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Fostering Economic Development in Sub-Saharan Africa: What Role for Reforming Business Regulations?

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Despite a promising period of higher GDP growth rates in recent years the development of Sub-Saharan African economies is still clearly lagging behind other developing regions. Since 2000, the annual GDP growth in Sub-Saharan African economies varied from three to six percent. Growth rates peaked in 2006–07 and, despite the global financial crisis, declined only slightly in 2008. However, for 2009 and subsequent years analysts expect growth rates to drop significantly to about two percent as a result of second wave effects of the crisis, e.g. dropping demand for raw materials, delaying or even suspension of foreign direct investment projects and decreasing remittances (UNECA 2009; OECD and AfDB 2009).

In previous decades the economies in Sub-Saharan Africa stagnated on average below two or even one percent of annual GDP growth rates. As growth rates were slightly higher in the 1960s – for many countries the early years after independence – the average growth curve of Sub-Saharan Africa economies from 1960 to the present is U-shaped (Ndulu et al. 2007). Due to an average population growth of two and a half to three percent, per capita income stagnated or even declined until 2000 in many Sub-Saharan African countries as compared to other developing regions, especially East Asia where higher and more sustainable growth paths led to an increase in per capita income already in the 1980–90s.

The recent more dynamic development since 2000 is therefore definitely a sign of hope for Sub-Saharan Africa, but among others the following factors do partly dampen the optimism. Diversification of most Sub-Saharan African economies is still very low. For instance, trade openness as measured by the share of aggregated imports and exports to GDP is quite high, but, according to OECD and AfDB (2009), 18 out of 45 Sub-Saharan African countries are exporting just four or even fewer products (mainly oil, mineral resources and some agricultural products), which accounted for more than 75 percent of their exports in 2007. UNECA (2007) suggests that over the last decades reaction of many Sub-Saharan African countries to the economic crisis has been rather defensive. While countries in other developing regions deliberately tried to diversify their economies, thus making them more competitive and less prone to external shocks, Sub-Saharan African countries failed to use e.g. windfalls gains from commodity sectors for making strategic investments and enhance structural change. Needless to say, this can often be attributed to severe governance problems and corruption.[1]

Furthermore, the productivity of the domestic private sector has improved rather slowly and is presently far from converging with the global productivity level. UNECA (2009) shows for agriculture that an increase in land and labour productivity taken place since the early 1980s was too marginal to reduce the gap to the rest of the world: for example, labour productivity increased by 10.6 percent since 1989-1991 but its 2003–2005 level amounted to only 31 percent of the average world labour productivity. Ndulu et al. (2007) point to the fact that such a competitive disadvantage has also been combined with the shortfalls in factory-floor productivity, while high indirect costs have further weakened the relative performance of the private sector.

Repeatedly the low level of productivity and the low degree of economic diversification are two of the main explaining factors for continuously prevailing low competitiveness of most Sub-Saharan African economies. The 2009 World Economic Forum's

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[1] Although there is a link between the investment climate and corruption, this phenomenon is beyond the scope of this article. Moreover the issue is extremely complex and cannot be analysed from an economic development perspective alone.

Global Competitiveness Index 2009–2010, for instance, covers overall 133 economies in the world, including 26 Sub-Saharan African countries of which 21 are positioned at the bottom of the ranking (WEF 2009a and 200b). And despite the relatively high GDP growth rates experienced since 2000, the increase in average per capita GNI adjusted by purchasing power parity for Sub-Saharan Africa has recently been outperformed by the countries in South Asia. On average, both regions had the similar per capita GNI level in the mid-1990s but, according to the latest World Bank's World Development Indicators, Sub-Saharan Africa reached its level of about USD 2,000 in 2008 compared to more than USD 2,700 in South Asia.

All this puts the pre-crisis growth rates of Sub-Saharan African economies into perspective and leaves economists, local policy makers and development cooperation with a puzzle: what can be done and what needs to be done to accelerate the necessary structural change in Sub-Saharan Africa? Traditional policy approaches cover a broad spectrum of strategies from interventionist policies to stimulate private sector development to the structural adjustment programmes of the 1980s and the concepts of a rather lean state for economic development. Recently the World Bank's approach to reforming the regulatory environment for businesses has been widely recommended as the promising response for promoting enterprise development and economic growth in developing countries. In the following the relevance of this approach for overcoming the serious bottlenecks of economic development in Sub-Saharan Africa is discussed.

The 'Doing Business approach' to reforming business regulations

Since 2004 the World Bank's Doing Business report series most prominently advocates for reforming business regulations in order to foster economic growth in developing countries – see World Bank (2009) for the most recent issue. In a nutshell, the approach recommends lessening regulations in areas like business and property registration, licences, employment and taxes as well as enhancing contract enforcement and strengthening property rights – particularly with regard to credit and investment. These recommendations come together with an indicator system that serves as a benchmarking tool. The Doing Business indicator system basically tries to capture time and monetary costs accruing to businesses in these regulatory areas. Countries are benchmarked against these indicators and ranked according to their index values, coming up with the ease-of-doing-business ranking. Most Sub-Saharan African countries rank poorly in this index, populating the lower third of the ranking. Although there are some notable exceptions – like Mauritius that ranks 17th out of 183 countries, South Africa 34th or Botswana 45th – the average rank of Sub-Saharan Africa with its 139th position is the lowest among the world regions (World Bank 2009).

At the first sight the policy recommendations of the 'Doing Business approach' sketched above appears to be plausible – particularly in the light of the region's low ranking in the ease-of-doing-business index and recalling the region's low average economic development. Nevertheless, in the remainder of the paper we get somewhat deeper into the subject and discuss the accuracy of the underlying reasoning as well as the relevance of the recommendations in the context of the various challenges for economic development which Sub-Saharan African countries are currently facing.

With respect to the accuracy of the underlying reasoning, it is worthwhile to briefly reflect on the theoretical underpinning of the Doing Business approach. To put it in a simple way, the approach can be classified as being in the tradition of a specific strand in institutional economics, namely the public choice school of thought (Djankov 2009). Contrary to the neoclassical economics, this school of thought explicitly models the state (politicians, bureaucrats) as being part of the economy and acknowledges the importance of fundamental institutions of market economies like the security of private property rights and contract enforcement that are backed by state institutions such as registries and courts. These basic market-enhancing institutions foster trust between buyers and sellers and reduce transaction costs, boosting the exchange of goods and services, investment as well as the supply of finance. In short such institutional aspects are seen crucial for economic development.

The normative benchmark of the public choice school is a setting where state actors limit themselves to securing this minimal set of institutions and to correct major market failures. However, this normative ideal is under constant threat, since politicians and bureaucrats, being self-interested individuals,

have incentives to establish regulations that are good for their own personal benefit (so that they can extract bribes from businesses and citizens) or for the benefit of business lobby groups (that engage in rent-seeking and manage to capture politicians and bureaucrats) but that are detrimental to the welfare of the economy as a whole. Therefore, regulations are mainly interpreted as being the result of state actors pursuing particularistic agendas, restricting market entry and hampering business activity.

There is some empirical support for this line of argumentation, mainly from cross-country regression analyses. First, with respect to the relevance and role of the quality of fundamental institutions Rodrik, Subramanian and Trebbi (2004) estimate the respective contributions of institutions, geography and trade integration to economic growth in terms of GDP per capita in a sample of 80 countries. They conclude that the quality of institutions, particularly the level of rule of law and the security of private property rights, clearly outplays the other factors. Second, there are several econometric studies using the Doing Business indicators as independent variables, particularly the indicator on start-up regulations, finding evidence for a positive correlation between less regulation and a smaller informal sector, less corruption, more entrepreneurship and greater employment opportunities respectively (World Bank 2009). Third, the Doing Business reports provide lively examples of highly cumbersome, lengthy and costly business regulations in Sub-Saharan African countries, illustrating in a very practical manner the burden this imposes on many enterprises (Sub-Saharan African countries are among those where registering and legalising an incorporated firm is most difficult and expensive: e.g. in Zimbabwe it takes 96 days and the associated cost equals to five times higher than the country's per capita income).[2]

Nevertheless, one should be cautious when deducing from this that the policy recommendations put forward in the Doing Business reports will make a great difference for Sub-Saharan African countries, significantly enhancing enterprise development and promoting economic growth. Does the overall picture sketched above really capture the main underlying reasons for lagging economic development or is it missing important aspects? In the following, two arguments are made for revising the conceptualisation of regulations and institutions and the recommendations deduced in the Sub-Saharan African context.

First, the social usefulness of regulations and institutions has to be evaluated looking from two different angles: the cost aspect and the benefit aspect. The Doing Business approach emphasises the cost angle. This is valid, and – going back to the aforementioned example – there is really no reason from a social perspective to have regulations in place for registering an incorporated firm that cost five times per capita income.[3] Cutting this cost will definitely improve social welfare. However, the measure will probably fall short in enhancing business growth. The problem with many formal institutions in Sub-Saharan Africa is that, in addition to being costly, they carry little value for economic agents or – to put it differently – they are not functional: the results of many surveys of African businesses support this fact as shown by Krause et al. (2010). Examples are registries that do not keep records or courts that do not respect the law. Hence, in general discussion of *de jure* content of regulations takes a back seat regarding the severe problem of lacking enforcement in many countries in Sub-Saharan Africa. However, it is evident that functional market-enhancing institutions, like e.g. business, property and credit registries, the courts or business associations that 'work' (i.e. that provide trustful information and enforcement rules) are key elements to enhance economic activity. Therefore, another – equally important – policy recommendation that can be drawn from the overall picture sketched, is to invest in market-enhancing institutions and public services, e.g. investing in human resources, paying civil servants better salaries and making procedures more transparent.

The second argument is linked to the question: what would be good business-enhancing regulations and institutions for Sub-Saharan African economies? The Doing Business approach has quite a clear picture of what are 'good' (and what are 'bad') regulations and institutions, inspired in the above sketched public choice perspective in combination with 'the common-sense interpretation of the institutional factors of success of Anglo-American market economies'. Like many other approaches that advocate for institutional reforms in developing countries (for instance also the ones that call for more state regu-

[2] See data from http://www.doingbusiness.org/CustomQuery.

[3] Such regulations are probably best explained by the kind of motivations assumed in the public choice approach.

lation), the Doing Business approach can be classified into the 'top-down view' of institutional change (Easterly 2008). This means that it is believed that improvements in the overall functioning of the institutional setting can be achieved "with a stroke of a pen" (World Bank 2007, 12) of the legislator, substituting old laws and regulations by new ones and copying the institutional pattern of 'front-runner' economies like Britain or the United States. However, there are good reasons to believe that the institutional pattern that serves as a model has been successful in these rich countries because it has evolved from 'bottom-up'. The experiences from land titling in Sub-Saharan Africa provide examples of how formal institutions introduced 'top-down' have little, or in some cases even negative effects, if they do not fit with local institutions and traditional rules. For instance, in Kenya the introduction of formal land property titles brought substantial uncertainties into the complex system of customary rights to land, leading to an increase in opportunistic behaviour and weak effects on credit use, land yields and investment. Studies from other countries in the region corroborate these results (Easterly 2008). In other words, the successful design and implementation of regulatory reforms needs a sound understanding of local (informal) institutions that are embedded in the social norms and traditions. Helmke and Levitsky (2004) outline a typology of informal institutions and suggest that these can be – e.g. in the presence of ineffective formal institutions – either substitutive or competing with the regulatory goals of the formal institutions. Fafchamps (2001) shows that the crucial role which segmented ethnical business networks play in many Sub-Saharan African economies for the exchange of goods and the provision of commercial loans, can be interpreted as the bottom-up institutional response to the absence of trustworthy state-backed market-enhancing institutions. This is clearly a case where the informal institutions are substituting for the ineffective formal institutions. Given the importance of these local institutions for businesses as well as the weakness of the state as backing and enforcing mechanism of western-style regulations and institutions, we have doubts that adopting the kind of regulatory reforms recommended by the Doing Business approach would have substantial effects on business development in Sub-Saharan African countries. The evidence rather calls for tailor-made reforms that are coherent with the local context and build on adapting existing institutions in order to make them more market-enhancing and functional.

A broader perspective on obstacles for economic development in Sub-Saharan Africa

However, even the bottom-up, tailor-made reforms of business regulation will arguably not be sufficient to significantly enhance enterprise development. Which observations do support this statement?

Let us take a look at what firm owners and business people regard to be main obstacles for business development. World Bank Enterprise Surveys[4] and the World Economic Forum's Executive Opinion Surveys (WEF 2007, 2009a and 2009b) are providing extensive data to explore the complexity of obstacles and opportunities for business development across countries. The analysis for Sub-Saharan Africa reveals that apart from the cumbersome business regulation acting as an obstacle to business development, various other factors are also making firms' investments and profitable operation of businesses difficult in many countries. Among them several significant determinants including infrastructure, health, education and technology as well as financial aspects are highlighted in the following.

Data of the World Bank Enterprise Surveys in Africa 2002–2006[5] as reported in WEF (2007) indicate that not less than 60 percent of firms in low-income African countries report the lack of or unreliable access to electricity as major or very severe constraint for business development. According to WEF (2009), African firms complain that nearly 13 percent of working hours are lost due to power outages, whereas firms in South Asia report just seven percent. Accessibility of telecommunication, on the other hand, has seen a major improvement through private investments in the mobile telecommunication infrastructure. This latter development is surely a ray of hope, as it creates new opportunities for doing business, eases access to information and recently even enables groundbreaking innovation in the area of mobile banking.

Nevertheless, regarding the weak health and educational systems in many countries in the region it is obvious that this not only causes social problems and injustices but also affects economic development. Above all, HIV/AIDS, malaria and tuberculosis severely affect labour productivity and are associated with high levels of absenteeism and underutilisation of capacity (in some countries of the region

[4] See http://www.enterprisesurveys.org.

[5] Figures given in this paragraph include data for North Africa.

HIV/AIDS prevalence in the working population ranges between 15 and 40 percent). Due mainly to the poorly developed healthcare systems, illness further weakens the productivity of families because cash income is diverted from investments in productive assets to payments for health treatment and burial expenses and because family members have to stay at home to care for patients. According to World Development Indicators for 2007, life expectancy reached only 51 years in Sub-Saharan Africa compared to 64 years in South Asia – the region with the next lowest average value.

Despite increases in primary and secondary school enrolment ratios, tertiary education remains a problem in many countries in the region. For instance, the education sub-indicator – simple average of the normalized scores of adult literacy and secondary and tertiary enrolment – of the World Bank's 'Knowledge Economy Index' (KEI)[6] shows that most Sub-Saharan African countries (except Botswana, Mauritius, Namibia, South African and Zimbabwe) receive a score less than two on a scale from zero to ten. Enrolment rates alone are, however, only part of the problem when it comes to a lack of linking higher education to the needs of the private sector. National innovation systems – i.e. nexuses between universities, institutions conducting applied research, private firms and the public sector – are developed only rudimentarily. According to WEF (2009), on a scale from one (worst) to seven (best), Sub-Saharan Africa scored 3.0 for the indicator for higher education and training, and 2.7 for the indicator for technological readiness.[7] In comparison the region Latin America and the Caribbean achieved 3.7 and 3.2, while Southeast Asia scored 4.1 and 3.6, respectively.

Regarding the relative weight of obstacles in the field of skilled labour and labour regulations, perception of business management on the constraints for firm growth is quite revealing. WEF (2007) shows that a share of about 21 percent of respondents in Africa assessed the shortage of skilled labour as a major or very severe growth constraint for firms, while the corresponding assessment for the labour regulations amounted to 15 percent of survey firms.

[6] For the Knowledge Assessment Methodology, see http://www.worldbank.org/kam.
[7] Both indicators are a mix of hard data and results from an opinion survey among senior management respondents in 26 Sub-Saharan African countries.

Finally, access to finance is throughout reported to be a main obstacle to business development. According to the World Bank Enterprise Surveys in Africa 2002–2006 (WEF 2007), more than 50 percent of firms in low-income (and also 25 percent of firms located in upper-middle income) countries in Africa chose the determinant as a major or very severe constraint. To be sure, the underdeveloped property registration system and insufficient collateral security required for obtaining formal loans is a problem and therefore the strategy aimed at easing property registration and establishing credit bureaus – as emphasised in the Doing Business reports – is one relevant part of reforms which addresses increasing access to finance.

Yet it should be noted that banks have been operating quite profitable in many Sub-Saharan African countries due to lending to large clients and the state (Beck and Honohan 2007). Average real lending interest rates of 10 to 20 percent prevailed in the period between 1995 and 2005 are not exactly providing favourable financing opportunities for businesses in general. The situation for many small and medium-sized enterprises is, however, even more difficult as their financing needs exceed the scope of microfinance products but, at the same time, these firms are underserved by commercial banks. This can partly be explained by high concentration and lacking competition in the banking sector. Beck and Honohan (2007) argue that in selected 22 African countries the market share of the top three banks averages 73 percent in each country, and show that at least three major background dimensions negatively affect banking efficiency in Sub-Saharan Africa: namely "the contractual and informational environment, the broader issues of systemic risk, and the lack of scale. Together these dimensions can explain the high risk premiums demanded by bankers, the high profitability, and the lack of competition" (Beck and Honohan 2007, 41).

Conclusion

In a review of private sector development in Sub-Saharan Africa, Altenburg and von Drachenfels (2008) highlight five fundamental weaknesses and shortcomings prevailing in the enterprise sector, which currently lead to the serious structural problems in this region. They include: (1) widespread and rising 'informality'; (2) a 'missing middle'– i.e. there are some profitable large firms and many struggling

micro and small firms which however lack the upward mobility; (3) weak inter-firm linkages; (4) lack of export competitiveness; and finally (5) lack of innovation capabilities. Without a doubt the regulatory environment also plays a significant role with regard to explaining some of these characteristics. For instance, a business owner may decide not to register his business due to the associated cost resulting from cumbersome procedures and thus stay informal. Furthermore, incentives for formation of inter-firm linkages are certainly lower if business transactions are more difficult and costly because of weak property rights and contract enforcement mechanisms.

Nevertheless, we argue that the World Bank's highly advertised 'Doing Business approach' to regulatory reform is not the answer to these structural problems in Sub-Saharan African economies, mainly due to three reasons:

- It focuses on reducing the private cost of regulations – which is only one part of the coin – and neglects increasing the functionality and social value of market-enhancing institutions and regulations – which is at least equally important.
- It advocates for a top-down institutional reform that follows a predetermined set of institutions and regulations inspired in 'western-style' market economies – without paying attention to whether this fits with traditional rules and local institutions that have developed from bottom up and without paying attention to potential adverse effects.
- Structural problems can hardly be solved by 'only' reforming the regulatory business environment. What is needed in addition, are targeted policies in the areas of infrastructure, education and technology, health as well as access to finance in order to increase the competitiveness of firms in Sub-Saharan Africa.

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