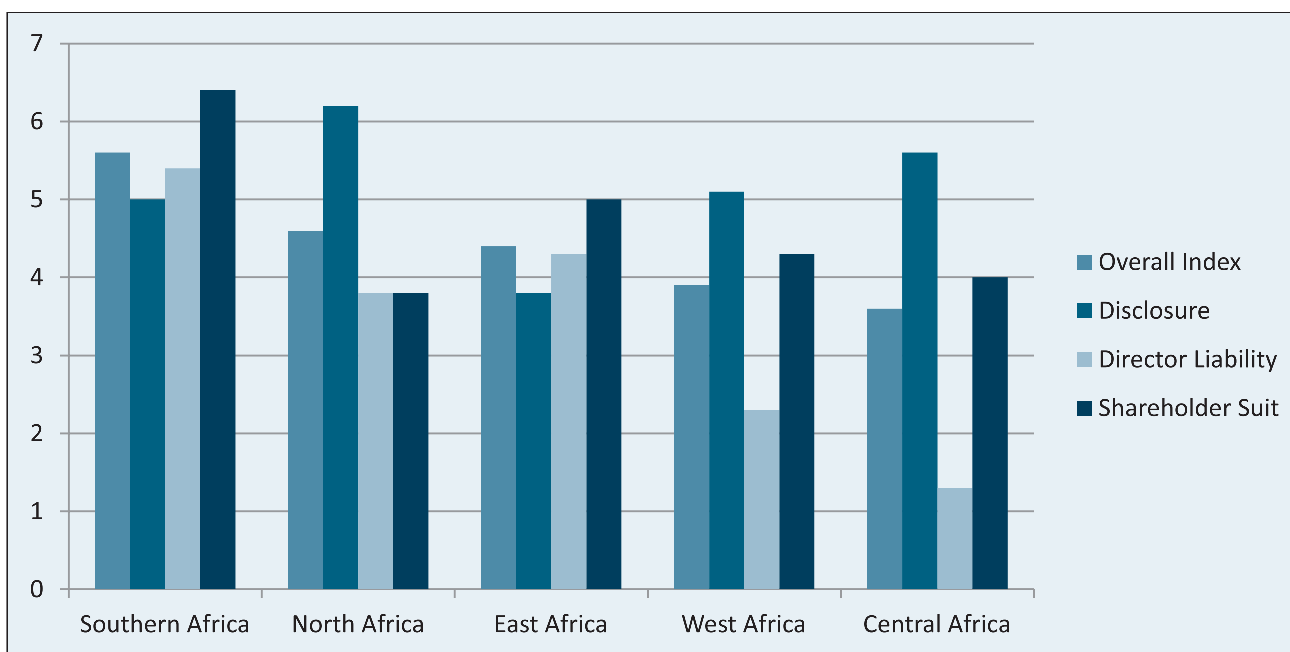
Source: World Bank Doing Business database 2011.

ADF country performance is mixed. Its overall investor protection rating is below that of ADB countries and higher than that of the Fragile States. This is also the case regarding the extent of director liability sub-index. However, it outperforms ADB countries with regard to the ease of shareholders suits sub-index and lags behind the performance of Fragile States on the extent of disclosure sub-index. Its relatively high rating with regard to ease of shareholders suits is due to the particularly strong performance by countries such as Kenya, Mozambique, Lesotho, Tanzania, and Zambia. In contrast, its relatively lower performance with regard to extent of disclosure is on account of the poor performance of countries such as Cote d'Ivoire, Gambia, Kenya, Lesotho, Tanzania, Uganda and Zambia which offset the strong performances by countries like Rwanda, Benin, Burkina-Faso, Cameroon, Mali, Niger, and Senegal.

In Fragile States, the high rating on the extent of disclosure sub-index relative to that for ADF countries is due to consistently strong performance by numerous countries, including the Central African Republic, Chad, Comoros, the Republic of Congo, Cote d'Ivoire, Guinea, Guinea-Bissau, Sierra Leone, Togo, and Zimbabwe. However, Fragile States consistently lagged behind both ADB and ADF countries with regard to the other sub-indices, particularly in the extent of director liability, in which two-thirds of the Fragile States were rated the lowest score.

Investor protection varies widely across the sub-regions (Figure 7.3). Southern African countries performed substantially better across most of the indices on account of the particularly strong showings by South Africa, Mauritius, Botswana, and Mozambique. Only in the case of extent of disclosure do southern African countries as a group fall below that of North African countries, although there are a greater number of individual strong performance in the South (South Africa, Botswana, Mauritius, and Zimbabwe) than in the North (Egypt, Morocco, and Algeria).

Figure 7.3: Strength of Investor Protection by African Sub-Regions



Source: World Bank Doing Business database 2011.

Performance in North Africa was comparable to that in East Africa regarding the overall investor protection index, with North Africa's particularly strong rating on the extent of disclosure sub-index offsetting its relatively poorer performance on both the extent of director liability and extent of shareholders suit sub-indices vis-à-vis East African countries. Notably, North African countries ranked the lowest of all the sub regions on the latter indicator, with the poor performance by Morocco, Mauritania, and Algeria offsetting the very strong performance by Tunisia in this area. In contrast, East

Africa countries ranked highest on this sub-index as well as for the extent of director liability sub-index. However, this was offset by being the poorest performer in all the sub regions for the extent of disclosure sub-index on account of very low ratings by Sudan, Uganda, Kenya, and Tanzania.

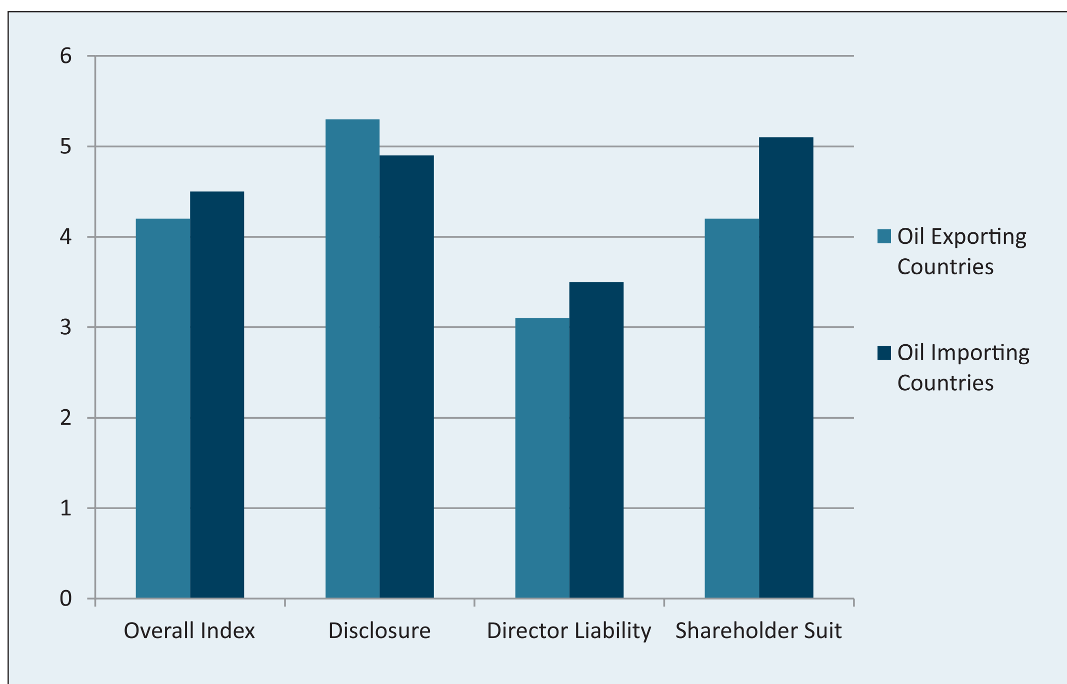
The West and Central African sub regions recorded the lowest ratings regarding investor protection. Both scored particularly low on the extent of director liability sub-index, with all countries with the exception of Nigeria, Sierra Leone, Ghana, and Cote-d'Ivoire (in West Africa) and the Democratic Republic of the Congo (in Central Africa) having rock-bottom ratings. However, the performance of these two sub regions exceeded that for North Africa regarding the shareholders suits sub-index and that for both East and Southern African countries regarding extent of disclosure sub-index. With regard to the latter, all Western African countries (with the exception of Cote d'Ivoire, Gambia, Liberia and Sao Tome and Principe) and Central African countries (with the exception of the Democratic Republic of the Congo) scored exceptionally high ratings.

Investor protection between oil exporting and oil importing countries was broadly the same, although the level and relative performance varied across the sub-indices (Figure 7.4). Oil exporters scored the highest-both in absolute and relative terms-on extent of disclosure sub-index. In contrast, oil importers scored higher on both the extent of director liability and the shareholders suit sub-index. For costal versus landlocked countries, there was no relative difference across each of the indices.

Main Challenges

The main challenges facing CG in Africa include: good economic governance, a legal and regulatory framework for CG, strong supervisory institutions with enforcement powers, a capacity for self-monitoring of compliance, a strong and a well-balanced Board of Directors, timely and accurate disclosure of information, and corporate social responsibility.

Figure 7.4: Strength of Investor Protection across Oil Exporting and Oil Importing Countries



Source: World Bank Doing Business database 2011.

Wider economic governance problems facing a country at the macro level will inevitably have direct implications for CG at the micro level. For example, many successful business persons in Africa become involved in politics. In such cases, there is a risk that the company's Board of Directors

and senior management become more concerned about advancing the business person's political ambitions than in maximizing shareholders' value. This is particularly true in family-owned or majority family-owned companies. In other cases, business persons may see politics as a means for expanding their personal interests through business related to government contracts. This could result in decisions being taken by government to award contracts to these individuals' businesses and/or the appointment of Directors and senior management that advance the business interests of the politician rather than of the electorate and thereby promote general corruption[10].

The legal and regulatory framework of CG at the country level is set through the national company codes. In principle, these codes specify the rights and obligations of a company, its directors, its shareholders, and other stakeholders. They also specify the disclosure requirements for companies and identify the division of responsibilities among the different supervisory, regulatory, and enforcement bodies in the country. Many RMCs still have antiquated codes inherited from colonial times or developed soon after Independence, while others have updated their codes. There are numerous guidelines for CG and examples of best practices regarding company codes, with the OECD Guidelines considered to be the standard bearer (Box 7.3)[11]. RMCs should begin from where they are and build on their existing structure and systems rather than applying codes and practices imported from abroad in a rote manner. To be effective, these codes need to be seen as African codes-developed, formulated, and ratified by Africans for the benefit of Africa. While they should clearly be brought into line with international standards, they should be customized to the country's context.

Box 7.3: OECD Principles of Good Governance

The OECD principles of good corporate governance framework are sub-dived into the following categories:

- Promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities.
- Protect and facilitate the exercise of shareholders' rights.
- Ensure equitable treatment of all shareholders, including minority and foreign shareholders who should have the opportunity to obtain effective redress for violation of their rights.
- Recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- Ensure timely and accurate disclosure is made of all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- Encourage the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders

Source: OECD 2002.

141 UNECA 2006, pg. 489.

142 These include the OECD Principles of Corporate Governance, the Guidelines and Principles for Corporate Governance in the Commonwealth, the Combined Code prepared by the Institute of Chartered Accountants in England and Wales, the Code of Corporate Practices and Conduct prepared by the King Commission in South Africa, and the ECA Guidelines for Enhancing Good Economic and Corporate Governance in Africa.

Strong supervisory institutions with effective monitoring and evaluation systems and enforcement capability are critical for good CG. The best Company Codes on paper will have minimal or no effect unless they are backed by an effective compliance system. There is an important role to be played, therefore, by supervisory institutions such as stock exchanges, security and exchange commissions, public enterprise commissions and, in the case of financial institutions, central banks and banking supervision commissions. However, at present there is a general lack of strong supervisory institutions in most African countries. Even in cases where such institutions exist, enforcement is rare and sanctions for violations even rarer.

Self enforcement of CG rules and procedures is generally preferable to government enforcement, if done properly. Compliance with these principles and practices should preferably take place voluntarily with the support of the relevant business association, and, ideally, by companies' Boards of Directors. There are numerous examples of professional and business associations taking on a lead role in defining and developing CG principles and best practices at the national level vis-à-vis its membership (Box 7.4– 7.6). In such cases, specialized institutions are often created to assist in the development, training, and dissemination of these principles and practices to member businesses, their boards, their senior management, and to wider parts of the business community.

Box 7.4: The Centre for Corporate Governance in Kenya

The Centre for Corporate Governance in Kenya has been instrumental through participatory processes in developing generic and sector specific corporate governance codes of best practices, covering all companies generally, state-owned enterprises, cooperatives, banks, reporting and disclosure and on the role, duties and obligations of shareholders and members. The Centre has also championed the creation of the Shareholders' Association and the Institute of Directors. It also offers training programs, including Commonwealth Certification, for Directors drawn from the public, private, and cooperative sectors. These and other activities are improving the standards of good corporate governance in the country.

The Institute of Directors (IOD) was established in 2003 and is based on the South African and British models. Its mission is to promote professionalism and enhance the standards and effectiveness of directorship. The immediate organization objective is to ensure that all directors are members. The IOD has members from all size organizations in Kenya, including SMEs.

The Kenya Shareholders' Association was formed in 2002 and is registered under the Societies Act. The goal of the organization is to create empowered shareholders that are able to play an effective role in the proper governance of the organizations whose shares they own. It has helps raise awareness of minority shareholders' rights and the need to form minority shareholder coalitions. It offers CG education, information, research and documentation services and advocacy to shareholders in Kenyan organizations and has designed training programs for managers on reviewing annual reports and other ownership tools.

Source: NEPAD APRM 2006, pg. 197.

Box 7.5: Institute of Directors and Institute of Management in Malawi

The Institute of Directors of Malawi was set up in 2001. It has benefited in recent years from an IFC Global Corporate Governance Forum project funded by the Flemish Government which provided seed funding and technical support. The IOD has produced a corporate governance curriculum for training members of boards in Malawi and trained trainers to deliver the curriculum.

The curriculum is comprehensive, consisting of 23 half-day working shops which cover all aspects of CG, from the role of the board, financial oversight and reporting, corporate social responsibility, and ethics. Members of the Boards of financial institutions and listed companies have been attending these workshops. The Malawi Institute of Management was commissioned by the Government of Malawi to deliver CG training for Boards of State Owned Enterprises. It partnered with Kenya's Institute of Directors (IOD) to deliver these training sessions.

Source: AfDB 2010 (a).

Box 7.6: The South African King Commission

In 1994, the South African King Committee on CG, headed by former High Court judge Mervyn King, published its seminal report (King I). The report advocated an integrated approach to good CG in the interests of a wide range of stakeholders. Although groundbreaking at the time, the evolving global economic environment, together with recent legislative developments necessitated the updating of King I.

In 2002, the King II report was issued. It applied to all companies with securities listed on the Johannesburg Stock Exchange; all banks, financial, and insurance entities; and certain public sector enterprises and agencies. It required companies to implement "sustainability reporting" as a core aspect of CG, which became the widely accepted practice in South Africa. It called for a move away from the single bottom line (i.e., profit for shareholders) to a triple bottom line, which embraced the economic, environmental, and social aspects of a company's activities. However, King II also needed to be updated in order to respond to the lingering trust deficit among civil society of the intentions and practices of big business, as well as concerns among business decision makers that sustainability reporting was not fulfilling their expectation in a cost-effective manner.

In response, the King III report was created in September 2009. It broadened the scope of CG by maintaining that: good governance was essentially about effective leadership; sustainability was not the primary moral and economic imperative; innovation, fairness, and collaboration were key aspects of the transition to sustainability; and social transformation and redress are important and need to be integrated with the broader transition to sustainability.

In contrast to the two previous King reports, King III applies to all entities regardless of their form of incorporation. It is at the forefront of CG internationally by focusing on the importance of annual reporting on how a company has both positively and negatively affected the economic life of the community in which it operates. Companies are required to report on how the company intends to enhance those positive aspects and eradicate or ameliorate any possible negative aspects. Its framework is "principles based" and there is no "one size fits all" solution. Firms are encouraged to tailor the principles of the Code as appropriate to the size, nature, and complexity of their organization. King III

recommended that all entities disclose which principles and/or practices they have decided not to apply and explain why. This level of disclosure is intended to allow stakeholders to comment on and challenge the Boards involved to improve the level of governance within an organization.

Source: Institute of Directors Southern Africa and King Committee on Corporate Governance 2009.

Role of Board of Directors. A strong and well balanced Board of Directors is important for good CG. As noted, many companies in Africa are family-owned. In most cases, the Chief Executive Officer (CEO) is the head of the family and other family members or persons close to the CEO dominate the Board. In other cases, there is a lack of separation and independence of the company's Board of Directors from the senior management of the company. Shareholders' interests – particularly minority shareholders – likely receive limited attention.

MNCs CG frameworks should therefore seek to ensure that companies' Boards are empowered to provide strategic guidance to the company, effectively monitor the companies' senior management, and ensure that the company is held accountable to its shareholders. Boards need to be well balanced-not only with both executive and non-executive directors, but more importantly, with outside or independent directors who are not tied to senior management and do not represent any shareholders of the company. These Directors also need to have the skills or be well trained in asking the right questions, having the capacity to remove CEOs who are not performing, and ensuring the separation of the CEO's position from the chairman's. The building of such knowledge and capacity through well designed training and education programs is essential at all levels including for directors, senior management, and regulators if shareholder's interests regarding the performance and management of these firms are to be safeguarded.

Information Disclosure. Another key aspect of CG is the timely and accurate disclosure of information regarding a company's operations, including its financial situation, performance, ownership, and governance. Shareholders have a right to full and equitable access to such information and the governance procedures should seek to safeguard these rights. Companies need to provide accurate and timely financial statements that have been reviewed by the company's internal audit unit and, ideally, audited by an independent external accounting firm. Even in cases where there is an external audit, Boards need to ensure the independence of the external auditors from the senior management and directors of the company, as all too often these relationships compromise the objectiveness of the reporting.

Corporate social responsibility and the role of the company vis-à-vis other stakeholders are also important components of CG. Companies have broader responsibilities to the community at large in terms of doing no harm and, ideally, contributing to the creation of wealth, employment, and growth. This includes, but is not limited to, environmental protection, human rights, health and safety standards, and labor rights. The CG framework should therefore recognize the rights of stakeholders that have been established through law or mutual agreements as well as encourage the active cooperation of corporations and their stakeholders.

Addressing the Challenges in Corporate Governance

Africa has by a vast array of companies by size and classification. Foreign-owned companies and MNCs are generally governed by CG practices in their home country. In most cases, these standards are quite high and should not be the focus of RMC's time and effort. For firms listed on national stock exchanges, CG standards are usually set by the exchange itself and/or the national securities and exchange commissions. Similarly, financial institutions are supervised by the central bank or the national banking supervision commission, who also set CG standards and norms for these institutions. State owned enterprises are supervised by the relevant public enterprise commissions, which oversee and enforce the rules and procedures set

forth by the national laws on public corporations. In each of the above cases, the focus of RMC's efforts should be on ensuring that these bodies not only have put in place good CG standards consistent with the national company codes, and more importantly are enforcing these standards, including by imposing sanctions for noncompliance.

In principle, CG also applies to SMEs. However, national codes and standards need to be streamlined and simplified to take into account the limited capacity of these firms. CG in SMEs is generally lacking and supervision and enforcement is much more problematic because there is usually no specific institution empowered to oversee them. As in the case of larger enterprises, SMEs need to improve CG regarding transparency, disclosure, and accountability in order to increase their ability to access to finance. This is particularly the case regarding family-owned businesses where there is a great reluctance to disclose financial information and/or be open to challenging the strategic and financial decisions taken by the controlling party. Good CG practices can also instill better management practices, stronger internal control, and a better strategic outlook through the use of a diversified board of directors.

Addressing deficiencies in corporate governance will therefore require a concerted effort on the part of RMCs, firms, business associations, and development partners. At the government level, RMCs need to: (i) customize existing international guidelines to their particular context; (ii) comply with the recommendations of the APRMs on corporate governance in individual countries; (iii) simplify and extend their national codes to include small and medium-size enterprises; and (iv) place priority focus on strengthening institutional capacity regarding compliance, oversight, and enforcement.

At the firm level, corporations should: (i) adopt the corporate governance principles in national company codes and embed them into their operational practices, (ii) produce and publish their financial statements in a timely manner and, ideally, have them audited both internally and externally; (iii) appoint a diversified set of Board directors, including independent directors, and ensure that they are properly trained regarding their roles, including the protection of minority shareholders' rights.

Business, trade, and other associations can play an important role in this regard by: (i) setting up participatory processes aimed at drawing up codes or charters of ethics to be distributed and implemented at all company levels; and (ii) raising awareness of business ethics among the different parties through information campaigns and training programs in partnership with Institutes of Directors, Institutes of Management, and Shareholders Associations.

Development partners can play a critical role in this area by: (i) "leading by example" and requiring private companies to meet basic CG standards before being able to benefit from their support; (ii) providing additional incentives for good CG by offering preferential terms and conditions to companies that exceed these standards; (iii) relying on financial intermediaries to channel and maximize support to SMEs using similar requirements; and (iv) expand support to regional training centers that "train the trainers" of regulators, directors, and managers regarding best practices in CG.

Conclusion

Although there has been good progress in many African countries to align their national legislation with international standards for CG, much more remains to be done regarding implementation and enforcement. Moreover, there continues to be a lack of good financial disclosure, protection of minority shareholder rights, and development of self-mechanisms for self-oversight. There is also a general lack of appreciation of the need for corporate social responsibility, although combined efforts between government and the local business community are beginning to be undertaken to this end. RMC's development partners, including the AfDB, should lead by example and demand that private firms benefiting from their financial and technical assistance should comply with minimum CG standards and norms and reward them with better terms and condition to the extent possible. This should also apply to the development financial institutions that act as intermediaries between donors and the private sector. The APRM has placed an important spotlight on CG practices in African countries and it is hoped that as the process continues-both with reviewing new countries and following up on previous reviews – there will be marked signs of progress.

Annex 7.1: Summary of the African Peer Review Mechanism Findings on Corporate Governance for Selected African Countries

Algeria: The Algerian government had signed and ratified a number of Corporate Governance codes in line with international standards, although progress achieved so far in terms of implementation and compliance has been insufficient. Public corporations and large private corporations generally comply with existing laws on the protection of labor law, social responsibility, and the implementation of environmental standards. By contrast, many SMEs-most of them family-owned businesses-are less compliant. Most Algerian corporations have not yet developed adequate internal systems for providing information to their trading partners or shareholders. The provision of financial information, even for shareholders, is rare except in the case of public corporations, where oversight by the supervisory authority is highly developed. Most of the shortcomings observed are due to the dearth of qualified accountants. As regards the accountability of corporations and their directors and management, although the legislative and regulatory texts spell out their respective duties, many heads of public corporations claim the right to take management decisions without risk of criminal sanctions for mistakes made in the daily management of the corporation when these decisions are taken in good faith.

Benin: Although the Benin authorities have ratified most of the international conventions related to corporate governance standards and codes, they have fallen short with regard to implementation. The current business climate is still perceived as not being conducive. The majority of enterprises considers the judicial system to be inefficient and ineffective and, hence, prefer to settle their cases out of court. This lack of confidence in the legal system also leads companies to only partially fulfill their statutory obligations to their various stakeholders. For instance, tax evasion is rampant, only a small percentage of employees are covered by the social security system, and the notion of corporate social responsibility is not widespread. As for business ethics, there have been several notable cases of embezzlement of public funds, but few ended-up with stiff sentences. The lack of transparency in formal sector enterprises, governance problems involving state-owned enterprises, and a limited chartered accounting profession in the country raises further challenges for the provision of reliable accounting and financial information.

Burkina Faso: Although Burkina Faso has ratified a number of codes and standards on corporate governance, the dissemination and implementation of these codes and standards remain problematic. The economy is characterized by a large informal sector and is dominated by small and family-owned enterprises which face challenges in accessing bank credit, let alone resources through the stock market. Burkinabe enterprises report weaknesses in the country's justice system and the embryonic state of arbitration and inefficiencies of the courts constitute key obstacles to enterprise development. Except for a few cases, enterprises in Burkina Faso have little sense of corporate social responsibility with regard to environmental management, energy conservation, waste management, and protection of water, soil and air quality.

Ghana: Despite recent efforts aimed at promoting favorable business environment and encouraging corporate bodies to be more transparent, the Ghanaian authorities continue to face challenges in connection with the country's corporate governance policy framework and its enforcement and compliance practices. Awareness of corporate governance, in general, and of corporate social responsibility, in particular, is low. The institutions that are active in the promotion of good corporate governance are weak in financial, human, and institutional terms. This has translated into weak enforcement and implementation of key

codes and standards, most notably the National Accounting Standards. Moreover, although shareholders rights in general are well observed and shareholders are equitably treated under the law, the level of awareness of the various rights is low and most Ghanaians would rather be “out of pocket” than go through the lengthy and expensive court system. Finally, non-owner stakeholders, including employees, complain of limited access to company information.

Lesotho: Although Lesotho subscribes to a number of the international and regional standards and codes for corporate governance, implementation has been lacking. For example, the legal and regulatory framework governing business activities includes a number of statutes, but there is no national corporate governance code. This in part reflects the low level of public awareness regarding matters of corporate governance and corporate social responsibility. Besides perceived delays in legislative action, other constraints include weak property rights, delays in commercial dispute resolution, and problems accessing finance. The labor laws are robust, but enforcement is lacking. Other shortcomings include a lack of protection of shareholders’, consumer protection, and intellectual property rights and weak accountability of corporations, directors, and officers. Although a number of corporation have put in place social responsibility programs, CSR is still widely viewed as philanthropic.

Mali: The Malian authorities have subscribed to a number of international codes and standards, but they have not followed up on their ratification and adaptation to the local context. Business managers lack confidence in the legal system due to the lack of clarity of the rules and weak enforcement of court decisions. Moreover, firms often complain about inequality of access to information on the business environment and an overly burdensome tax system which gives provides incentive to operate informally. Companies in Mali recognize the importance of CSR, as a large numbers of firms believe that industrial pollution is the main business constraint. Finally, employees are not always protected by the legal text, as there have been a number of discretionary actions taken whereby employees were declared redundant without any compensation.

Nigeria: The Nigerian authorities have made notable efforts to improve CG. The Nigeria Code of Corporate Governance for public liability companies was developed in 1993 through a joint effort of the Securities and Exchange Commission (SEC) and the Corporate Affairs Commission (CAC). The Committee on Corporate Governance of Public Companies in Nigeria was also established in November 2003 with a mandate to identify weaknesses in CG practice in Nigeria and to implement changes that would align these practices with international standards. Nevertheless, CG remains relatively new and sensitization programs have yet to be undertaken, with only 40 percent of the companies having adopted corporate governance codes. Awareness among banks and listed companies is better than among smaller enterprises, mainly on account of joint effort by the Central Bank of Nigeria and the SEC to promote good CG. However, their regulatory functions of oversight and enforcing sanctions are limited. The CAC’s supervisory capacity is also weak and stakeholders rarely use it to investigate a company’s affairs. Moreover, judicial remedies are inadequate and corruption is a key factor deterring the effective enforcement of relevant laws. Generally, corporations are failing in terms of disclosure and reporting, partly because of an inadequate regulatory framework for accounting and auditing. Finally, corporate social responsibility is also not well understood and is widely seen more as a philanthropic gesture than as an attribute of corporate citizenship.

Rwanda: CG is fairly new in Rwanda. There is no capital market, the private sector is in its infancy, and the state until recently was widely involved in producing and providing economic essential services. The country still lacks the key institutions of CG, such as

chambers of commerce and industry or genuine regulatory, supervisory oversight bodies, including an institute of directors and professional associations. Although Rwanda has ratified or adopted a significant number of key international standards and codes in CG, there is an overall lack of awareness and country would benefit from proceeding with a large consultation to formulate a comprehensive strategy on CG. Although a regulatory framework for promoting good CG in Rwanda exists, much remains to be done to establish and enforce these legislative obligations and duties, as well as update and expand them. The country's commercial law clearly establishes the role and responsibilities of corporate boards and management. However, specific training sessions for directors and managers need to be designed with the Human and Institutional Capacity Development Agency, the National University of Rwanda, the School of Finance and Banking, and other private sector entities. The accounting plan currently used by Rwandan corporations is not compliant with the International Accounting Standards and the International Standards on auditing are not largely applied by corporations. It is hoped that when created, the Rwandan Institute of Certified Accountants will contribute to the revision of the accounting plan, the training of local accountants, and the sensitization of corporate managers, directors, and shareholders to the usefulness of auditing practices.

Uganda: Although there has been some good progress in CG in Uganda, there are still a number of shortcomings that need to be addressed. Current laws are not fully aligned with international standards and political interference in the administration of justice, compounded by pervasive corruption, has undermined the Ugandan investment climate. Corporate financial transparency is largely lacking with the exception of banks, insurance, and listed companies. Also, despite commendable progress made in strengthening systems for commercial and labor dispute resolution, the judiciary remains plagued with backlogs. In addition, the supervisory and regulatory bodies face critical shortages of human, technical, and financial resources which render them ineffective. In this context, a number of private institutions have been created (i.e., the Institute of Directors, the Shareholders' Association, etc.) with a view to improve accountability and strengthen corporations and their directors and management. Notwithstanding, these institutions lack sufficient resources and need to also expand their coverage to include public awareness on the importance of corporate social responsibility.

Chapter 8 :

ROLE OF THE AFRICAN DEVELOPMENT BANK IN PRIVATE SECTOR DEVELOPMENT

The AfDB has long recognized the critical role played by the private sector in Africa's economic development. To this end, it has provided indirect support aimed at improving the enabling environment, including through technical assistance, infrastructure project financing, lines of credit to national and sub-regional financial institutions, and the creation of sub-regional development finance institutions. However, in order to increase the development impact of its assistance to RMCs, the Bank realized that it needed to provide direct support to the private sector through targeted operations. Against the backdrop of its Medium Term Strategy (2008-12) and drawing on the lessons learned from its past efforts, the AfDB has recently decided to mainstream PSD throughout its all of its operations under a "One Bank" approach. It is in the process of finalizing a new PSP and updating its PSS with a view to increase its effectiveness and remain relevant to RMCs by ensuring that its operations contribute directly to bolstering the private sector as a means to increase inclusive growth and reduce unemployment and poverty. Going forward, the AfDB and other development partners should endeavor to scale up support for PSD in infrastructure development, access to finance, human capital development, and regional integration, as well as engagements with the private sector, including through PPPs.

Introduction

The AfDB recognizes the importance of a flourishing private sector for inclusive, sustainable economic growth and has been supporting private sector development in Africa for over 40 years. The Bank has continually taken stock to determine how it can have the greatest impact and, most recently, has undertaken a comprehensive exercise to develop a new PSP that mainstreams PSD throughout all of its operations and that will be implemented through its revised PSS. This initiative is the result of 3 key considerations:

- The most recent gross capital increase commits to implementing more non-sovereign operations in ADF countries in recognition that most shareholders cannot borrow from the Bank, yet have had to pay their share of the 200 % capital increase;
- The state of play among Bank Group sovereign clients is evolving, as they have potential new sources of finance, greater appetite for private sector led growth, and are now experimenting with various forms of private sector investment and financing in infrastructure and service delivery; and

Beyond non-sovereign operations, there is also opportunity to leverage all of the Bank's resources to enhance the enabling environment and socio-economic infrastructure for PSD.

This chapter provides an overview of the AfDB's evolving approach to PSD in Africa, summarizes of its key interventions aimed at addressing the main challenges to PSD, highlights the lessons learned from recent experience, and sheds light on the way forward in its continuing effort to support PSD on the continent. The AfDB will continue to refine its interventions and instruments while at the same time strengthening its monitoring and evaluation capacity to ensure that its efforts have the desired development impact.

Historical Evolution

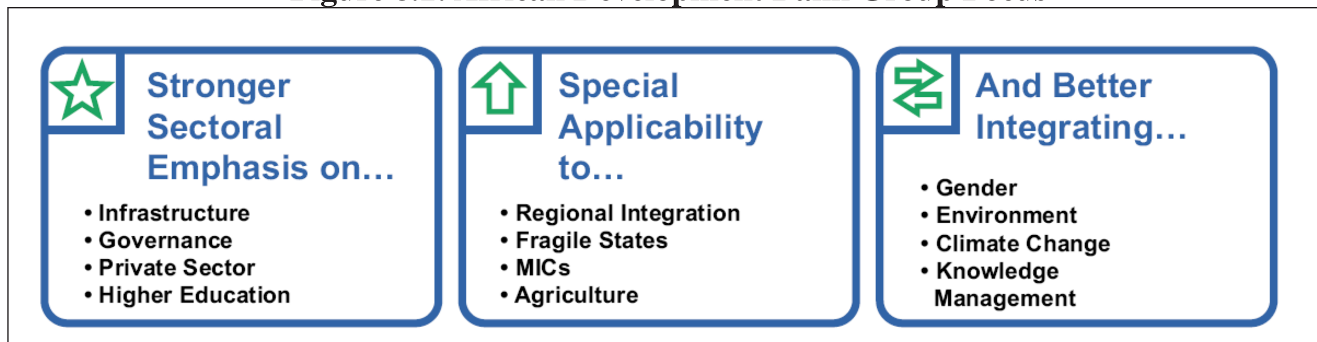
Since its inception in 1969 through 1991, the AfDB provided assistance to the private sector in RMCs indirectly, mainly through interventions aimed at supporting the creation of an enabling environment-through technical assistance, infrastructure project financing, lines of credit to national and sub-regional financial institutions for on-lending to private enterprises, support for the creation of sub-regional development finance institutions (including through direct equity contributions), policy-based lending, macroeconomic financial management, and regulatory reform[143].

By the early 1990s, the Bank realized that to be more effective it needed to provide direct support to the private sector through targeted operations. In late 1990, the Bank's Board of Directors approved the creation of a Private Sector Development Unit (PSDU), with effect from March 1991. The unit was upgraded into a department (OPSD) in 1998, and later renamed the Private Sector and Microfinance Department (OPSM) in July 2006. Through OPSM, the Bank provided direct project support to selected private enterprises and indirect support to SMEs through regional and national financial intermediaries. These were mainly operations in support of industrialization. The volume of investments remained modest (around US$ 200 million per year up to 2006). In parallel, other Bank departments continued to promote the private sector through sovereign infrastructure financing and technical assistance to RMCs.

The AfDB Board and Management believed more could be done and the Bank Group's 2003-07 Strategic Plan specifically addressed PSD. The Bank also launched its new PSS in 2004 in fulfillment of a commitment undertaken during the AFD-9 replenishment consultations to assign more roles and responsibilities for PSD throughout the Bank. The Strategy stated that "a special premium will be paid to private sector development and capacity building initiatives and programmes to bring the benefits of globalization to regional member countries, in particular through increased foreign direct investment inflows and the promotion of small and initiatives to ameliorate the enabling environment.

The 2004 PSS was not fully implemented, however, because the sBank Group operations continued to be conducted in twin silos-a dominant public sector complex and a minor private sector department – with little synergy between them. Drawing on lessons from the past, the AfDB made PSD one of its four main priorities (along with infrastructure, governance, and higher education) in its 2008-12 MTS (Figure 8.1). Moreover, it placed greater emphasis on the delivery of development outcomes, improving portfolio quality, and accelerating project implementation. At the same time, it updated the 2004 PSS for the period 2008-12 and refined its priority pillars: infrastructure, industry and services, financial intermediation, and SMEs and microfinance. The AfDB's vision for PSD under the MTS was one in which the private sector is connected to sustainable development and poverty reduction.

Figure 8.1: African Development Bank Group Focus



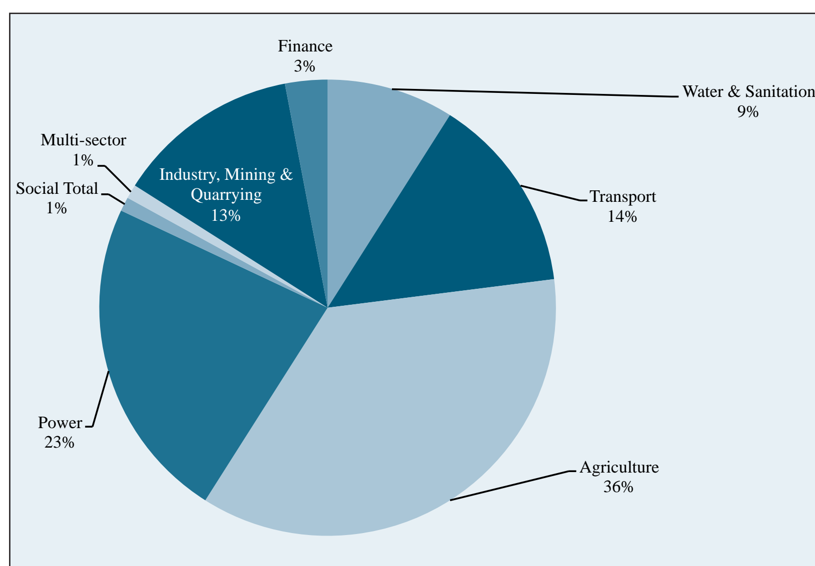
Source*:* AfDB 2008.

143 AfDB 1997.

Bank Operations for Private Sector Development

The AfDB has provided substantial support to PSD in RMCs in the legal and regulatory environment, infrastructure, finance, higher education and vocational training, entrepreneurial development, and corporate governance (Figure 8.2). It has done so through its sovereign lending, private sector operations (PSO), Policy Based Operations (PBOs), Institutional Support Programs (ISPs), technical assistance, and knowledge products.

Figure 8.2: Cumulative Active Projects in African Development Bank Portfolio by Sector



Source: AfDB 2008.

The AfDB is supporting RMCs to improve their legal and regulatory environment for businesses through PBOs and ISPs. The Bank's Governance Action Plan specifies a number of operational areas of focus to assist RMCs, including improving business laws and institutions, enhancing corporate governance (through, for example, the APRM), combating corruption, supporting financial sector development (through, for instance, improved payments systems and the "Making Finance Work for Africa" program), and strengthening the legal and regulatory environment, including through the Business Enabling Environment (BEE) program. The AfDB's support in these areas includes the creation of one-stop shops, streamlining of tax and customs administration, improving land title administration, and implementing the Extractive Industries Transparency Initiative. In addition to the increased PSO portfolio noted above, between 2007 and 2010 the Bank developed 44 PBOs, of which 21 had at least one component supporting the business enabling environment and 24 ISPs, of which 13 had components designed to improve the business environment (Box 8.1).

Box 8.1: AfDB/OSGE Support to the Legal and Regulatory Environment in Selected RMCs

AfDB supports legal and regulatory framework development in West Africa and in several countries including Rwanda, Mozambique, Morocco and Tunisia.

Rwanda, PBO: Following the 2004 and 2007 budget support programs, the Poverty Reduction Strategy Support Program III was approved in early 2009. These three operations supported Rwanda's transition from post-conflict reconstruction to re-engagement with the international community, through enhancement of the country's

public financial management systems and governance institutions. Key outcomes under the Bank's budget support operations included stronger local institutions that are better able to manage their economic and financial affairs. It also improved transparency in the public procurement process. Recent legal and institutional reforms focused on protecting investors have resulted in Rwanda improving its overall ranking in the World Bank's 2010 Doing Business Report to 67th, up from 143rd in 2008 (out of a total of 183 economies).

Mozambique: The One Stop Shops (OSS) is an innovative project (2009) supported by the Bank aimed at simplifying doing business in Mozambique. The 2010 Doing Business Report, which ranks countries on their "Ease of Doing Business", upgraded Mozambique by 5 positions. Much of the gains relate to the fast and reliable access to business registration and licensing procedures streamlined through the OSS. One-Stop-Shops are administrative service centers that gather all concerned governmental departments under the same building enabling entrepreneurs to register and obtain licenses for their companies in one single location. The centers also provide other services such as issuing national identity cards, passports as well as births, marriage and property certificates. They also offer tax and social security services, notary services, and emigration services. The Bank currently finances six OSS across the country by providing them with IT equipment, training staff and financing communication programs.

Morocco, PBO: The Financial Sector Development Support Program approved by the Bank in December 2009 aims at improving access to banking services, strengthening the microcredit sector, improving effectiveness of the national guarantee system, sharing risk information, developing venture capital, strengthening financial market and insurance sector supervision and control, and revitalizing the financial market. This second generation reform program will benefit the Moroccan people as a whole, including the government, households, the private sector, and, in particular, small and medium enterprises.

Tunisia, Integration Support Program (2009): The support reinforces Bank's contribution to the development of the financial sector and the business environment. It supports the Tunisia's 11th National Development Plan (2007-11), which aims to strengthen growth and employment generation. The main thrust of the program is to continue growth-enhancing reforms anchored around a deeper integration of Tunisia to the global economy and assist the Government in responding to the global financial crisis. The program focuses on, among others, helping Tunisia to restructure balance sheets of banks and insurance companies, and improve the quality and availability of financial information; Strengthening of competition policy including increased convergence of tax treatment of offshore and onshore sectors.

West Africa, regional ISP: The Bank is supporting access to banking services in the CFA zone by promoting the modernization of payment systems in the West Africa Monetary Zone (WAMZ). The core objective is to increase access to financial services in the CFA region from 10 % (2009) to 20 % (2015). The program supports the establishment of national and regional mechanisms of payment to ensure that the new systems meet internationally acceptable standards, thus promoting consumer confidence in West African Monetary Zone financial systems.

Source: AfDB Governance, Economics, and Financial Reforms Department 2011.

The AfDB is involved in financing infrastructure and catalyzing funds through traditional and innovative methods for both the public and private sectors in order to facilitate PSD. Over the past five years, the Bank has increased the volume of financing for infrastructure projects, as well as the proportion of financing that goes to regional projects. The Bank has also been utilizing blended financing packages and risk management instruments to attract private finance, build capacity in RMCs, and broker complex

regional projects. In addition to providing loans for infrastructure development projects, the Bank has also introduced the use of quasi-equity instruments, such as subordinated loans, to raise the overall return on investment, and/or to enhance credit structures to acceptable risk levels. To address exchange rate risk, the Bank has invested more than 25 million dollars in the Currency Exchange Fund (TCX). The Fund helps investors hedge against risks associated with project financing in local currencies. The Bank has also become increasingly more involved in providing guarantees, and participating in currency swaps markets. In addition, it is promoting capacity building in RMCs to build efficient and sustainable institutions and regulatory frameworks that are robust enough to develop even the most complex projects. The Bank is also working closely with the AU through the recently launched PIDA, and is developing a road map for the execution of a priority set of regional integration infrastructure projects.

The Bank has been promoting financial sector development and private sector access to finance in Africa, primarily by strengthening financial institutions and regulatory and supervisory institutions. Initial interventions focused mainly on providing financing to the real sector through lines of credit to financial institutions. This remains the main instrument used by the Bank's private sector window to channel financing to private sector players through financial intermediaries. But the Bank has also been promoting microfinance institutions to cater to micro enterprises and households. Over time, the Bank has placed greater emphasis on policies, institutions, and financial infrastructure by supporting payment system reforms, funding capacity building programs aimed at strengthening institutions and supervisory capacity, and offering policy-based loans and budget support operations to foster financial sector reforms[144]. More recently, the Bank has developed innovative direct solutions to improve private sector access to finance, including the creation of the Microfinance Capacity Building Trust Fund in 2009 and the African Guarantee Fund for SMEs.

The Bank's support for human capital and skills development in RMCs is underpinned by its HEST strategy, which has 3 pillars (i.e., centers of excellence, infrastructure, and linkage with the productive sectors). The Bank supports the diverse needs for STI taking into account countries' different needs and levels of development. This support includes capacity building, policy advice, building STI infrastructure, and establishing national and regional centers of excellence. It focuses on addressing the need to develop manufacturing capabilities through enterprise incubators and job creation, such as financing linkages between universities and research institutions in Rwanda using the Knowledge Transfer Partnership approach. It is also promoting linkages with the productive sectors via the Bank's support for the Technical Vocation and Educational Training (TVET) project in Kenya (2009) and Mali's ICT Technopole project (to be presented to the Board in 2011). In addition, the Bank is working with other development partners and the private sector to assist RMCs to: (i) assess skills needs; (ii) strengthen HEST-industry linkages; (iii) promote and support measures to increase women's participation in STI-related training and research activities; and (iv) cultivate technological development through partnerships with the private sector.

The Bank has recently begun to promote entrepreneurial development through a variety of efforts, spearheaded by FAPA and the AfDB Human and Social Development Department (OSHD) (Box 8.2). The FAPA Regional Franchising project (2006), which is being implemented in Ghana, Senegal, and South Africa, advances franchising with the aim of contributing to economic growth and job creation. Training is offered through seminars and manuals. Its export-oriented SMEs project (2007) provided technical assistance to Ghanaian SMEs that had high potential of exporting non-traditional products, while its Growth-Oriented Women Entrepreneurs project (2005-2006) bolsters female entrepreneurship in Cameroon and Kenya (Box 8.3). Finally, FAPA's Private Sector Capacity Building project (2008) provides business information (resource center, magazine, and radio programs), MSME competitiveness (business development centers, mini-exhibitions), special entrepreneurship programs for women and youth, and public-private sector dialogue.

144 Examples include the reform of the banking system in Egypt and the payment systems in the West African Economic and Monetary Union (WAEMU). The Bank also launched the Fund for African Private Sector Assistance (FAPA) in 2005.

Box 8.2: The Fund for African Private Sector Assistance and AfDB's Support to Female Entrepreneurs

The Fund for African Private Sector Assistance (FAPA) was created in 2005 in partnership with the Japanese government, under the Enhanced Private Sector Assistance Initiative for Africa, as a thematic trust fund that provides untied grants for technical assistance and capacity building in support of the AfDB's PSD strategy.

FAPA's grants complement the Bank's conventional financial instruments (equity investments, project loans, credit lines, and guarantees). The grants are offered to governments, regional economic communities, business associations, market regulatory institutions, business development service providers, business training and research institutions, and public/private enterprises. FAPA's five areas of focus are in line with the PSD strategy: (i) creating an enabling environment; (ii) strengthening financial systems through technical assistance; (iii) building competitive infrastructure; (iv) promoting the development of micro-, small-, and medium-scale enterprises, particularly promoting entrepreneurship and formalization through support programs that address weak business support institutions, skills shortages in business development, weak equity capacity, and limited access to commercial financing; and (v) promoting trade by providing support to remove trade barriers and strengthening the capacity of local trade finance institutions.

FAPA is now in the process of replenishing its funds and undergoing a thorough evaluation of its projects.

One of the programs FAPA supports is for female entrepreneurs.

The AfDB recognizes the importance of female entrepreneurship and skills development. To help African female entrepreneurs, the Bank has developed the Growth Oriented Women Entrepreneurs (GOWE) projects in Cameroon (2006) and Kenya (2005). The project facilitates affordable financing by reducing the collateral requirements and enhancing the credit assessment capacities of partner banks through partial credit guarantee facilities to select participating banks in Cameroon and Kenya. These banks in turn finance underserved GOWEs, Women Entrepreneur Associations, and Business Development Service providers.

The GOWE projects also have technical assistance facilities, which cover (i) training and mentoring clients based on a thorough needs assessment and (ii) capacity building of partner institutions, including local banks, business development service providers and women's associations. Capacity building includes technical training in relevant areas, heightening gender awareness, and in some cases, purchase or development of software tools. Technical assistance is funded by FAPA and implemented by PEP-Africa in cooperation with the International Labour Office.

The two programs together are expected to finance at least 800 women entrepreneurs, enhance and expand entrepreneurship development in these countries, create employment of at least 1,000 people, encourage banks to provide longer-term loans, and strengthen the technical and financial plans of associations of women entrepreneurs, business development services providers and partner banks.

Source: AfDB 2010 and 2011.

OHSD's social protection unit has three main operational approaches to supporting the development of business managers and entrepreneurs in Africa: building capacity for MSMEs; facilitating access to finance; and improving the business enabling environment for MSME development. Its projects cover every region of Africa and provide capacity building usually in tandem with access to finance (Box 8.3).

Box 8.3: Examples of AfDB's HD Department's Support to Entrepreneurship Development

Two examples of AfDB's Human Development Department's projects supporting entrepreneurship are in Mauritania and Guinea.

In Mauritania, the Project to Build the Capabilities of Microfinance Operators (2007)—builds stakeholder capacities with respect to the supply and demand for microfinance services through the provision of technical training on demand and coaching to 1,500 MSE promoters and the provision of training on entrepreneurship and the creation and management of SMEs.

In Guinea, the Sustainable Social Development Project (2010) reduces poverty through entrepreneurship development, job creation and support to local governments through the strengthening of technical, organizational, and management capacity of 150 SMEs and 150 corporative associations.

Source: AfDB Human Development Department 2011.

The Bank adopted a comprehensive CG strategy in 2005, which serves as the framework for its interventions in this area. Its objective is to contribute to economic development by promoting good CG in both private (including family-owned) and public corporations to create value for shareholders and other stakeholders in a financially, socially, and environmentally responsible manner. Good CG is also a direct concern to the Bank as an equity investor in private sector ventures and a financier of development projects, which often rely on the involvement of private sector corporations and state-owned enterprises. Since adopting its strategy the Bank has taken steps to strengthen its internal institutional framework, increase knowledge transfer and dissemination, and develop effective interventions based on best practices and lessons learned. The Bank is encouraging RMCs to adapt international best practices of CG principles to their specific country context and corporations to adopt these principles. It is focusing its financial and technical assistance on the development and enforcement of CG codes and on strengthening the capacity of financial intermediaries to enforce the CG standards by including them as a key part of their lending policy (Box 8.4). The Bank is also supporting regional training, building on existing regional mechanisms.

Box 8.4: AfDB Initiatives in Support of Good Corporate Governance in Africa

Recent Bank initiatives in Corporate Governance (GC) include:

- Continuous support to NEPAD and the African Peer Review Mechanism (APRM) Secretariat, NEPAD counties, professional bodies, and Pan-African institutions, such as the Pan-African Consultative Corporate governance Forum.
- Active participation in the preparation and adoption of the common DFI's position on CG. The declaration was signed by 31 DFIs (including the AfDB) during the 2007 World Bank Group Annual Meeting.
- Hosting an annual consultative meeting on key developments with selected stakeholders involved in CG with a view to exchanging information and improving coordination in the field (2005, 2006, and 2007).
- Organization of a workshop during the Bank's Annual Meetings in Shanghai

Source: AfDB Governance, Economic, and Financial Reforms Department 2011.

Lessons Learned

The AfDB has evaluated the lessons learned from its past efforts to promote PSD. While the Bank's PSOs have grown substantially, particularly over the past 5 years, its other tools to promote PSD have been underutilized. This section outlines key areas requiring improvement or reorientation.

The Bank's evaluation group reviewed its PSOs from 1997-2005 and found that almost 80 % of its projects had positive development outcomes. The majority of its additionality impact was financial and the key to good performance was through support to RMCs' business environments. Increased efforts in project planning and monitoring were also important for positive development outcomes. Though the findings were mostly positive, as indicted below, the impact of these operations could have been greater.

Although PSD has been a priority in the Bank's operations, it has not been fully integrated into the institutional culture of the Bank, thus reducing its potential impact. The lack of integration is a direct yet unintended result of the creation of the private sector unit in 1991 which, in effect, splitting the Bank into two silos—the private sector department and the rest of the Bank. As a consequence, though PSOs grew impressively, the development impact of these operations was undermined by the missed opportunities for synergies between the Bank's public and private sector operational departments. Country strategy papers also reflected the cleavage, showing a systematic lack of focus on PSD opportunities, challenges, and solutions. Therefore, in order to achieve the organization-wide mandate for PSD with strong, positive outcomes, the Bank must further develop the necessary roles, functions, and business processes and identify and harness the links between its sovereign and non-sovereign activities.

The AfDB could strengthen its impact through a more focused approach. The Bank has undergone several institutional reforms to make its PSO credit processes more rigorous as these operations grew rapidly in recent years. This model, which initially focused only on those directly involved with PSO business processes, could be applied. Adopting a sector-focused project identification approach and review process to address enabling environment issues upfront, along with a more targeted sovereign financing to catalyze non-sovereign transactions, could enhance the effectiveness of both types of financing.

The current resources available to finance the Bank's knowledge products are fragmented and insufficient to mobilize the best available market and business information. Moreover, the high transaction cost involved in attracting resources to finance such activities is a barrier to their utilization. The programming and financing of research and development are also under-resourced, under-executed, and not systematically disseminated to guide the design of Bank operations. This is also the case regarding institutional knowledge management within the Bank, resulting in a limited ability to document approaches and best practices to scale up and replicate.

Currently, institutional development, capacity building, and technical assistance are primarily conducted by external consultants and financed from operational budget and trust funds without any forms of cost recovery. This is in stark contrast with other development institutions that have in-house services and capacities, such as the IFC whose advisory services staff exceeds that involved in investment transactions. A more integrated and structured approach to the mobilization and financing of technical assistance and advisory services is therefore needed. The focus should be on leveraging the Bank-wide strategy on capacity building, which emphasizes the need to support African institutions as partners in technical assistance and advisory services.

As the AfDB expands its PSO into lower-income countries, including Fragile States, with increased emphasis on microfinance, SME development, and equity investments, this will affect the risk profile of the Bank's non-sovereign portfolio. Therefore, an increasing number of new operations will likely be rated as high risk, requiring intensified capital planning on the part of the Bank.

In order to ensure that it is getting the maximum development impact from its private sector operations, the Bank relies on its independent Operations Evaluations Department (OPEV) and its newly created (2008) Additionality and Development Outcome Assessment (ADOA) team. These entities thoroughly examine projects both at the front end (ADOA) and at their conclusion (OPEV) to make sure that the projects

were well-designed, that development outcomes were clearly defined, that the Bank's additionality was clearly demonstrated, and that the desired outcomes were achieved. Up unto the present, the AfDB has focused its evaluations on PSOs, leaving gaps regarding the assessment of the developmental impact of its other operations in support of PSD, including in the areas of the business environment, infrastructure development, access to finance, human capital and skills development, entrepreneurial development, and corporate governance. The Bank's new PSP and PSS will need to address these omissions.

The Way Forward

The Bank is mainstreaming PSD throughout all of its operations against the backdrop of its 2008-12 Medium Term Strategy (MTS) and is placing greater emphasis on the delivery of development outcomes, improving portfolio quality, and accelerating project implementation.

Drawing on the lessons learned, the AfDB is preparing a new PSP and an updated PSS. Their purpose is to increase the Bank's effectiveness so that it can remain relevant to its RMCs by ensuring that its operations contribute directly to bolstering the African private sector as a means to increasing inclusive economic growth and reducing poverty. The three main objectives are to:

Support RMCs in improving their business enabling environments and advancing their international competitiveness. This includes policy reform, regional integration, infrastructure development and services delivery, and supporting financial markets.

- Promote private sector-led economic growth by fostering entrepreneurship, providing direct and indirect support to microenterprises and MSMEs, empowering women to become entrepreneurs, and encouraging economic integration and diversification.

- Encourage social and environmental responsibility, sustainability, and good corporate governance.

The AfDB's efforts will be guided by the following four principles: (a) ownership of PSD begins first and foremost with RMCs, (b) use of Bank resources must be results-oriented to ensure additionality and its catalytic effect; (c) Bank operations should be aimed at promoting a private sector that is sustainable, inclusive, socially equitable, open, and competitive; and (d) risk-taking must be properly paired with financial prudence.

This "One Bank" approach will therefore mainstream PSD in every dimension of the Bank's work. Country Strategy Papers and Regional Integration Strategy Papers from the country and regional departments will be central to this effort as they will provide the framework for multi-stakeholder review and identify priority areas for policy dialogue, policy-based operations, investment financing operations, and analytical economic and sector work. Business enabling environment operations will include knowledge products, policy-based operations, and sovereign projects. Non-sovereign operations will include private sector operations, sub-sovereign operations, and technical assistance and advisory services. Risk management, additionality and development outcomes assessment, and monitoring and evaluation will continue to be used to ensure additionality, effectiveness, financial sustainability, and catalytic effects. All these will be couched against the single optic of PSD.

Going forward, apart from supporting RMCs in improving investment climates, the AfDB and other development partners should scale up their resource support for infrastructure, finance, human capital (especially higher education and skills development), and regional networks in line with its MTS. The Bank should also scale up its engagement with the private sector through PPPs and support for changes in trading structures and practices. Stakeholders in PSD, including the Bank, should catalyze the private sector by scaling up successes such as big reformers, the ICT and tourism sectors, and regionalization of business, finance and infrastructure development. Unleashing financial, entrepreneurial and knowledge resources in RMCs will also support PSD and create a more sustainable and inclusive pattern of growth and development.

METHODOLOGY NOTE

This report analyzes Africa's private sector using an income-based classification separating low-income or ADF countries, including Fragile States, from middle-income or ADB countries.

ADF countries: Angola, Benin, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Cote d'Ivoire, Democratic Republic of Congo, Djibouti, Eritrea, Ethiopia, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Nigeria, Republic of Congo, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Zambia, and Zimbabwe.

Fragile States: Burundi, Central African Republic, Chad, Cote d'Ivoire, Democratic Republic of Congo, Eritrea, Republic of Congo, Guinea, Guinea-Bissau, Liberia, Sierra Leone, Sao Tome and Principe, Somalia, Sudan, Togo, and Zimbabwe.

ADB countries: Algeria, Botswana, Egypt, Equatorial Guinea, Gabon, Libya, Mauritius, Morocco, Namibia, South Africa, Seychelles, Swaziland and Tunisia.

The data are also broken down by sub-regions:

North Africa countries: Algeria, Egypt, Libya, Mauritania, Morocco, and Tunisia.

Southern Africa countries: Angola, Botswana, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Zambia, and Zimbabwe.

East Africa countries: Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Rwanda, Seychelles, Somalia, Sudan, Tanzania, and Uganda.

West Africa countries: Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, the Gambia, Ghana, Guinea, Guinea Bissau, Liberia, Mali, Niger, Nigeria, Sao Tome and Principe, Senegal, Sierra Leone, and Togo.

Central Africa countries: Cameroon, Central African Republic, Chad, Democratic Republic of Congo, Republic of Congo, Equatorial Guinea, and Gabon.

And finally, the data are broken down by oil status (exporting versus importing):

Net oil-exporting countries: Algeria, Angola, Cameroon, Chad, Cote d'Ivoire, Democratic Republic of Congo, Egypt, Equatorial Guinea, Gabon, Libya, Republic of Congo, Nigeria, and Sudan.

Net oil-importing countries: Benin, Botswana, Burkina Faso, Burundi, Cape Verde, Central African Republic, Comoros, Djibouti, Eritrea, Ethiopia, the Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Mozambique, Namibia, Niger, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Somalia, South Africa, Swaziland, Tanzania, Togo, Tunisia, Uganda, Zambia, and Zimbabwe.

An alternative method recently developed by Bank staff but not yet officially adopted ranks countries based on their level of development and/or attractiveness of their financial markets to foreign investors[145]. The term 'emerging markets' defines the countries that have reached a certain level of development and/or their financial markets have attracted substantial interest of foreign investors. A broader categorization was designed to reflect Africa's diversity based on the recognition that all low income

145 The alternative classification scheme was developed by Zuzana Brixiova and Léonce Ndikumana, with contributions from Kaouther Abderrahim, in the Africa Economic Brief, Volume 2, Issue 8, published by the AfDB in June 2011.

countries (LICs) in Africa are transitioning to the status of emerging market countries, albeit at different speeds. Resource-rich countries and Fragile States are also classified separately reflecting their specific structural features and challenges. The results using this alternative method are broadly in line with the findings of the income-based classification in most areas, except in its three more disaggregated low-income country classifications, for which data is subject to wide variations.

Emerging Markets (MICs): Cape Verde, Mauritius, Morocco, Seychelles, South Africa, Swaziland and Tunisia.

LICs, Frontier Markets: Ghana, Kenya, Mozambique, Senegal, Tanzania and Uganda.

LICs, Transition Countries: Burkina Faso, Djibouti, Ethiopia, Lesotho, Malawi, Rwanda and Sao Tome and Principe.

LICs, Pre transition Countries: Benin, the Gambia, Madagascar, Mali, Mauritania, Niger and Togo.

LICs, Fragile States: Burundi, Central African Republic, Comoros, Guinea, Guinea-Bissau and Liberia.

Resource-rich Countries: Algeria, Angola, Botswana, Cameroon, Chad, Côte d'Ivoire, Democratic Republic of Congo, Egypt, Equatorial Guinea, Gabon, Libya, Namibia, Nigeria, Republic of Congo, Sierra Leone, Sudan and Zambia.

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