2

Spurring and Sustaining Economic Growth

Economic growth is central to reducing poverty and meeting the Millennium Development Goals (MDGs). Globally, prospects are promising for halving income poverty—the first goal—by 2015. The two countries that in 1990 were home to the most poor people, China and India, have accelerated economic growth for sustained periods and made significant inroads into reducing the incidence of poverty. Due partly to their efforts, East Asia has already achieved the poverty goal, and South Asia is on target. Most other developing regions are making steady progress and are expected to either achieve the goal or come close, even as pockets of poverty remain at the national and subnational levels. But in Sub-Saharan Africa the momentum has been slower, and most countries are at severe risk of falling short.

To accelerate progress toward the poverty goal, Sub-Saharan Africa will need to substantially boost economic growth. Increases in a country's overall income tend to lift the income of its poor people proportionately, and there is little doubt that differences in policies and institutions have played a major role in explaining the divergent poverty trends seen, for example, in East Asia and Sub-Saharan Africa. The growth process in Africa, although subject to some initial disadvantages such as difficult geography and high incidence of disease, responds to key policy drivers in a manner fundamentally similar to economies elsewhere. Thus the promotion of higher growth rates through policy and institutional reforms is critical for poverty reduction (box 2.1), and outlining the agenda for spurring and sustaining growth in Sub-Saharan Africa is the focus of this chapter.

Recently there has been evidence that Sub-Saharan Africa is starting to turn the corner. Twelve countries are experiencing a growth acceleration of the type more commonly associated with other regions. More generally, improvements in economic policies and political institutions have supported higher growth rates across the region. But these achievements are only the beginning of what is needed to sustain needed improvements in income levels and living standards. It is considerably more difficult to sustain growth than merely to initiate it.

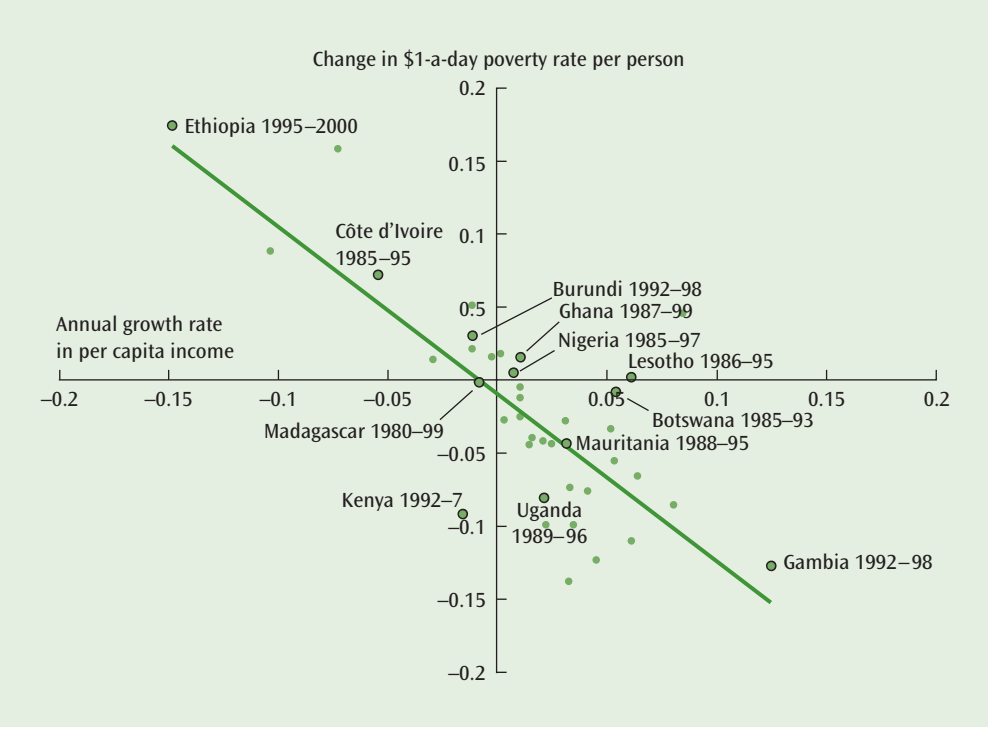
Sub-Saharan Africa's weak economic performance over the past four decades, and its difficult prospects for reaching the MDGs, have led some analyses to conclude that many African countries are caught in "poverty traps." The suggestion in these analyses is that large amounts of aid are needed to jumpstart growth across the region. But increased aid is insufficient to spur and sustain higher

BOX 2.1 Growth is central to sustained poverty reduction

The strong relationship between income growth and poverty reduction has been documented in a large empirical literature. This relationship can also be seen in the figure below, which shows changes in poverty over the past two decades—using the $1 a day headcount measure—for a large sample of developing countries. (For details on the data and decomposition methodology used in this box, see Kraay, forthcoming.) The figure also indicates wide variation around this average relationship. What implications do these differences have for poverty reduction?

Consistent with other developing regions, most countries in Sub-Saharan Africa are clustered in the top left quadrant (with negative growth and rising poverty) or bottom right quadrant (with positive growth and declining poverty). Sub-Saharan countries have a median per capita growth rate of 0.8 percent a year, substantially lower than the overall median of 2.1 percent, and most fall above the regression line, indicating worse poverty reduction performance than for a typical developing country with similar growth performance.

The figure also indicates important differences across countries in the rate at which poverty declines for a given growth rate. Ghana, and Uganda, for example, had similar annual growth rates (1–3 percent), but their rates of annual change in poverty ranged from about –8 percent to +2 percent. There are two reasons for such differences: cross-country differences in the sensitivity of poverty to growth, holding constant the distribution of income; and cross-country differences in how the distribution of income changes over time.



Note: Sub-Saharan countries are labeled, including the years of the change in poverty.

Regression line shown: $y = -1.15x - 0.01$; $R^2 = 0.54$

BOX 2.1 Growth is central to sustained poverty reduction *(Continued)*

Sub-Saharan countries tend to have a low sensitivity of poverty to growth, and the contribution of changes in inequality to changes in poverty in the region is similar to that in the developing world as a whole. Together these findings suggest that poverty reduction in Sub-Saharan Africa has been disappointing primarily because of its slow growth and low sensitivity of poverty to growth (holding constant the distribution of income). This low sensitivity can be traced to the region's low incomes and high inequality. (Sub-Saharan Africa and Latin America are the world's most unequal regions.)

What are the implications for policy? At a basic level, growth remains crucial for reducing poverty in Africa—all the more so given that the region's low income levels imply a relatively low sensitivity of poverty to growth. Moreover, the dominance of growth as the driver of changes in poverty seems to be even clearer over longer periods, suggesting that growth is especially critical for sustained reductions in poverty. Finally, evidence does not suggest that policy and institutional reforms aimed at promoting growth lead to higher inequality, which would temper the poverty impacts of growth.

Recent case studies on the factors driving pro-poor growth in 14 developing countries confirm the importance of macroeconomic reforms, followed by substantially higher growth without any short-term increase in the Gini coefficient. During the first five years of economic reforms, annual per capita growth rose by 2.0 percentage points in Burkina Faso and 4.5 points in Uganda. During the same period the Gini coefficient fell from about 0.47 to 0.45 in Burkina Faso. Although lack of pre-reform data preempts a similar comparison for Uganda, a relatively low post-reform Gini coefficient of 0.36 does not raise serious concerns about rising inequality.

Source: World Bank 2004; Dollar and Kraay 2002; Ghura, Leite, and Tsangarides 2002; Lopez 2004.

growth—and its provision by itself does not constitute a growth strategy. While certain forms of aid do appear to raise growth rates, the effects can be relatively small and are subject to diminishing returns. There is also no systematic evidence supporting the empirical relevance of poverty traps.

The policy agenda discussed in this chapter is daunting in its breadth, complexity, and ambition. It would be useful to describe the minimum set of reforms required to spur growth, or the larger set sufficient to sustain it. But neither is possible: the relationship between growth and policies, aid, shocks, the external environment, and other factors is complex. The policy recommendations in this chapter reflect a wealth of cross-country, time series, and case study experiences. Yet growth often occurs in countries where several of these mechanisms are not in place. Similarly, countries may undertake substantial reforms and observe disappointing growth payoffs for a while. With respect to growth accelerations, for example, occurrences are both fairly common and hard to explain—though both policy and institutional improvements help extend these episodes.

The priorities emphasized in this chapter are macroeconomic stability, and institutions and policies that promote private sector growth. For countries that have achieved broad macroeconomic stability, better expenditure management is critical to sustaining it and creating fiscal space for investments aimed at promoting growth and reducing poverty, including those that complement private activity. To invigorate the private sector and encourage a wider range of profitable opportunities to be taken up, it is essential to remove excessive regulatory and institutional constraints and improve weak infrastructure.

To underpin these efforts, recent progress on political governance must begin to be translated more clearly into progress on economic governance. Better economic governance is important for improving the private sector environment and increasing public sector effectiveness. Transparency in its various dimensions is a theme underlying many of the interventions identified here. Trade liberalization is also a policy priority in many countries (see chapter 4).

This discussion of priorities is inevitably broad because, in the end, the best path will be tailored to each country. While there are many similarities, different countries face different problems to different degrees. Equally important, the relationship between different aspects of reform will vary across countries. Progress must occur on a number of fronts, and the key areas will differ by country. In many cases, trade liberalization will create possibilities for reform in other areas. In others, improvements in the regulatory environment will have an important impact. In still others, improving the regulatory environment or even achieving macroeconomic stability will depend on improving public sector governance. Countries must adapt the recommendations in this chapter, in terms of form and sequence, to their own circumstances, in the context of country-owned poverty reduction strategies. Still, the priorities and progress indicators described here should help in determining the direction of reforms and assessing progress.

In Sub-Saharan Africa, home to most low-income countries under stress (LICUS), the road ahead is not easy, and there is a need for bold action. Within the agenda outlined above, there is substantial room for enabling virtuous circles. For example, as credible evidence of a change in the macroeconomic policy regime takes hold, the uncertainty attached to fixed investments begins to decrease—and as more investors consider taking up profitable opportunities, the demand for a better investment climate increases. Because there will remain vested interests intent on maintaining the status quo, political commitment is key to initiating and sustaining reforms.

The scale of the challenge in Sub-Saharan Africa means that domestic efforts will require external support. Large increases in aid will be needed, particularly to accelerate progress toward the nonincome MDGs (see chapter 3). Better access to the markets of developed countries is needed to promote and diversify exports (chapter 4), and external debt levels must be sustainable to ease the burden on fiscal policy (chapter 5).

The first section of this chapter provides the context for the discussion of the growth agenda by reviewing medium-term projections for growth and poverty rates, analyzing Sub-Saharan Africa's record of economic performance, and identifying conditions that have historically accompanied the onset of, and tended to sustain, periods of growth acceleration. The subsequent sections focus on the three key elements of the growth agenda: the macroeconomic environment, the private investment climate, and public sector governance.

Growth and Its Implications for Poverty

The overall outlook for growth remains promising over the next decade (figure 2.1).[1] Strong growth should continue in East Asia even as China's spectacular growth rates ease, and in Europe and Central Asia as the benefits of EU accession continue for several countries in the region. Elsewhere, ongoing reforms should ensure a better investment climate and stable macroeconomic environment—particularly in South Asia, where the average annual increase in per capita income is expected to exceed 4 percent over 2005–15.[2] After various difficulties in recent years, including contagion from Argentina's long crisis, per capita growth in Latin America is expected to average nearly 2.5 percent a year. Although Sub-Saharan Africa's performance has improved since the mid-1990s (see below), the region continues to lag in terms of economic growth.

FIGURE 2.1 Growth prospects are promising, but wide regional disparities remain

Source: World Bank staff estimates.

If these projections hold, the income poverty MDG will be achieved globally. Worldwide, the poverty headcount index will fall from 28 percent in 1990 to 10 percent in 2015, and the number of people living on less than $1 a day will fall from 1.22 billion to 622 million (table 2.1). These achievements will largely reflect successes in China and India, which contained most of the world's poor people in 1990 but where income growth has since accelerated and remained high. In Europe and Central Asia, where the rate of poverty is relatively low, the increase in poverty that accompanied the sharp drop in incomes in the early 1990s has been reversed, as it has in Latin America.

Still, many individual countries are not on track to achieve the poverty goal, including most countries in Sub-Saharan Africa. Even in regions with strong overall performance and prospects for achieving the poverty MDG, some countries need to substantially accelerate progress, such as Cambodia and Papua New Guinea in East Asia. In some large middle-income countries the national poverty rate is low, but some subnational regions continue to have large concentrations of poverty, such as inland western provinces in China, some southern states in Mexico, and the northeast region of Brazil.[3]

In Sub-Saharan Africa, reaching the poverty goal will require a substantial acceleration in

TABLE 2.1 Over the next 10 years growth is expected to rise and poverty fall around the world (percent unless otherwise indicated)

	Average annual growth rate, 2005–15		Population living on less than $1 a day					
			Headcount index			Number of people (millions)		
Region	Per capita GDP	GDP	1990	2001	2015	1990	2001	2015
East Asia and Pacific	5.5	6.3	29.6	14.9	0.9	472	271	19
China	6.0	6.7	33.0	16.6	1.2	375	212	16
Europe and Central Asia	3.6	3.7	0.5	3.6	0.4	2	17	2
Latin America and the Caribbean	2.4	3.6	11.3	9.5	6.9	49	50	43
Middle East and North Africa	2.4	4.2	2.3	2.4	0.9	6	7	4
South Asia	4.2	5.6	41.3	31.3	12.8	462	431	216
Sub-Saharan Africa	1.7	3.6	44.6	46.4	38.4	227	313	340
Average/total	3.6	4.8	27.9	21.1	10.2	1,219	1,089	622
Excluding China	2.8	4.2	26.1	22.5	12.9	844	877	606

Source: World Bank staff estimates.

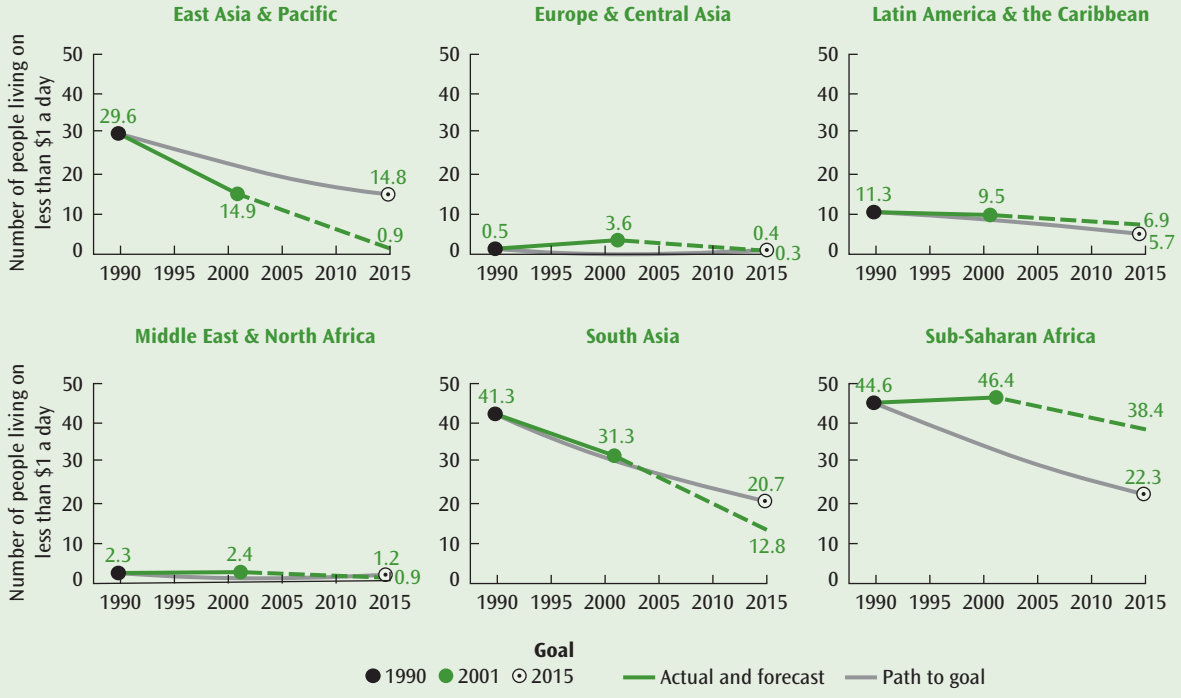
income growth or a significant increase in the poverty elasticity of growth. While the recent pickup in growth has improved prospects, the economic stagnation of the early 1990s caused poverty rates—already the highest in the world in 1990—to increase even further by 2001 (figure 2.2). Household surveys, which are available for 28 countries (accounting for 78 percent of the region's population and 87 percent of its GDP), suggest that the weighted average annual growth in per capita income required to achieve the income poverty goal is about 5 percent (table 2.2). Of these countries, Cameroon, Ethiopia, Senegal, South Africa, and Swaziland have a required per capita growth rate of less than 3 percent a year, leaving them well positioned to meet the poverty goal. Also close are Mauritania and Mozambique, where the required per capita growth rate is less than 3.5 percent a year. But together these seven countries contain less than a quarter of the population of Sub-Saharan Africa.

Ensuring that Sub-Saharan Africa makes significant progress toward the income poverty goal will require substantial efforts from countries in the region and all their development partners. For a successful example the region might look to South Asia, where similar initial disadvantages—including a high incidence of conflict—and similar income levels have not prevented rapid progress toward the MDGs. In South Asia an improving investment climate and stronger policies have sustained rapid economic growth since 1990 and made significant inroads into reducing poverty. Important developments in service delivery, such as provision of basic services by nongovernmental organizations (NGOs) and the private sector, have also contributed to the MDGs in some South Asian countries. Still, sustaining and accelerating economic growth, increasing the effectiveness of public spending, making services work for all people, and dealing with lagging regions and countries remain vast challenges in South Asia (box 2.2).

Africa's Growth Record

Although Sub-Saharan Africa's performance has recently improved, its overall economic record over recent decades presents a somber picture.[4] Since 1980 real per capita GDP growth has been lower than in other developing regions, and growth rates have been more volatile (figure 2.3).[5] Of the 45 Sub-Saharan

FIGURE 2.2 Most regions will reach the poverty MDG by 2015, but Sub-Saharan Africa is seriously off track



Source: World Bank staff estimates.

TABLE 2.2 Many Sub-Saharan countries require rapid growth to achieve the income poverty MDG

Required growth of per capita GDP, 2005–15	Number of countries	Population, 2000 (millions)	Share of Sub-Saharan population (percent)	Share of Sub-Saharan GDP, 2000 (percent)
< 2 percent	1	9.5	1	2
2 –3 percent	4	124.5	19	52
3–4 percent	2	20.2	3	1
4–6 percent	4	44.4	7	5
> 6 percent	17	315.4	48	27
Total	28	514.0	78	87

Source: World Bank staff estimates.
Note: For the 28 countries in this sample, the weighted average required growth in per capita GDP is 5.2 percent a year.

BOX 2.2 South Asia shows that stronger growth and better service delivery are key to the MDGs

With per capita income averaging $460 a year, the eight countries of South Asia—Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka—are home to nearly 40 percent of the world's people living on less than $1 a day. But since 1990 the region has achieved annual GDP growth of nearly 5.5 percent, helping to reduce poverty significantly. For example, India—the region's largest country, with a population of more than 1 billion people—has reduced its poverty rate by 7–10 percentage points since 1990. Most other countries in the region have registered similarly significant reductions. Two notable exceptions are Afghanistan, which is emerging from decades of conflict, and Pakistan, where poverty has stagnated at around one-third of the population.

Improving the delivery of human development and key related services has also been instrumental in boosting MDG-related outcomes and prospects. Three places in South Asia stand out as having especially good MDG indicators for their income levels. Sri Lanka and the Indian state of Kerala have strong records of good performance (similar to those in high-income countries), reflecting the priority that successive governments have long given to investing in human development. And Bangladesh has shown remarkable progress on many of the MDGs despite its low income, high poverty (second only to Afghanistan in the region), adverse initial conditions, high population density, contentious politics, and vulnerability to natural disasters. Bangladesh's success has owed much to an effective scaling up of basic services based largely on partnerships between the public sector and NGOs and a resulting high degree of community involvement, local innovation, and experimentation.

Although reducing poverty remains a huge challenge for South Asia, the income poverty MDG is within reach, as continued high economic growth will raise incomes, widen economic opportunities, and create jobs for poor people. But sustaining rapid growth will require further improvements throughout the region in the investment climate, basic infrastructure, and delivery of basic services within a framework of macroeconomic (especially fiscal) stability.

A number of other MDGs are also within the region's reach if service access and delivery improve for poor people—as shown by the region's success stories. Yet despite substantial public spending, health, education, water, and sanitation services continue to fail poor people in some countries and states. In many cases this is due to the fragile accountability between users, providers, politicians, and policymakers caused by ineffective public institutions, poor focus on outcomes and incentives, political clientelism and patronage, and difficulty of monitoring and supervision. But with democracy firmly rooted across the region, the devolution of political power to lower levels of governments is proceeding. While progress varies, decentralizing resources and responsibilities to local providers and communities holds prospects for better service delivery. Against this backdrop the universal primary education, gender equality, child mortality, and major disease MDGs appear within reach of most South Asian countries, with only Afghanistan, Pakistan, and poorer states in India remaining off track unless progress quickens substantially.

Source: World Bank South Asia Vice Presidency.

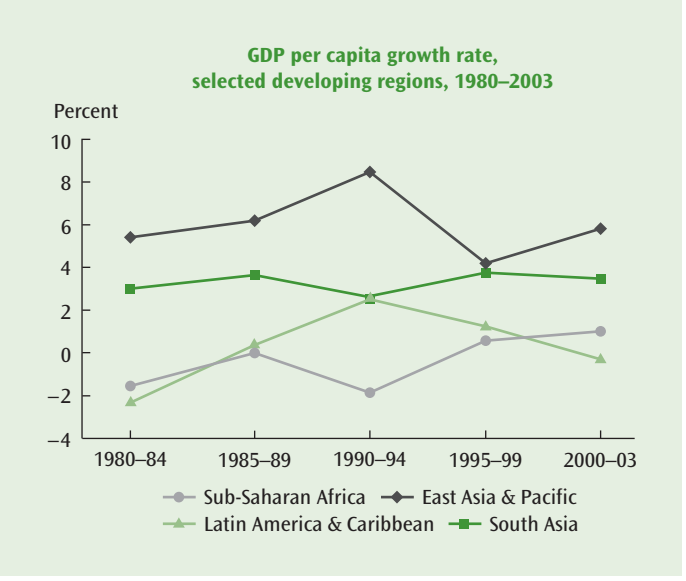
countries, only 5 consistently recorded real per capita growth rates above 2 percent a year: Botswana, Cape Verde, Mauritius, Seychelles, and Swaziland.[6] Moreover, economic disruptions have been widespread, with nearly three-quarters of the region's countries recording at least one year of per capita growth lower than –10 percent. Consequently, Africa's real income per capita has steadily declined relative to other regions, and is roughly the same as in the mid-1970s (figure 2.4).

At the same time, the region's income distributions may have become more unequal. Empirical estimates indicate that inequality in

Africa has increased since 1970, with the income of the poorest people deteriorating but the income of the richest remaining stable. These findings have potentially important political and economic consequences: With the elite buffered from poor economic performance, they are less likely to introduce the reforms needed to improve Africa's outlook.[7] This problem is perhaps more evident in countries where the elite have a more autonomous source of income, such as oil sector rents.

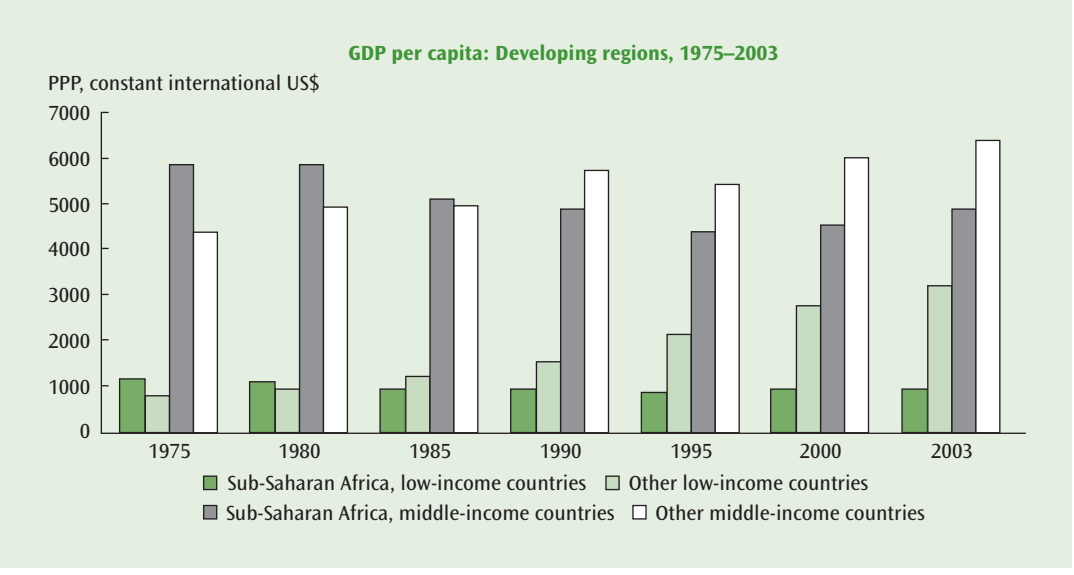
Although factor accumulation rates have been lower than in other regions, negligible improvements in productivity have been the primary source of Africa's slow growth. Since the 1960s the private investment rate has consistently been lower in Sub-Saharan Africa—even when the comparison is restricted to low-income countries in other developing regions (figure 2.5)—and in the 1990s a small number of major oil-producing countries received the bulk of the increase in such investment.[8] Similarly, modest increases in

FIGURE 2.3 Sub-Saharan Africa has lagged behind other regions



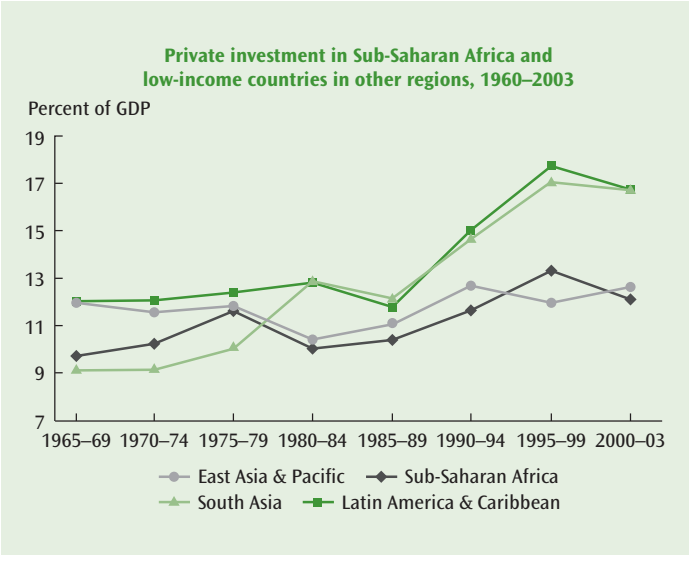
Source: World Bank staff estimates.

FIGURE 2.4 And the gap in income levels is widening



Source: World Bank World Development Indicators database; and World Bank and IMF staff estimates.
Note: In this figure, income classification groups follow the earliest available World Bank analytical classification (1987), in order to minimize the effects of selectivity bias. The conclusion on a widening gap is robust to the use of classifications for different years.

FIGURE 2.5 Lower investment rates in Sub-Saharan Africa have been a source of low growth



Sources: IMF, *World Economic Outlook;* World Bank, World Development Indicators database; and IMF staff estimates.

education enrollments have implied a smaller contribution from increased human capital than for most other developing regions.[9] But the key source for the region's weak economic performance was that total factor productivity growth was nonexistent between 1960 and 2002—unlike in other developing regions, where such efficiency improvements played an important role in supporting growth.[10]

On a more positive note, since the mid-1990s economic growth has improved to levels last recorded in the region in the early 1970s. Since 1995 more than 15 Sub-Saharan countries have persistently recorded real per capita growth rates above 2 percent a year, compared with only 5 in 1960–94. This improvement has benefited a range of countries, including low- and middle-income countries and even those that recently suffered conflict. On the whole, though, oil-based economies have enjoyed the best performance, with real per capita growth of close to 4 percent a year since the mid-1990s.

What explains Sub-Saharan Africa's poor economic record—and incipient recovery? On the former, it has suffered, and continues to suffer, from a number of major disadvantages relative to other regions. It has a disproportionately large number of landlocked countries that, given weak regional infrastructure, are unduly dependent on trade with their immediate neighbors. Many countries are heavily dependent on low-value agriculture and therefore vulnerable to climatic fluctuations, including periodic droughts. Its population endures high rates of malaria, HIV/AIDS, and other communicable diseases.[11] Since 1970 one-quarter of its countries have experienced civil conflict. And like other developing regions, Sub-Saharan Africa has been handicapped by lack of access for its exports to markets of developed countries and vulnerability to natural disasters and terms-of-trade shocks.

Still, there is a general view that drivers of growth operate in much the same way in Africa as elsewhere.[12] Critically, on the main dimensions of macroeconomic and structural policies as well as the effectiveness of institutions, Sub-Saharan Africa tends to underperform relative to other developing regions. The World Bank's Country Policy and Institutional Assessment (CPIA) ratings confirm that Sub-Saharan Africa achieves a lower average score than other developing regions on each of the main categories assessed: economic management, structural policies, social inclusion and equity policies, and public sector management and institutions. In addition, macroeconomic instability—as measured, for example, by the standard deviation of consumer price inflation or the parallel market exchange rate—has tended to be higher in Africa than most developing regions.[13] Even when the comparison is restricted to low-income countries in other regions, the quality of macroeconomic policies is still lower in Africa (table 2.3).

Empirical studies confirm that weak macroeconomic policies and governance have had a negative impact on growth in Sub-Saharan Africa. These studies indicate that in recent decades growth could have been significantly

TABLE 2.3 Macroeconomic policies are weaker in Sub-Saharan Africa than in other low-income countries (percentage of countries)

Region/rating	Fiscal policy	Composition of public spending	Monetary policy	Consistency of macro policies	Public sector governance	Governance and transparency in monetary and financial institutions	Trade regime
Sub-Saharan Africa							
Unsatisfactory	42	68	17	30	46	30	14
Good	22	3	72	46	14	52	73
Other low-income countries							
Unsatisfactory	19	57	7	14	26	7	5
Good	48	10	74	55	14	63	86

Source: IMF staff assessments.
Note: Policies are assessed as unsatisfactory, satisfactory, or good. Percentages do not sum to 100 because the intermediate category —satisfactory—is not shown.

raised by better fiscal policies (including lower government consumption and smaller fiscal deficits), policies that promoted human capital formation and private investment, and stronger institutions. Estimates of the additional growth that Africa would have enjoyed with the adoption of policies, institutions, and rates of factor accumulation similar to those in other regions range from 2–8 percentage points a year.[14]

One explanation for which there is no systematic empirical evidence is the view that poverty traps explain Sub-Saharan Africa's poor economic record. Proponents of such explanations argue that low productivity and savings rates make it difficult for poor countries to rise past a threshold income level. This logic is plausible, given the persistence of poverty. In general, however, neither macroeconomic nor microeconomic evidence tends to support the existence of such traps. Moreover, there is little evidence of the type of productivity and savings behavior needed at low income levels to generate poverty traps (box 2.3).

Empirical evidence also offers some words of caution on the commonly proposed solution for poverty traps—namely, large external resource transfers. Certainly, large increases in foreign assistance are needed in many Sub-Saharan countries, including to allow significant increases in key public services (see chapter 5). Moreover, aid increases complement improvements in policy, institutions, and the international environment. But the apparently limited growth impact of aid, combined with its diminishing returns, implies that by itself aid does not constitute a growth strategy.[15]

Experiences with oil windfalls in Sub-Saharan Africa in the late 1970s illustrate that increases in public investment driven by foreign inflows are also unlikely, in themselves, to lead to sustained growth. Because of large increases in oil production and prices, countries such as Congo enjoyed large windfalls over nearly 10 years starting in the late 1970s. But the medium-run impact on living standards was negligible at best (box 2.4). This example is particularly relevant because oil rents share many characteristics with and have similar macroeconomic effects as foreign assistance flows.

Since the 1960s Sub-Saharan Africa has also experienced widespread conflict and endured the associated heavy costs (figure 2.6). In the region's low-income countries the typical civil war has lasted about seven years and caused GDP to decline (relative to the counterfactual) by more than 2 percentage points for each year of conflict. It has typically taken

BOX 2.3 Do poverty traps account for Africa's underdevelopment?

A popular and plausible explanation for Africa's persistent underdevelopment is that much of the continent is caught in a trap: Poverty leads to low savings, low investment productivity, poor health, and other features that cause poverty to persist (Sachs and others 2004; Collier 2004). But there is little empirical work testing for poverty traps, and much of what exists tends not to support the hypothesis.

The persistence of poverty across countries is consistent with the hypothesis. A number of papers have documented that over the past 50 years the cross-country distribution of per capita incomes has become bimodal, with a group of countries clustered around quite a low income level. (See Azariadis and Stachurski 2004 for links between models of poverty traps and this kind of empirical evidence; Quah 1993a, 1993b, 1996, and 1997 for the evidence; and Kremer, Onatski, and Stock 2001 for a critique. Bloom, Canning, and Sevilla 2003 also provide closely related cross-country evidence.) Other evidence comes from looking at the dynamics of individual incomes. Many models of poverty traps suggest that individuals receiving large income shocks may take a long time to recover—and if their incomes fall below a certain threshold, they may never recover. But Lokshin and Ravallion (2004) carefully examine household data from Hungary and Russia, and conclude that there is no evidence of the kind of "threshold effects" associated with models of poverty traps.

Reduced-form evidence such as this can demonstrate the persistence of poverty but not the nature of the underlying mechanism that may be creating a trap. Without such information it is difficult to distinguish a poverty trap from persistence in the determinants of poverty, or to formulate an appropriate policy response. Several recent studies have looked for evidence of particular mechanisms generating poverty traps. One such mechanism involves financial market imperfections. If the upfront cost of starting a small business is large, and poor individuals cannot borrow to finance this investment, they will be unable to reap the benefits of self-employment. McKenzie and Woodruff (2004), using data on microenterprises in Mexico, show that the costs of starting such a business are surprisingly small—averaging just two weeks' income for a typical low-wage Mexican worker. This finding casts doubt on the idea that fixed costs, combined with financial frictions, are responsible for poverty traps.

Another possible mechanism is that productivity is low at low levels of development. This may be because it is difficult to reach minimum efficient scales of production, or because complementary investments in public goods (such as infrastructure) are inadequate in poor countries. Once these thresholds are crossed, it is possible that productivity will increase sharply, allowing countries

about 14 years after the end of a conflict for a country to recover to its prewar growth path. In addition, substantial spillover costs undermine economic performance in neighboring countries. In the typical low-income African country, with a purchasing power parity value of GDP of around $20 billion, the present value of the cost of conflict is about $50 billion. Most costs arise in the form of externalities, accruing either to people in the future or to neighbors.[16] Crucially, the risk of conflict tends to be strongly affected by low economic performance (box 2.5).

Sub-Saharan Africa's recent recovery has been supported by improvements in key macroeconomic indicators, particularly in the fastest-growing economies, and some strengthening of political institutions. Across the continent, macroeconomic indicators have improved since the mid-1990s: price inflation is at near-historic lows, distortions in exchange rates have been mostly eliminated, fiscal deficits are lower, and export volumes have increased. School enrollments are also increasing, along with budget allocations to both education and health. The percentage of countries holding

BOX 2.3 Do poverty traps account for Africa's underdevelopment? *(continued)*

to reach much higher income levels. Kraay and Raddatz (2005) embed this mechanism in a standard growth model and show that for this mechanism to generate a poverty trap, productivity must increase (implausibly) sharply with the level of development. In particular, the authors show that if this mechanism is at work, one should expect to see increasing returns to scale much larger than are ever seen in the extensive empirical literature on estimating production functions. Somewhat more directly, McKenzie and Woodruff (2004) find in their Mexican data that returns to investment are very high even for microenterprises.

Poverty traps might also arise because of low savings rates in poor countries. If many households live at the margins of subsistence, they will be unable to save much. In addition, public saving might be low in poor countries because governments have difficulty with tax collection. Low savings rates may translate into such low investment rates that countries are unable to accumulate significant stocks of productive assets per capita. And if savings rates only begin to increase at much higher levels of development, countries that start out poor may be stuck in a poverty trap.

Kraay and Raddatz (2005) confirm that savings rates tend to increase with income—but not in a way that would explain the existence of poverty traps for most African countries. The authors also calibrate a growth model with subsistence consumption and find that the impact on saving and growth is substantial only for countries that start out close to subsistence levels. But the observed dispersion in per capita incomes, which is significant even in a poor region such as Sub-Saharan Africa, implies that the role of subsistence consumption can explain low saving and growth in only a few of the region's poorest countries.

There are also potential poverty traps based on self-reinforcing dynamics in the area of governance. For example, there is evidence that civil wars are both a consequence and a cause of low income, creating the possibility of a conflict trap (Collier and others 2003). There are also reasons to believe that high corruption creates self-perpetuating expectations of future corruption. The role of such mechanisms in generating stable poverty traps in growth models has not been fully studied. But in these cases, large increases in foreign aid might actually be counterproductive, increasing incentives and opportunities for corruption and conflict. Tackling these underlying dysfunctions directly must be done in parallel with any large increases in aid (Collier 2004).

Source: Kraay and Raddatz (2005).

competitive elections has increased, and the incidence of conflict appears to be declining.

Policy improvements since the mid-1990s have been particularly striking among the fastest-growing Sub-Saharan countries. Relative to slower growers, these countries have a much lower average inflation rate, smaller fiscal deficits (despite similar spending levels), and significantly higher trade openness (measured by the share of exports and imports in GDP). Moreover, growth in productivity was a robust 2.4 percent for the fastest growers, compared with close to zero for the others.

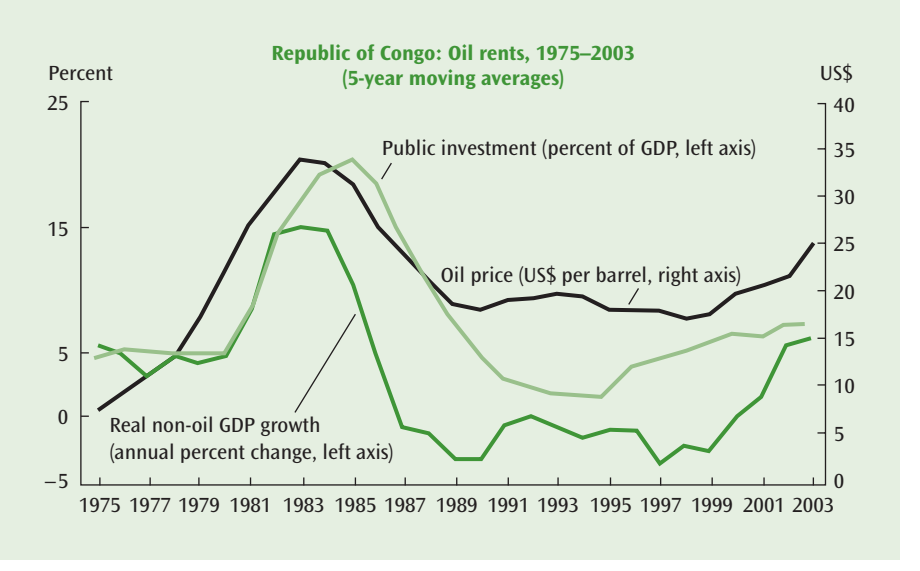
Growth Accelerations

To achieve the MDGs, the central challenge facing Africa is generating at least 10 years of sharply accelerated growth. Such growth accelerations, while not uncommon, have proven somewhat more elusive in Sub-Saharan Africa (table 2.4).[17] Between 1960 and 2003, across developing countries as a whole, the probability of a growth acceleration starting in a country in any year averaged 3.3 percent, while 37 percent of observed country years occurred during an acceleration episode. But in

BOX 2.4 A gush of oil rents and surge in public investment do not ensure sustained growth

In the 1970s the Republic of Congo began to benefit from a large rise in oil rents as international oil prices surged and national oil production increased. In 1979–86 oil prices averaged more than $30 a barrel (up from $14 in 1978 and $2 in 1970), and by 1986 national production reached 120,000 barrels a day (up from 65,000 in 1980). Suddenly the Congo was much richer and the state treasury—as the main local beneficiary of the enclave oil sector—experienced a surge in revenues. The ensuring increase in government spending helped to generate a temporary growth acceleration (see figure below, and Hausmann and others 2004).

The failure to sustain the growth spurt of the early 1980s was apparently not due to appropriation of the rents for consumption. The Congo significantly boosted public investment—indeed, between 1980 and 1986 (again taking 1979 as the base year) the increase in public capital spending was equivalent to 93 percent of the additional government oil revenues. The impact on social indicators was positive, including a surge in electricity consumption and school enrollments. Ultimately, however, weak policies and institutions (including a highly overvalued real exchange rate and low governance ratings) did not sustain the growth spurt. Real per capita income, which had risen to almost $1,000 in the mid-1980s, fell to less than $900 by 2000 (measured in purchasing power parity terms and constant dollars), and the improvements in social indicators proved temporary. Significantly, aid flows increased throughout the oil boom until reaching a peak, at just over $70 per capita, in the mid-1990s.



Source: IMF (2004).
Note: The use of five-year moving averages is intended to capture the effects of faster financial than physical execution and of the usual lags in bringing projects fully online.

FIGURE 2.6 Sub-Saharan Africa has suffered from many conflicts

Source: World Bank Staff estimates.

BOX 2.5 Political commitment is central to breaking the conflict cycle

Conflict tends to have multiple causes. Typically, an incipient rebel group gets a charismatic leader, the government mishandles counter-insurgency, and a neighboring government sees an opportunity for mischief. But susceptibility to such events is strongly affected by economic circumstances—namely, low income, low growth, dependence on natural resource exports, and vulnerability to adverse shocks. A legacy of previous conflict also increases the probability of conflict, possibly because the only organizations that flourish are those that profit from violence. The role of aid and economic policy is limited to their impact on the growth rate. If Côte d'Ivoire conforms to the global pattern, its prospects are for prolonged and intermittent violent conflict.

Postconflict experience is highly diverse. Some economies recover rapidly, while others continue to decline. Recent analysis finds that choices of policy, institutions, and governance are radically more important for growth during the postconflict decade than at other times: The same improvement (as measured by country policy and institutional assessments) generates much more growth during the postconflict decade. Aid also appears effective in raising growth during the postconflict decade. But the peak effect of aid occurs in the middle of the decade. In the first few years, although needs are great, capacity to absorb project aid is probably rather limited. Hence an early priority is to rebuild the institutions that manage the spending process.

Because the risk of repeat conflict is high, policy needs to be directed to managing it. Postconflict governments typically maintain high military spending—almost at conflict levels—resulting in very small peace dividends. This can be a major policy error because high military spending in postconflict situations can increase the risk of further conflict. Two good models are Mozambique, where the government radically cut military spending, and Sierra Leone, where peace has been guaranteed not by domestic military spending but by robust external peacekeeping. In addition, strong political commitment to economic development and social inclusion is fundamental.

Sources: Collier and Hoeffler 2002b, 2004; Miguel, Satyanath, and Sergenti 2004.

TABLE 2.4 Growth accelerations have been much less common in Sub-Saharan Africa (percent)

	Probability of growth episode starting			Proportion of country years occurring in a growth episode		
Period	Sub-Saharan Africa	Europe and Central Asia	Other	Sub-Saharan Africa	Europe and Central Asia	Other
1960s	5.5	6.7	8.1	18.8	42.1	42.6
1970s	1.8	0.0	2.7	25.7	14.3	50.2
1980s	0.9	2.7	2.5	11.8	13.4	30.5
1990s	3.3	8.2	3.2	20.2	30.2	32.2
2000–03	...	...	...	28.4	60.2	9.7
All periods	2.4	2.5	3.3	20.0	32.5	36.7

Sources: Penn World Tables database; IMF, *World Economic Outlook;* and IMF staff calculations.

Sub-Saharan Africa the annual probability of such an episode starting was just 2.4 percent, and only 20 percent of country years occurred during such an episode.[18]

Not only has it been more difficult to initiate sustained growth in Sub-Saharan Africa, but safeguarding those advances has also been more problematic. Growth acceleration episodes in Sub-Saharan Africa have been more likely to be followed by a period of negative per capita growth: of the 23 accelerations that ended before 1998, only 7 were followed by a period of positive growth.[19] This observation is in sharp contrast to the post-acceleration experience in other regions—such as Latin American and the Caribbean, where 20 of 33 acceleration periods were followed by positive per capita growth.

On a more positive note, in the midst of the general slump of the 1990s, when the average per capita growth rate was negative for the region as a whole, some successes began to emerge in Sub-Saharan Africa. Over the past decade or so Africa saw a faster increase in the frequency of growth episodes, and in the proportion of country years spent in such episodes, than did other regions (with the exception of Europe and Central Asia). Average growth performance during these recent African episodes was similar to that of other regions. In terms of episodes ending in the 1990s or ongoing at the end of 2003, the average annual per capita growth rate was about 5 percent in Sub-Saharan Africa (figure 2.7).

The experience on the duration of growth accelerations raises a note of caution about episodes under way in Sub-Saharan Africa. Historically, 75 percent (44 percent) of episodes in low-income (middle-income) Sub-Saharan countries end before their 10th anniversary. At the end of 2003 the average length of the episodes under way was 8.5 years for low-income countries and close to 20 years for middle-income countries.

Initial analyses of the determinants of growth accelerations have found that these episodes are not easily amenable to explanation or prediction.[20] Still, it is possible to identify some policy and institutional measures that are significant correlates with their inception (box 2.6). The analyses suggest that lower inflation, higher fiscal expenditures on investment (within a given spending envelope), higher private investment, and better governance are associated with the beginning of growth accelerations, particularly those that last longer.

Macroeconomic Policy: Stability, Sustainability, and Space

Recent progress toward macroeconomic stability across Sub-Saharan Africa has begun to remove obstacles to vigorous economic growth, and growth has picked up in some

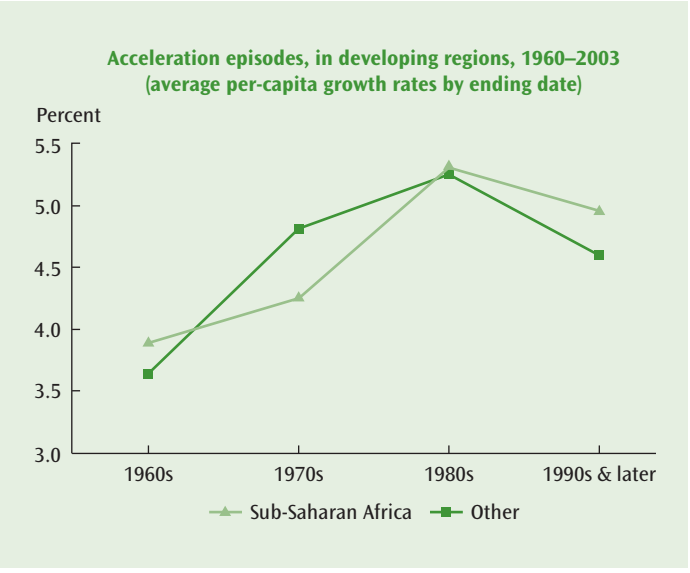
countries. On the whole, however, the region continues to suffer from low growth. Key macroeconomic issues include the sustainability of the fiscal stance and the availability of fiscal space for additional investments in such crucial areas as physical infrastructure and human capital.

Underlying this discussion is the notion that a stable policy framework is a crucial determinant of an enabling macroeconomic environment. Moreover, the relationship between the policy framework, macroeconomic stability, and economic growth is intermediated by the institutional setting.[21] Ultimately, higher growth is the result of profitable investment opportunities, whose feasibility depends not just on macroeconomic predictability but also on the state of the microeconomy and the (enabling) role of institutions. Macroeconomic stability is thus a necessary but insufficient condition for sustained growth.

Over the medium term it is crucial that fiscal policy be perceived as sustainable. The fiscal stance is sustainable when it is unlikely that wrenching policy adjustments will be required to maintain stability and avoid crisis. Such a policy configuration increases the predictability of the macroeconomic environment and ensures the long-term viability of a noninflationary growth path. Policy stability contributes to macroeconomic stability by removing the effects of destabilizing policies and enabling a stabilizing response to exogenous shocks.

In low-income countries fiscal sustainability has two crucial dimensions: reliance on external concessional financing; and the need to limit recourse to domestic financing. The high degree of concessionality of external finance implies that, as long as the productivity of public investment is reasonable and the country does not experience large adverse shocks, further external finance should not threaten sustainability.[22] With underdeveloped financial sectors, most governments in Sub-Saharan Africa do not have the option of raising substantial sums from domestic capital markets, and the growth of domestic credit (and therefore money supply and prices) tends to be closely linked to government financing requirements.[23]

FIGURE 2.7 Annual growth rates during accelerations are improving in Sub-Saharan Africa



Source: IMF staff calculations.

Additionally, the effect of government spending on growth depends on the macroeconomic context and the composition of expenditures. If macroeconomic stability is lacking, even productive government spending can, on net, have an adverse effect on growth, due to negative macroeconomic consequences. On the other hand, a structure of spending that is financed in a sustainable manner and that favors growth-sensitive sectors can be expected to increase factor productivity and crowd in private investment, including by reducing private sector costs.

Targeting fiscal sustainability while paying attention to the structure and quality of fiscal spending is fully consistent with the goal of promoting productive public investment. For Sub-Saharan Africa, further progress toward fiscal sustainability will be necessary to secure recent gains, and the current structure of spending could be made more commensurate with the growth imperative. Institutionalizing improvements in macroeconomic policy may be a quick way to change perceptions.

BOX 2.6 Better macroeconomic policies and stronger institutions are associated with longer growth accelerations

While statistical models of growth accelerations have modest explanatory power, there is some evidence that improvements in key policies and institutions tend to accompany the onset of such accelerations—particularly in the case of longer episodes. Comparing the behavior of key policy and institutional variables at the onset of growth accelerations with the preceding five-year period indicates that rapid increases in growth tend to be accompanied by a lower level of inflation, a less distorted exchange rate, and an improved perception of law and order. On the other hand, there is no evidence of major changes in investment, exports, terms of trade, foreign aid, or savings.

Over the lifetime of growth accelerations, there is improvement in a broader set of indicators. While this result would generally be expected for macroeconomic variables, including private investment and the fiscal balance, it is perhaps surprising in the case of institutions, which are generally thought to be relatively stable. During a typical 10–12 year acceleration, indicators of political regime, bureaucratic quality, and law and order improve by a statistically significant amount, raising the possibility of a virtuous circle whereby higher growth facilitates institutional reform.

Just as critical as spurring growth accelerations is sustaining them. The improvements observed during accelerations are consistent with the idea that ongoing reforms are necessary to sustain such accelerations, but it is also possible that faster growth enables policy improvements. Comparing the degree of upfront improvements in indicators across longer episodes (those lasting at least nine years) and shorter episodes (those lasting less than eight years) sheds some light on what tends to make accelerations durable.

Upfront improvements in macroeconomic indicators are more generalized for longer than shorter episodes (see table). First, the improvements in inflation and the exchange rate that tend to accompany the onset of accelerations are stronger for longer accelerations. Second, longer episodes tend to be more private sector–led, with lower government consumption and higher private investment. Third, there is an upfront improvement in the perception of corruption in episodes that turn out to be longer. These results are generally robust across different groups of countries, including Sub-Saharan and low-income countries, and similar conclusions emerge when the assessment is made three years into episodes of growth accelerations.

These results offer hope that recent improvements in these indicators in a number of Sub-Saharan countries may mean that ongoing African accelerations will prove more sustained than in the past.

Changes in values of key indicators at the onset of long relative to short acceleration episodes (percent except where noted)

Inflation rate	**–10.6**
Government consumption/GDP	**–4.1**
Noninterest spending/GDP	**–4.2**
Black market premium	**–39.2**
Law and order (index)	0.1
Corruption (index)	**0.6**
Private investment/GDP	**2.5**

Note: Numbers in bold indicate statistical significance at the 10 percent level. Corruption and law and order are measured on a scale of 1–6, where a higher score indicates less corruption and stronger law and order.

Source: IMF staff.

Note: For purposes of this analysis, a growth acceleration is deemed to last at least five years (the average duration exceeds eight years) and to be defined by an increase in annual average per capita GDP growth of at least 2 percent (accelerating growth) and annual average per capita growth of at least 3.5 percent (rapid growth). Accelerations are deemed to end when annual per capita GDP growth dips below an average of 2 percent for the subsequent five-year period, or below 3 percent in the year immediately following the period of acceleration. This is an extension of the definition proposed by Hausmann, Pritchett, and Rodrik (2004).

Recent Developments in Macroeconomic Policy and Stability

Across low-income countries as a whole, macroeconomic policies have improved over the past decade. Inflation has slowed appreciably, and other indicators—such as fiscal and current account deficits—have also improved, though more modestly (table 2.5). Similar patterns have emerged in Sub-Saharan Africa. On this basis, to what extent can stabilization in Sub-Saharan Africa, as the region most in need of a growth payoff, be considered a success?

Macroeconomic stability depends heavily on control of inflation and sound fiscal performance, although some definitions of stability also include criteria on growth rates (as an additional measure of internal macroeconomic balance) and international reserve levels (as a measure of robustness to external shocks).[24] The rationale for the inclusion of a fiscal criterion derives from the close link between the fiscal stance and inflation, particularly in an environment where fiscal policy holds sway over monetary policy or where the scope for noninflationary domestic financing is limited.

Given Sub-Saharan Africa's heavy reliance on concessional external financing, it seems appropriate to assess the fiscal contribution to stabilization by monitoring domestic financing of the budget deficit, instead of the deficit itself. Not only does external financing have less of an impact on inflation than does domestic financing, but most of this borrowing tends to come with a sizable grant element, further diluting the applicability of the fiscal balance measure. In this context a forthcoming International Monetary Fund (IMF) study, in defining successful stabilization efforts in developing countries, measures fiscal sustainability in terms of limited recourse to domestic financing, proxied by a target of less than 1 percent of GDP.[25]

With the recent progress toward price stability, most countries in Sub-Saharan Africa have reasonably low inflation. During 2000–3 the median rate of inflation was 5 percent, and only a half-dozen countries (Angola, Eritrea, Liberia, Nigeria, Zambia, Zimbabwe) recorded annual price increases persistently above 10 percent. But progress on the fiscal front has been less consistent.[26] Although domestic financing in Sub-Saharan Africa averaged close to 1 percent of GDP during 2001–3, about one-third of countries in the region exceeded this level. Of those, 12 recorded domestic financing ratios persistently higher than 3 percent of GDP. In these countries further progress on fiscal consolidation would appear particularly prudent in order to safeguard the recent improvements on the inflation front.[27]

This general assessment disguises considerable variation across the region. As a group, middle-income Sub-Saharan countries have registered substantial progress on macroeconomic stability since the early 1990s.[28] These countries have averaged annual per capita growth rates of nearly 4.5 percent, and their fiscal positions appear sound. At the end of 2003 their recourse to domestic budget financing stood at close to 1 percent of GDP, while their stock of international reserves reached five months of imports—levels that would allow flexibility in the event of unanticipated fiscal challenges.

For low-income Sub-Saharan countries, tangible progress toward stabilization started to materialize only in the second half of the 1990s. But by 2000–3 the picture had brightened considerably. Within this group, natural resource–dependent economies have benefited most from recent movements in international prices. As a result their fiscal position has strengthened, with the primary budget in balance, supplemented by external grants of almost 4 percent of GDP. Of potential concern, however, these countries remain exposed to international price corrections—and domestically, recent appreciations in real

TABLE 2.5 Macroeconomic indicators have generally improved in low-income countries (annual average except where indicated)

Indicator/region	1984–8	1989–93	1994–8	1999–03	2004 (estimate)	2005–9 (projected)
Inflation (percent, median) [a]						
East Asia and the Pacific	7.1	9.5	8.7	6.1	5.8	3.6
Europe and Central Asia	1.2	417.7	233.8	10.2	5.6	4.2
Latin America and the Caribbean	4.4	12.6	6.7	3.3	3.9	3.1
Middle East and North Africa	14.2	23.1	21.0	6.3	8.6	7.1
South Asia	7.7	10.5	8.4	3.7	4.6	4.1
Sub-Saharan Africa	9.9	10.6	12.7	5.6	6.5	3.6
All low-income countries	6.8	10.8	11.9	4.7	5.0	3.8
Current account balance (percentage of GDP) [b]						
East Asia and the Pacific	–1.9	–4.4	–1.5	–1.3	–1.1	–3.1
Europe and Central Asia	–1.0	–6.4	–11.7	–7.1	–7.7	–2.5
Latin America and the Caribbean	–10.8	–14.3	–14.1	–12.1	–11.7	–11.3
Middle East and North Africa	–6.5	–5.4	–1.4	0.3	–3.6	–9.8
South Asia	–7.2	–5.7	–2.4	–1.3	–2.0	–2.3
Sub-Saharan Africa	–7.2	–8.5	–9.1	–8.8	–7.7	–6.8
All low-income countries	–6.1	–8.0	–8.0	–6.9	–6.5	–5.9
External debt (percentage of GDP)						
East Asia and the Pacific	63.1	69.4	58.5	60.1	56.5	52.3
Europe and Central Asia	0.0	14.2	49.8	63.8	49.8	43.6
Latin America and the Caribbean	105.8	178.2	92.5	68.0	60.6	58.8
Middle East and North Africa	53.4	57.1	68.6	59.9	53.3	48.4
South Asia	45.5	50.8	45.1	45.6	46.0	40.1
Sub-Saharan Africa	85.9	108.1	136.7	120.5	97.4	84.0
All low-income countries	70.6	93.5	99.2	89.6	75.1	66.2
Fiscal balance (percentage of GDP) [b]						
East Asia and the Pacific	–8.9	–5.7	–4.0	–5.0	–3.8	–3.5
Europe and Central Asia	–1.2	–11.1	–7.7	–3.6	–2.0	–0.2
Latin America and the Caribbean	–7.7	–5.1	–2.4	–5.0	–3.9	–2.8
Middle East and North Africa	–16.7	–11.2	–6.0	–0.5	–1.8	–8.2
South Asia	–5.5	–5.0	–4.8	–5.9	–4.9	–4.7
Sub-Saharan Africa	–6.2	–6.9	–5.5	–5.4	–3.2	–1.3
All low-income countries	–6.5	–6.9	–5.1	–5.0	–3.3	–2.2
Memorandum item: real per capita GDP growth (percent)						
All low-income countries	1.3	–1.3	1.5	1.5	2.8	3.3

Source: IMF, World Economic Outlook database.
Note: Averages are calculated as unweighted means of country values.
a. Calculated from annual medians, then averaged over five-year periods.
b. Includes grants.

exchange rates may weaken the competitive position of nonresource sectors, on which most people depend. In addition, fiscal policy in these countries has tended to be procyclical, partly a reflection of some unique challenges imposed on public policy by the nature of oil operations (box 2.7).

For most of these countries the challenge is to strengthen the fiscal outlook (and stabilize prices) not just for an interim phase, but for a

BOX 2.7 Challenges for fiscal policy in oil-producing Sub-Saharan countries

Like oil-producing countries elsewhere, those in Sub-Saharan Africa face some sharp challenges. At a technical level, the main challenges stem from the high volatility and unpredictability of oil prices and the nonrenewable nature of oil reserves. At an institutional level, the nature of oil operations raises the social benefit of good governance.

Uncertainty about oil prices translates into uncertainty about fiscal revenues. As a result the fiscal balance tends to be volatile and unrelated to developments in domestic demand. One of the main concerns of policymakers should be insulating the local economy from this volatility. In this context two standard policy prescriptions are that fiscal policy should be guided by the non-oil primary balance, as a fiscal target, and by caution, as a motive for building up financial reserves. Contrary to these prescriptions, oil economies in Sub-Saharan Africa have tended to carry out fiscal polices that are procyclical relative to oil price movements, leading to variability in the real exchange rate, which tends to be damaging to the non-oil sector and capital formation, and to increased fiscal costs, including through a negative impact on spending levels and quality induced by boom-bust cycles. It is also desirable for such countries to build up financial reserves against unanticipated falls in revenue, but such prudence in fiscal policies has not always emerged. One example of good practice is Botswana, which in 2001–2 absorbed a confluence of shocks by relying on income from accumulated financial assets.

The second challenge stems from the nonrenewable nature of oil revenues and the attendant rise in the importance of long-run fiscal sustainability, mainly due to concerns for intergenerational equity. In countries with significant short-term development needs and insufficient physical and human capital, intergenerational equity could conceivably be secured through sufficient accumulation of financial and nonfinancial assets. In this context it is essential that projects be compatible with broader development strategies and projected returns secured by strong oversight. But as discussed in the case of the Congo (see box 2.4), returns have not always matched expectations.

At an institutional level, strong governance is of primary importance in the context of an enclave oil sector, which benefits a country mainly through its tax payments, and the nature of oil revenues, which tend to be both high and easily appropriated. With the government being the channel of most of the possible benefits of an enclave oil sector, judicious use of government revenues is even more critical than usual. Otherwise the rest of the economy only sees its competitiveness eroded (the Dutch disease effect).

In an environment with weak oversight institutions, the size of oil revenues may mean that the public sector is asked to manage more resources than it can prudently administer and that the governing elite acquires substantial financial independence. Oil-producing Sub-Saharan countries tend to underperform on key dimensions of economic governance. Yet given the extreme need to ensure judicious administration of public resources, these are precisely the countries where good governance has the highest social benefit. With their income derived mostly from the oil sector, including possibly in illicit ways, the governing elite are less motivated to strengthen oversight institutions, and the overall investment climate suffers.

The nature of oil contracts tends to further obfuscate public sector management and hamper revenue transparency. The typical results are fiscal policies that are beholden not to the population, but to entrenched elites. Under the typical oil contract in Sub-Saharan Africa, the bulk of the fiscal regime is subject to confidentiality clauses and unknown to the public. In such circumstances the system draws resources, including human capital, into activities geared to appropriating rents rather than encouraging more directly productive activities. Elites tend to favor excessive and imprudent investments—especially large projects, which are particularly prone to graft, and other inefficient means of rent distribution, such as sustained protection for favored firms.

In light of the resulting difficulties of implementing prudent fiscal policy and promoting sound economic governance in oil-producing countries, the creation of oil savings funds is often proposed as a solution. It is crucial to integrate such funds into the overall design of fiscal policy and the budget process. They have tended to work well in environments with strong institutions, such as Canada (Alberta), Norway, and the United States (Alaska). But savings funds have tended not to work where underlying institutions were weak and political commitment was lacking, as with Mexico's oil stabilization fund and the Venezuelan Investment Fund.

Source: IMF staff.

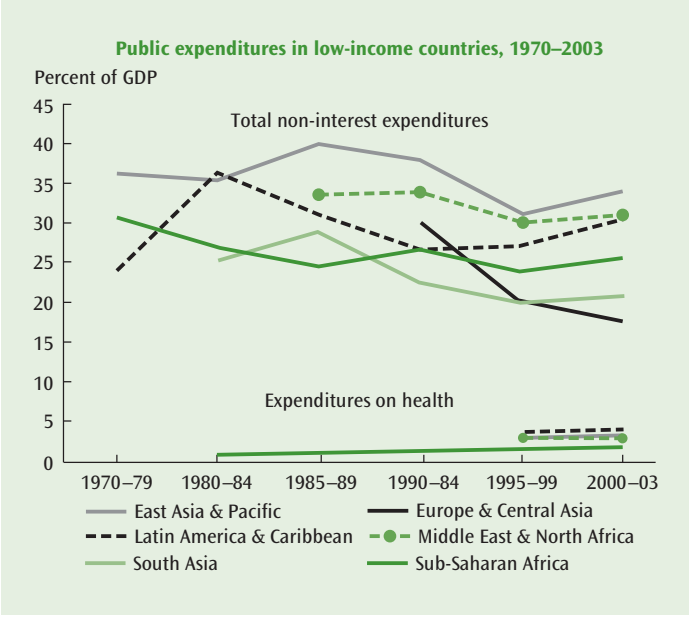
sustained period and in a credible manner. For a significant impact on growth, "gains in macroeconomic stability need to be viewed by the private sector as indicative of a *permanent* change in the macroeconomic policy regime."[29]

Fiscal Institutions: Key to Fiscal Sustainability and Macroeconomic Predictability

At a fundamental level, strong fiscal institutions enhance fiscal discipline and provide clear evidence on the direction of policy. A growing literature has indicated that institutional weaknesses, such as budget institutions that allow narrow interests to prevail, play an important role in influencing fiscal outcomes. Some developing countries lack institutions that can promote sound fiscal policies, such as:

- Transparency, including wide dissemination of key economic data and controls on public enterprise budgets.
- Judicial systems that control tax evasion.
- Spending constraints that mitigate tendencies toward inefficient and procyclical spending policies.

FIGURE 2.8 There is scope for allocating more to priority sectors such as health



Sources: IMF, World Economic Outlook database and World Bank, World Development Indicators database.

The structure of public spending in some Sub-Saharan countries could be made more commensurate with the growth imperative. Fiscal adjustment and sustainability should be viewed not just in terms of quantity but also quality. To the extent that basic investments in physical and human capital raise growth, it is crucial to orient public spending toward productive projects in these areas.

Recent increases in social sector allocations in low-income countries implementing poverty reduction strategies (PRSs) have begun to make a difference, but there is scope for further improvement. In 2000–3 increases in the spending envelope (noninterest spending as a percentage of GDP) have not resulted in additional allocations to public investment. Moreover, given the consensus on the need to rapidly raise the level of human capital across the region, further progress on raising the share of noninterest spending allocated to education and health would appear necessary. This is particularly the case for health spending, for which Sub-Saharan Africa falls at the bottom among developing regions (figure 2.8).[30]

Looking ahead, it will be essential that Sub-Saharan countries underpin attempts to strengthen their fiscal outlook with enhanced transparency and stronger fiscal institutions. Budget transparency has been associated with enhanced fiscal discipline, particularly in the aftermath of the East Asian crisis of the late 1990s, and enhanced government accountability. The more transparent government operations are, the easier it is to identify fiscal policy weaknesses and address them. Fiscal transparency improves the business environment because investors (domestic and foreign) gain more confidence in government policies, and transparency can improve sovereign credit rating—a tangible benefit for cash-strapped governments. Consequently, the IMF published the *Fiscal Transparency Code* in 1999 and the *Manual on Fiscal*

Transparency in 2001, and a draft *Guide on Resource Revenue Transparency* is available for public comments and will be published in the near future. The earlier publications serve as a framework for the fiscal Report on the Observance of Standards and Codes (ROSC), a voluntary diagnostic tool that assesses the availability and quality of fiscal data. In Sub-Saharan Africa 11 countries have agreed to publish fiscal ROSCs, and the assessments, while recording some progress and examples of good practice, highlight the general need for better budget formulation and reporting, and broader data coverage (box 2.8).

One Sub-Saharan country that has recently made significant strides toward fiscal transparency is the Republic of Congo, where the publication of fiscal data, audit reports on oil activities, and reports on external verification of government revenues, oil contracts, and data

BOX 2.8 Fiscal transparency has improved in Africa, but much remains to be done

Country-specific fiscal transparency assessments—called fiscal Reports on the Observance of Standards and Codes, or fiscal ROSCs—have been published on the IMF's Web site for more than 70 countries, including a number of countries in Sub-Saharan Africa (Benin, Burkina Faso, Cameroon, Ghana, Malawi, Mali, Mauritania, Mozambique, Rwanda, Tanzania, Uganda). Reports are being prepared for several other Sub-Saharan countries.

The assessments record some progress in improving fiscal transparency in a number of areas, including the quality of budget formulation and investment in fiscal reporting systems. South Africa, while it has not published a fiscal ROSC, provides examples of good transparency practices, including clear policy statements and publication of a "budget in brief"—a summary of the government budget written for the layman. But fiscal ROSCs have also found that much still remains to be done in Africa. For example, in many Sub-Saharan countries central government budget data remain weak and unreliable, and there is insufficient reporting on local government fiscal operations. Fiscal risks related to off-budget activities (such as quasi-fiscal activities related to state-owned enterprises or banks, contingent liabilities, tax expenditures) are often not transparent. External audit is generally weak, impairing the ability of parliaments and the general public to monitor government operations and hold the executive branch accountable for its actions. There appears to be a strong need to maintain continuing assessment of fiscal transparency in Sub-Saharan Africa and to encourage publication and dissemination of good practices that are in place.

The need for better fiscal transparency in resource-rich countries has recently gained some prominence. Several Sub-Saharan countries, including Ghana and Nigeria, have begun to participate in the Extractive Industries Transparency Initiative. This initiative emphasizes the need for oil and other extractive industry companies to publish what they pay to governments and to reconcile these payments with what government reports show that they have received from companies. The IMF has prepared a draft *Guide on Resource Revenue Transparency,* which supplements its *Manual on Fiscal Transparency* and can be used to assess fiscal transparency in resource-rich countries. The draft guide has been released for public comments (http://www.imf.org/external/np/sec/pr/2004/pr04274.htm). A number of pilot country assessments are being undertaken in resource-rich countries—including Equatorial Guinea, which recently hosted a seminar for parliamentarians from the six countries of the Economic and Monetary Community of Central African States (CEMAC) that focused on fiscal transparency and accountability (see *IMF Survey,* 7 February 2005).

Note: The IMF has promoted fiscal transparency over the past several years as part of its Standards and Codes initiative. Its Fiscal Transparency Code and *Manual on Fiscal Transparency* are available at http://www.imf.org/.
Source: IMF staff.

has been influential in convincing development partners that a significant change in the policy regime is under way.[31] Nevertheless, as discussed below, broader gains in governance are needed for Sub-Saharan Africa to reach the level attained by other developing regions.

More broadly, stronger fiscal institutions can improve fiscal management by clarifying lines of responsibility and constraining the political bargaining that typically affects fiscal outcomes. One approach has been to create autonomous revenue agencies and grant central banks independence in the pursuit of price stability. Another has been to strengthen rules governing budget procedures and reporting, often in the context of medium-term expenditure frameworks (MTEF). Neither approach has been widely embraced in Sub-Saharan Africa. Institutional independence is more likely to be effective in a climate with multiple checks and balances, and an MTEF is only effective when fully integrated with the budget process and related documents—which has only happened in five Sub-Saharan countries.[32] Yet another approach is to adopt a fiscal responsibility act, under which broad discussion of the policies underlying budget documents precedes formal presentation of the budget. The debate takes place both within and outside parliament, improving transparency and binding government over the medium term—as in Brazil, which adopted a fiscal responsibility law in 2000.[33]

Fiscal Space: Safeguarding Development Spending

The identification of significant infrastructure gaps, particularly in Latin America, has led to calls for the creation of fiscal space through a revision in accounting rules and change in the approach to fiscal analysis. It has been suggested that data on fiscal expenditures should not cover the operations of public enterprises, and that fiscal programming should target the current, instead of overall, fiscal deficit. These arguments have also been marshaled as a way to substantially increase government spending on the MDGs.

Ultimately, a change in accounting rules cannot make the resource envelope larger or ensure that additional spending is justified. For Sub-Saharan Africa the proposed change in fiscal data coverage would not have much of an impact, given that standard practice across the region already limits coverage to general government (and only records direct transfers to public enterprises as fiscal expenditures). Moreover, targeting the current deficit (as a way of treating investment spending differently from recurrent spending) would not obviate the need to assess the sustainability of debt loads, the impact of higher domestic financing on inflation and private investment, and the productivity of expenditure.[34]

Effectively creating fiscal space would require, first, generating additional resources and, second, ensuring that projects are appropriately selected and implemented. Domestic sources of additional resources include mobilization of additional fiscal revenue and domestic borrowing. Scope for the latter is typically limited, however, in part because financial markets in Sub-Saharan Africa are thin and in part because of a need to preserve domestic savings for private investment. External sources include a sustained and predictable flow of external grants (and, to a lesser extent, other concessional borrowing). Ensuring the overall adequacy and quality of development spending may entail reprioritizing expenditure toward more productive sectors and projects (as discussed earlier), and lifting limits on absorption capacity, including by improving expenditure monitoring systems.

In Sub-Saharan Africa the bulk of the additional financing required to achieve the MDGs will have to come from sources other than additional taxation. Certainly, tax revenue ratios in low-income Sub-Saharan countries are on the low side. But raising revenue ratios will require improvements in tax administration and resolution of important issues of tax design, including greater reliance on indirect taxation schemes such as the value added tax (VAT).[35] The associated political and administrative challenges are not easily overcome in a short period.[36]

External grants unambiguously enhance fiscal space—in contrast to borrowing, where such space is constrained by debt sustainability considerations, even when loans are concessional. Still, a sustained, predictable flow of external grants is needed to secure a sustained scaling up of expenditures. Historically, aid flows have been more volatile and less predictable than other sources of revenue.[37] These tendencies have been more pronounced for countries least capable of absorbing external shocks: those with a higher proportion of aid-financed budgets and those with fewer domestic financial instruments to smooth the fiscal impact. These effects undermine some of the benefits of foreign assistance.

In Sub-Saharan Africa recent drops in public investment underscore the importance of improving capacity to implement productive projects. Over the past two decades the share of public investment has fallen by about 3 percentage points of GDP across the region. Although part of the drop has been offset by rising private investment, budget execution in low-income Sub-Saharan countries regularly results in lower than programmed capital spending and overruns on current spending. The shortfalls in capital spending cannot be attributed entirely to lower than expected foreign financing—underscoring the importance of improving project selection and implementation.

Better public expenditure management is critical in addressing concerns about the relationship between additional spending, public service delivery, and improved outcomes. Attempts have been made to address public expenditure management in the context of efforts to increase pro-poor spending under the aegis of the enhanced HIPC Initiative (box 2.9). The reported increase in poverty-reducing spending will have to be supplemented by improvements in efficiency and targeting to raise social outcomes. For this, countries must also develop the means to assess the effectiveness and social impact of poverty-reducing spending.

More generally, identifying and addressing absorptive capacity constraints requires formulating country-specific strategies. At the macroeconomic level, aid may distort domestic markets by raising the price of domestic goods and services, and impair economic performance by threatening fiscal sustainability (particularly with volatile and unpredictable aid flows). Managing these policy challenges is facilitated by the use of a medium-term fiscal framework and flexibility in adjusting expenditure and revenues, and possibly by the absorption of shortfalls in aid flows with the use of international reserves or nonmonetary financing instruments. For some sectors, such as health and education, human and physical infrastructure constraints may also be relevant. Addressing these concerns is likely to require more resources and time.

In sum, sustained effort is necessary to ensure that recent progress toward a stable macroeconomic environment marks a permanent shift in the policy regime. In the short term, with high fiscal deficits and limited ability to raise revenues, most increases in domestic contributions to the region's development needs will come from higher economic growth and a shift in spending toward high-quality projects in growth-sensitive sectors.

Finally, macroeconomic stability cannot bear the entire burden of boosting economic growth. As the past two decades have shown, Sub-Saharan Africa's institutional environment has not always ensured that policy gains translate into permanent improvements. Fiscal institutions should ensure transparency, effective expenditure monitoring, and sustainability. Institutionalizing nascent improvements in macroeconomic policy may be a quick way to change perceptions.

Enabling Climate for Private Sector Activity

The earlier analysis of growth accelerations indicates that private investment can play a significant role in supporting sustained economic growth. In slow-growing economies in Sub-Saharan Africa and elsewhere, investment is typically low.[38] The rate of return on investment also tends to be low, due to low

BOX 2.9 Strengthening expenditure monitoring under the enhanced HIPC Initiative

The IMF and World Bank have been working closely with countries benefiting from the enhanced HIPC initiative to strengthen the link between HIPC assistance and poverty reduction. Recognizing that public expenditure management plays a key role in poverty reduction, action plans for expenditure management were agreed with the authorities of each HIPC—taking into account the technical assistance available to them from their development partners—and two assessments of those plans have been completed. (More generally, a key feature of the IMF's Poverty Reduction and Growth Facility, the Bank's Poverty Reduction Strategy Credits, and the PRS approach is that the budgets of low-income countries should become more pro-poor, which makes tracking poverty-reducing spending relevant to all PRS countries.) Under the 2001 assessment, progress was tracked using 15 indicators: 7 related to budget preparation and 4 each to execution and reporting. For the 2004 assessment a new indicator was added, on procurement.

After the first assessment confirmed the weak state of public expenditure management systems, HIPCs began strengthening expenditure management and monitoring. By 2004 most were able to report poverty-reducing spending as defined in their PRSs, and the average number of benchmarks met increased from 6.0 to 6.5. (The second assessment covered 25 HIPCs—22 in Sub-Saharan Africa and 3 in Latin America; see table.) On average, pro-poor spending has grown by about 2 percent of GDP a year. But to reduce poverty, higher spending must be accompanied by increased efficiency and better targeting to improve social outcomes. Revised action plans are being incorporated into IMF-supported programs and Bank adjustment operations—and to increase ownership, should also be incorporated into PRSs.

Many HIPCs need to substantially upgrade public expenditure management

Level of upgrading required	2004		
2001	Substantial	Some	Little
Substantial (7 or fewer benchmarks met)	Bolivia (5, 4) Cameroon (4, 7) Ethiopia (6, 7) The Gambia (5, 3) Ghana (1, 7) Guinea (5, 5) Madagascar (7, 4) Malawi (7, 5) Mozambique (5, 4) Niger (3, 5) São Tomé and Principe (4, 4) Senegal (4, 7) Zambia (3, 3)		
Some (8–10 benchmarks met)	Chad (8, 7) Honduras (8, 7)	Benin (8, 8) Burkina Faso (8, 9) Guyana (8, 10) Rwanda (8, 8) Uganda (9, 8)	Mali (8, 11) Tanzania (8, 11)
Little (11 or more benchmarks met)			
Not assessed in 2001	Democratic Republic of Congo (4) Guinea-Bissau (0) Sierra Leone (7)		

Note: Numbers in parentheses are the number of benchmarks met in 2001 and 2004, in that order.

Source: IMF (2003); and IMF and World Bank staff.

productivity and high costs of doing business.[39] Faster growth requires a business climate that enables the private sector to take up profitable investment opportunities, raising both the level and productivity of investment.

In many developing countries excessive regulation and other institutional constraints impose a heavy burden on entrepreneurial activity. A number of countries are implementing regulatory reforms, but recent improvements need to be deepened and underpinned by stronger institutions—particularly those related to property rights and the rule of law. Alongside regulatory and institutional reform, access to finance and availability of key infrastructure need to be improved. Limited access to credit and poor infrastructure undermine private activity in many countries, limiting growth in industry and agriculture alike. Among regions, Sub-Saharan Africa has the greatest need to improve these determinants of the business environment.

Assessing the Business Environment

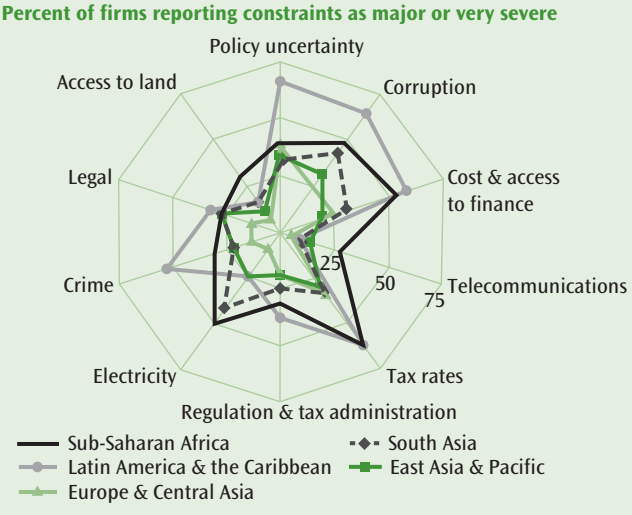
Recent enterprise surveys and business regulation assessments provide the necessary metrics for a careful evaluation of the investment climate in developing countries.[40] The enterprise surveys provide benchmarks of investment climate indicators and firm performance, allowing conclusions to be drawn on constraints facing entrepreneurs. The business regulation assessments provide benchmarks of regulatory and property protection systems, providing policy guidance on areas needing improvement. Across the developing world, entrepreneurs consistently report regulatory impediments, corruption, and lack of access to finance and key infrastructure (such as electricity) as major constraints on their activity.

Firms in Sub-Saharan Africa consider high taxes and poor access to finance to be among their most significant constraints (figure 2.9). In countries with small tax bases, firms often bear a disproportionate share of the tax burden, particularly small and medium-size firms. With the informal sector representing more than 70 percent of nonagricultural employment in the region, many firms do not pay any taxes—or report only a fraction of their sales to the authorities. And many firms, particularly small ones, do not see many benefits from becoming formal. Most firms lack confidence that courts will uphold their property rights, and most have little access to finance due to shallow financial systems and the difficulty of obtaining collateral.

Corruption and policy uncertainty are also significant constraints in Sub-Saharan Africa. In particular, the discretion that many officials enjoy in implementing complex regulations creates opportunities for bribes and uneven application of requirements. More than 95 percent of firms in the region report that corruption or policy uncertainty are a problem, with most firms calling them major or very severe constraints on their ability to operate and expand.

Unreliable electricity supply is reported as a constraint by 52 percent of firms in Sub-Saharan Africa, compared with 42 percent in

FIGURE 2.9 Sub-Saharan firms view taxes, finance, electricity, and corruption as particularly constraining



Source: World Bank Investment Climate Surveys.
Note: The graph does not include every country in each region.

South Asia, 24 percent in East Asia and Latin America, and less than 10 percent in Europe and Central Asia. Moreover, a much larger share of African firms report frequent power outages and serious production losses stemming from such interruptions in production.

There is considerable cross-country variation in the ranking of constraints reported by Sub-Saharan firms. For example, policy uncertainty is reported as a major or severe constraint by 27 percent of firms in Uganda but by 57 percent in Zambia. Similarly, unpredictable interpretation of regulations is a problem cited by 40 percent of firms in Uganda but by 70 percent in Zambia (table 2.6). In Kenya more than 75 percent of firms report paying bribes, averaging more than 5 percent of sales. Losses from power interruptions average 6–7 percent of sales in Ethiopia and Zambia, and 10 percent or more in Eritrea, Kenya, and Senegal.

The above picture, derived from the World Bank's Investment Climate Surveys, is corroborated by its Doing Business indicators. The business environment, as measured by the regulatory burden, is weakest in Sub-Saharan Africa (figure 2.10).[41] Among the 20 countries with the most regulatory obstacles to doing business, 16 are in Sub-Saharan Africa—with Angola, Burkina Faso, Chad, and the Democratic Republic of Congo ranking among the worst 5 worldwide. Entrepreneurs in these countries face a staggering array of costs, including those related to starting a business, registering property, enforcing contracts, hiring and firing workers, getting credit, closing a business, and protecting investors.

On average, starting a company in Sub-Saharan Africa costs the equivalent of 224 percent of national per capita income, compared with 45 percent in South Asia and only 7 percent in high-income countries. Similarly, a simple, formal property transfer costs 14 percent of the value of the property and takes more than 100 days in Africa, compared with 48 days in East Asia and the Pacific and 36 days in high-income countries.

Nigeria has some of the world's most cumbersome regulations for registering property, requiring 21 procedures, 27 percent of the property value in fees, and a registration period of 274 days. Other African countries present similar obstacles to registering property: Completing the transfer process takes more than a year in Ghana and 354 days in Rwanda, and costs 34 percent of the property value in Senegal and 23 percent in the Republic of Congo. Moreover, Africa's property registries tend to be poorly organized and provide little security of ownership.

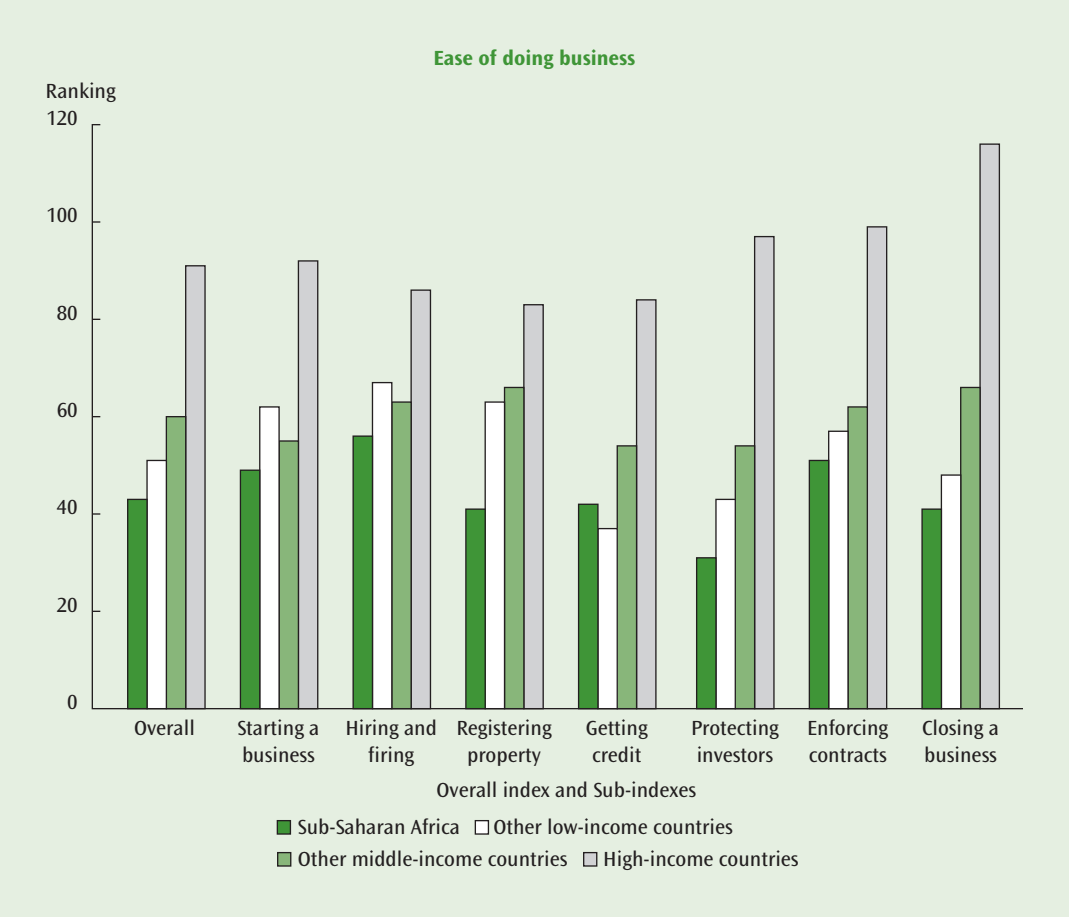
Sub-Saharan Africa is also the region where it is most difficult to enforce a simple com-

TABLE 2.6 Investment climate constraints vary across Sub-Saharan Africa
(percentage of firms citing problem, unless otherwise indicated)

Country	Unpredictable interpretation of regulations	Lack confidence courts will uphold property rights	Management time spent dealing with officials (percentage of time)	Average number of days to clear customs	Finance a major constraint	Infrastructure a major constraint	Skills a major constraint
China	33.7	17.5	19.0	7.9	22.3	29.7	30.7
Kenya	45.5	51.3	13.8	8.9	58.3	48.1	27.6
Mozambique			11.3	11.9	78.0	64.0	33.5
Senegal	42.5	40.5	13.8	6.5	60.0	30.7	18.5
Tanzania	58.6	55.1	16.2	17.5	53.0	58.9	25.0
Uganda	40.0	30.1	5.0		52.8	44.5	30.8
Zambia	70.1	36.0	14.1	4.8	67.7	39.6	35.7

Sources: World Bank, *World Development Report 2005;* World Bank Investment Climate Surveys.

FIGURE 2.10 Sub-Saharan Africa lags other regions in the quality of the business environment



Source: Doing Business in 2005 database.

mercial contract through the courts. On average, creditors must go through 35 steps, wait 15 months, and pay 43 percent of their country's per capita income before receiving their due payment. The result is less access to justice and weaker protection of property rights, leading to fewer formal business transactions.

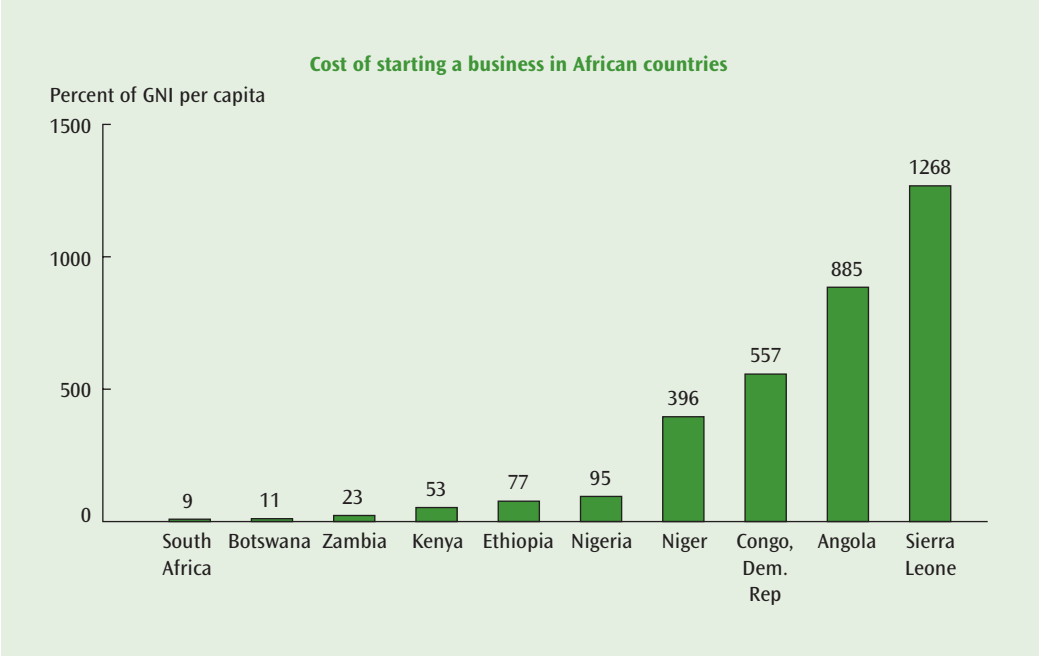
Hiring and firing workers in the formal sector in Africa is also not easy. The region has the most rigid labor regulations and among the highest firing costs.[42] In Burkina Faso employers cannot write a fixed-term contract unless a job is seasonal; the mandated minimum wage is $54 a month, which at 82 percent of value added per worker is the third highest in the world; night and weekend work are prohibited; and women are not permitted to work more than 8 hours a day. If a business needs to downsize, it must notify the Ministry of Labor of its intention to retrench workers, and the law requires that redundant workers be trained and placed in other jobs prior to dismissal. If an employer follows these procedures, a redundancy costs an average of 18 months' wages in severance pay and penalties. Thus it is little wonder that many businesses operate in the informal economy, which accounts for about 40 percent of the country's output. High firing costs make employers less likely to hire.

Moreover, without clearly defined property rights and efficient contract enforcement, lenders are less likely to extend credit to entrepreneurs. Although Sub-Saharan Africa performs better on indicators of legal rights for borrowers and lenders than do South Asia, Latin America, and the Middle East and North Africa, institutions that support credit markets are weak. For example, only four Sub-Saharan countries—Botswana, Ghana, Namibia, and South Africa—have private credit bureaus to provide lenders with information on a borrower's creditworthiness.

Within Sub-Saharan Africa's overall difficult business environment, however, performance varies considerably, and there are several examples of good practice. The cost of starting a business varies across countries by more than 100-fold, from 10 percent of per capita income to more than 10 times (figure 2.11). Botswana and South Africa have low official fees, in line with those in high-income countries, while Angola and Sierra Leone have costs that are among the world's highest. In other examples of good practice, Tanzania and Uganda have commercial or small claims courts, Tanzania has a specialized court for bankruptcy, Botswana and Tanzania have no minimum capital requirement for starting a business, Madagascar and Namibia have introduced moderate severance pay for redundant employees, and South Africa gives investors access to ownership and financial data before they invest in a company.

There are also broader patterns across the region. As in other regions, middle-income countries have more efficient regulation than do low-income countries. For instance, it takes an average of 234 days to enforce a debt contract in a middle-income country, but

FIGURE 2.11 The cost of starting a business varies widely



Source: Doing Business in 2005 database.

almost twice that in a low-income country. On the other hand, business regimes tend to be most onerous in oil-dependent economies (box 2.10) and countries that have recently endured civil conflict.

Improving the Business Environment

The costs of a weak investment climate are substantial, and the impacts widespread. At the enterprise level the estimated costs, measured in terms of the share of sales lost, range from less than 10 percent in Poland to more than 30 percent in Zambia. The composition of costs also varies dramatically across countries. In Kenya, Tanzania, and Uganda weak infrastructure services are particularly burdensome, while in Zambia bribes are especially costly (figure 2.12). Priorities for reform thus vary by country.

Reform offers large payoffs. In Ethiopia annual business registrations increased by 48 percent after the process was simplified in 2003. In Namibia the cost of expanding output fell by 15 percent as a result of more flexible working hours introduced in 2003. In Mozambique commercial banks report that reforms to the public credit registry have helped provide credit to a wider set of entrepreneurs. Empirical analysis indicates that Africa could grow by an additional 1.6 percentage points a year if the average country were to improve its business regulation system to the level of the average OECD country.[43] Countries with better business environments tend to benefit from higher private investment: among Sub-Saharan countries that scored 50 or higher on the ease of doing business index in 2005, the correlation between that score and the rate of private investment during 1990–2003 was 70 percent. Improvements in Uganda's business environment have contributed significantly to stronger economic performance since the early 1990s (box 2.11).

While some countries in Sub-Saharan Africa are taking notable steps to improve the private business environment, reforms need to be quickened and extended to other countries. Despite their heavier burden of business regulation and weaker protection of property rights, African countries lagged those in other regions in the scope and pace of reform achieved in the past year, as assessed by the annual *Doing Business* report.[44] Of the 58 countries in the sample that had reformed regulation or strengthened property rights, only 8 were in Africa. Most reforms in Africa were in the relatively straightforward area of starting a business, while outside Africa there were reforms in every area measured (figure 2.13).

Among Sub-Saharan nations enacting reforms, Ethiopia improved the process for starting a business by cutting the number of required procedures and reducing the associated cost and time. Madagascar slashed the time required to start a business by establishing a new one-stop shop for entrepreneurs. Benin, the Democratic Republic of Congo, Côte d'Ivoire, and Kenya also reformed entry regulation. In Mozambique a public credit registry went online, strengthening the quality of data. In contrast, some countries worsened their investment climates: actions in Malawi, Mauritania, Rwanda, and Zimbabwe raised the cost of starting a business.

Looking ahead, how can the business environment be improved in Sub-Saharan Africa? The evidence points to a broad agenda of reform, with specific priorities and sequencing varying by country. Assessments of the business environment suggest the following as key areas for improving the regulatory and institutional framework in many countries:

- *Streamlining entry regulations and cutting fees.* In Africa the official fees for starting a business are prohibitive for most would-be entrepreneurs. Cutting these fees would encourage more businesses to operate in the formal sector. To reduce the pro-

BOX 2.10 Comparing business regulations in two resource-dependent economies: Angola and Botswana

One of the manifestations of the "resource curse" is lack of economic diversification in resource-dependent economies. Among the most severe cases have been oil-dependent economies in Sub-Saharan Africa, such as Angola, where significant private investments have flowed to the oil sector (with its enclave fiscal, regulatory, and legal regime) but, for the most part, not to other sectors. Other countries, including Botswana, have been able to harness the power of natural resources by implementing sound macroeconomic and structural policies and providing adequate incentives for entrepreneurs to take up profitable opportunities in all sectors. The table below compares the regulatory burden imposed on entrepreneurs in Angola and Botswana.

Businesses face a lower regulatory burden in Botswana than Angola

	Starting a business		Registering property		Enforcing contracts		Hiring and firing		Getting credit		Closing a business	Protecting investors
Country	Days	Cost	Days	Cost	Days	Cost	Labor rigidity	Firing costs	Legal rights	Credit information	Recovery rate	Disclosure
Angola	146	885	335	11	1,011	9	75	116	3	4	1	2
Botswana	108	11	69	5	154	25	20	19	9	5	51	5

Note: Cost of starting a business is measured as a percentage of per capita gross national income (GNI). Cost of registering property is measured as a percentage of property value. Cost of enforcing contracts is measured as a percentage of debt value. Labor rigidity is an index from 0–100, with higher values indicating more rigid regulation. Firing costs are measured in number of weeks of salary due as severance payment. Legal rights is an index from 0–10, with higher scores indicating the degree to which collateral and bankruptcy laws facilitate lending. Credit information is an index from 0–6, with higher scores indicating more availability of information through public or private bureaus. Recovery rate is measured in cents on the dollar. Disclosure is an index from 0–7, with higher scores indicating more disclosure of corporate information.

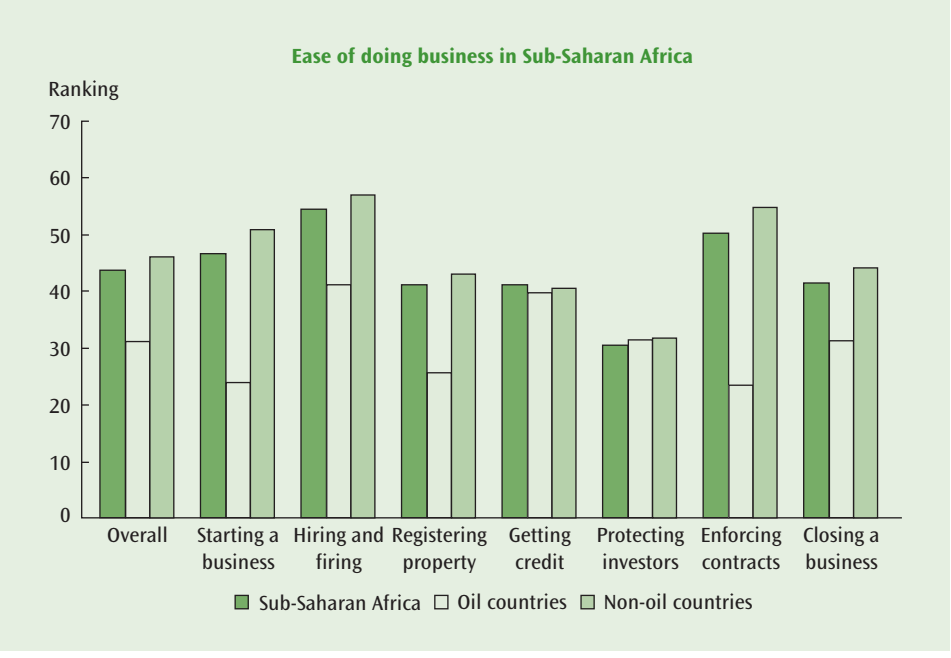
Worldwide, Angola is among the 20 countries with the least business-friendly regulations, while Botswana is among the top 20. On most indicators measured by the *Doing Business* project, Botswana substantially outperforms Angola. Registering property—essential for obtaining credit in many countries—takes almost five times longer in Angola. Hiring and firing workers is considerably less flexible and more costly in Angola. And closing a business, which helps entrepreneurs start and

cedures and time required for business registration (which can also significantly reduce the cost), governments could also create single access points for business (as in Madagascar), introduce temporary business licenses, impose "a silence is consent" rule for business registration, and standardize paperwork.

- *Cutting fees and unnecessary procedures for property registration.* A large bottleneck in several African countries is the requirement for government consent before property is transferred. This causes delays, usually requires an exorbitant fee, and can be a major source of corruption. Lesotho, Malawi, Nigeria, Rwanda, Senegal, and Zambia all have government consent requirements. The impact of such requirements can be considerable. For example, if Malawi eliminated the requirement of obtaining consent from its Ministry of Land (procedure 3 in figure 2.14), registering property would take 28 days instead of 118.

BOX 2.10 Comparing business regulations in two resource-dependent economies: Angola and Botswana *(continued)*

grow their businesses, is significantly more complex in Angola. Not surprisingly, Botswana has a more diversified economy and has grown roughly twice as fast as Angola over the past 10 years.



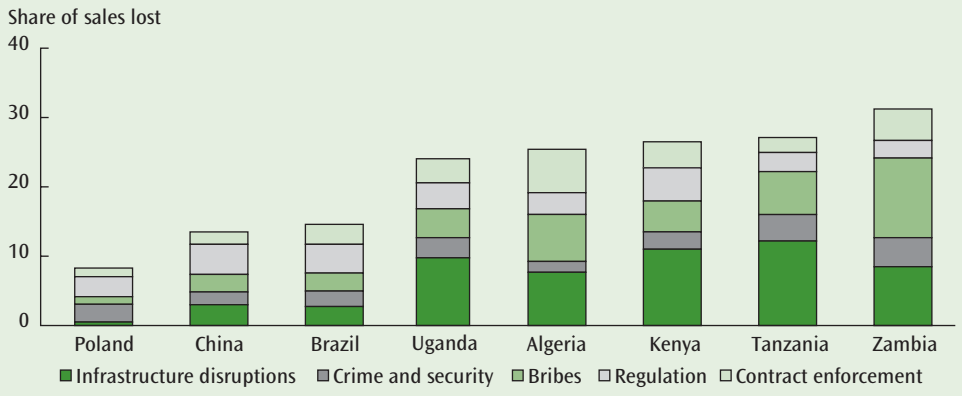
Across Sub-Saharan Africa, Angola is typical of oil-driven economies, which tend to have more cumbersome business regulations and weaker protection of property rights than do non-oil economies (see figure). Reforms in these areas could significantly enhance the attractiveness of non-oil private investment in oil economies.

Source: Doing Business in 2005 database.

Other reforms that strengthen property rights and encourage investment include simplifying and consolidating procedures at the property registry, cutting fees, linking the cadastre and property registry, and providing easier access to information in the registry.

- *Encouraging the establishment of credit bureaus*. Access to credit would be made easier if lenders had assurance that borrowers are creditworthy (and that it is possible to recover debt, in cases of default). By encouraging the development of credit bureaus, African governments can help furnish creditors with information to sort good from bad borrowers, price loans correctly, and reduce screening costs.
- *Making labor regulations more flexible and reducing the cost of firing*. To accomplish this, African countries can increase the length and scope of term contracts, introduce apprentice wages (following the example of Madagascar), allow flexible working hours (as in Namibia), and

FIGURE 2.12 A weak investment climate entails high costs



Sources: World Bank 2004b; World Bank Investment Climate Surveys.

BOX 2.11 High returns to investment climate improvements in Uganda

The economic successes of China and India are well known, with China growing at 10 percent a year and India having doubled its growth rate since the 1970s, following major reforms over the past two decades. But the benefits of investment climate reforms are not limited to large countries. Uganda's experience shows the importance of persistence, rather than perfection, in translating investment climate reforms into increased growth and poverty reduction. Uganda initiated its investment climate improvements in the early 1990s, after a period of civil conflict and macroeconomic instability.

Reforms covered many areas affecting the investment climate: Macroeconomic stability was achieved, expropriations by a previous government were reversed, trade barriers were reduced, and tax and court systems were strengthened. The persistence of the government's reform efforts enhanced its credibility, giving firms confidence to invest. Indeed, private investment as a share of GDP more than doubled, from just over 6 percent in 1990 to 15 percent in 2002. These improvements contributed to stronger per capita income growth, which averaged 4 percent a year in 1993–2002 (eight times the average in Sub-Saharan Africa), and a reduction in the share of Uganda's population living below the poverty line, from 56 percent in 1992 to 35 percent in 2000.

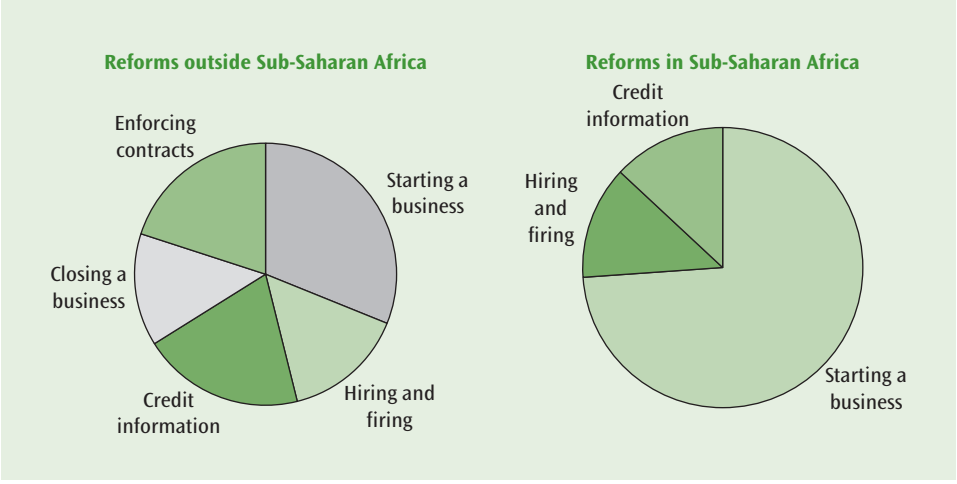
Source: Adapted from World Bank 2004b.

remove administrative approvals for dismissal.

- *Reducing unnecessary procedures and contract enforcement times.* Approaches include introducing case management (as in Uganda), reducing abuse of appeals procedures (as in Botswana), improving enforcement (in Uganda the creditor's attorney is responsible for enforcement, with the help of the police), and creating specialized courts or sections of commercial courts (as in Ghana and Tanzania).

Some reforms, such as improvements to entry regulations, credit reporting systems, and property registries, can be achieved relatively quickly through administrative reforms. Others, such as those involving labor regula-

FIGURE 2.13 Business environment reforms need to be scaled up in Sub-Saharan Africa



Source: Doing Business in 2005 database.

tions and court reforms, require longer-term efforts and legislative action. Investment climate reform is a process, not an event. Not everything needs to be fixed at once, or perfectly at one go. Significant progress can be achieved by addressing the more important constraints facing businesses in a way that gives them confidence to invest and by sustaining a process of ongoing improvements.[45]

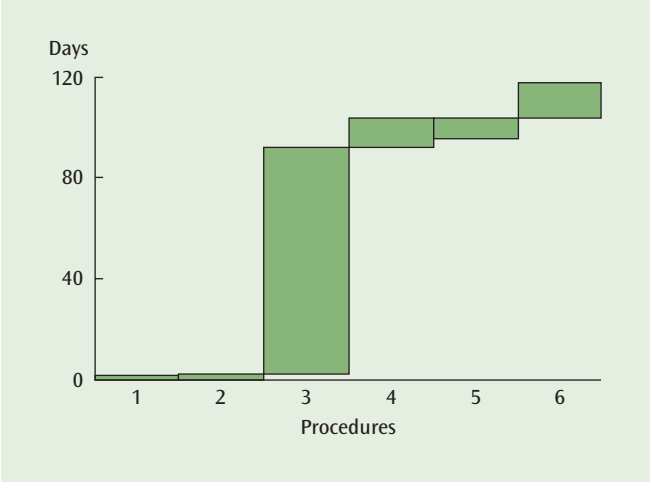
The foregoing discussion focuses on the need for regulatory and institutional reform. The evidence presented also points to lack of financial and physical infrastructure as major constraints in many countries. The next two sections focus on these aspects of the agenda.

Financial sector

Sub-Saharan Africa's financial sector has gone through major changes over the past 15 years, and has largely been transformed into an open system that includes a variety of institutions owned by domestic and foreign private entities. With the proliferation of financial institutions, the average bank size has shrunk by about 25 percent. These changes have revealed weaknesses in regulatory capacity and limitations in risk assessment within financial institutions, and many African countries have had to cope with significant bank failures. The resolution of these failed banks through restructuring and privatizing has been the main focus of policymakers over the past 15 years.

In addition, considerable efforts have been made to improve legal and regulatory frameworks and to build regulatory capacity to prevent further failures. African banking laws and regulations are now largely comparable

FIGURE 2.14 Registering property is unduly time-consuming in Malawi



Source: Doing Business in 2005 database.

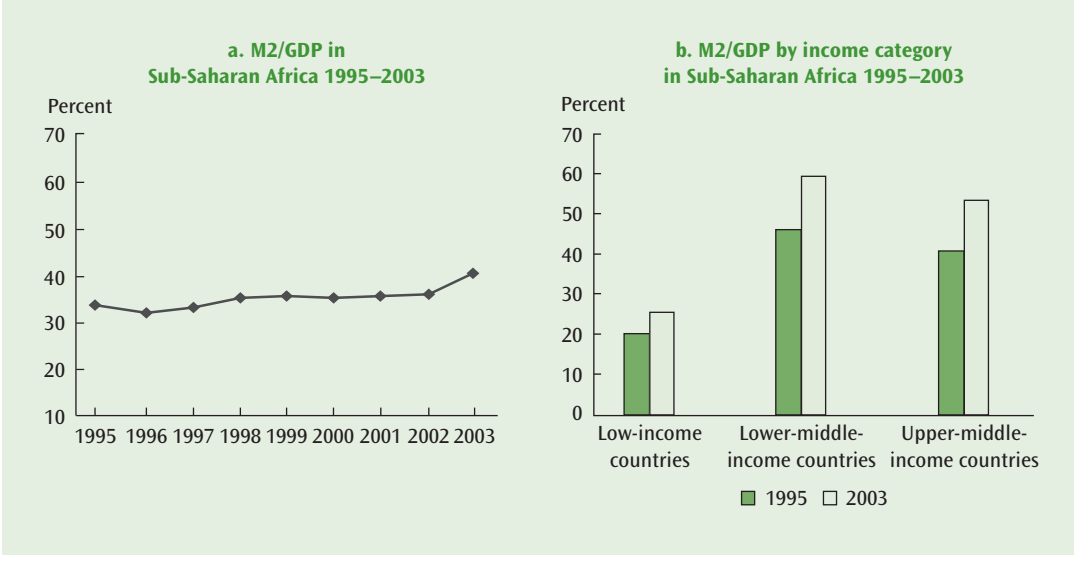
to international standards—although the enforcement of regulatory standards is weak, as in many other developing countries. The region's reforms have achieved substantial results, and financial system stability has improved appreciably.

Despite this legal and regulatory progress, financial systems in Sub-Saharan Africa remain underdeveloped. Outside Mauritius and South Africa, lending to the private sector is still limited and costly. Since 1995 there has been limited progress on financial sector deepening (figure 2.15). Excluding South Africa, private sector credit relative to GDP has grown by only about 2 percentage points over the past 10 years, with most of the growth occurring recently (figure 2.16). A number of explanations have been advanced, including increased holdings of government paper by banks due to bank restructuring, crowding out, and more conservative lending in the face of high credit risks.[46] Another problem is that the cost of borrowing is higher in Sub-Saharan Africa than in other regions (figure 2.16b).

In this context, improving access to financial services poses a significant challenge. As noted, investment climate surveys in Sub-Saharan Africa reveal that inadequate access to finance is a major constraint for entrepreneurs. The surveys also indicate that access is hampered for two reasons. First, high real interest rates and banking fees make financial services too costly. Second, mainstream financial institutions fail to serve the needs of important population segments, including small-scale entrepreneurs. Virtually all surveys indicate that financial institutions are hesitant to lend because of difficulties in securing collateral and seizing assets in case of default. The availability of financial services is also crucially related to financial system supporting structures, including regulation, information infrastructure, property rights enforcement, and overall governance and institutional development.

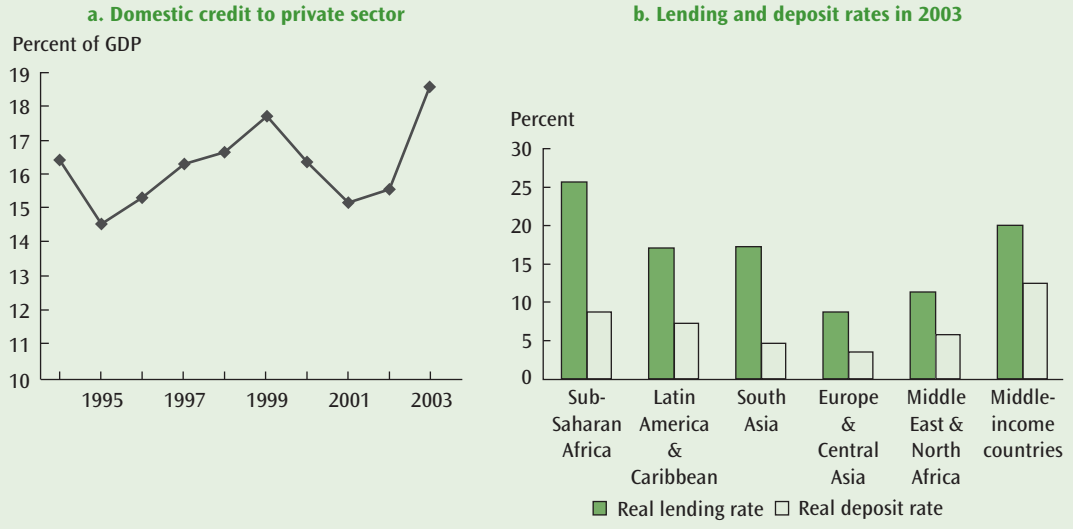
There have been notable efforts to develop credit information systems and improve regulations to facilitate access to finance.[47] The World Bank has documented the incipient development of credit reporting systems in 30 Sub-Saharan countries, including systems operated by private firms in Botswana, Cape Verde, Equatorial Guinea, Eritrea, and Namibia. A number of countries have

FIGURE 2.15 Financial depth is lowest among low-income Sub-Saharan countries



Source: World Bank Staff estimates.

FIGURE 2.16 The cost of borrowing is higher in Sub-Saharan Africa



Source: World Bank staff estimates.

improved their regulatory systems to facilitate access to finance, notably legal rights for creditors in Kenya, Nigeria, and Zimbabwe and registration of movable collateral in Botswana and South Africa. In addition, Ghana, Kenya, Mauritius, Tanzania, and Uganda have introduced regulations to facilitate the integration of microfinance institutions with mainstream financial systems. These are all promising efforts, as development of financial infrastructure can secure access to credit for a wider segment of the population.

Most African countries receive (bilateral and multilateral) donor-funded facilities for trade and investment finance purposes. When these facilities are implemented effectively, they substantially enhance domestic private sector credit (as in Zambia). But experiences with donor-funded financing vehicles have shown the need for terms and conditions more consistent with long-term goals for financial sector development. Donor-funded facilities that are priced below market rates, targeted to specific sectors and borrowers, and channeled through a few select intermediaries do not provide an adequate framework for promoting efficient resource allocation. Coordination among providers of these facilities and harmonization of terms and conditions are among the most important challenges for donor-funded facilities to improve financial intermediation.

Physical infrastructure

Inadequacies in the level and quality of infrastructure—including electricity, transportation, and communications—can adversely affect private sector productivity and investment rates. While macro evidence on the growth impacts of infrastructure remains somewhat inconclusive, businesses in developing countries often cite infrastructure quality among their top constraints, particularly in Sub-Saharan Africa and South Asia. For example, entrepreneurs in Sub-Saharan Africa consider unreliable electricity one of their biggest constraints (see figure 2.9). Transport infrastructure is also key in the region, given its long distances and many landlocked countries. But the wide variation

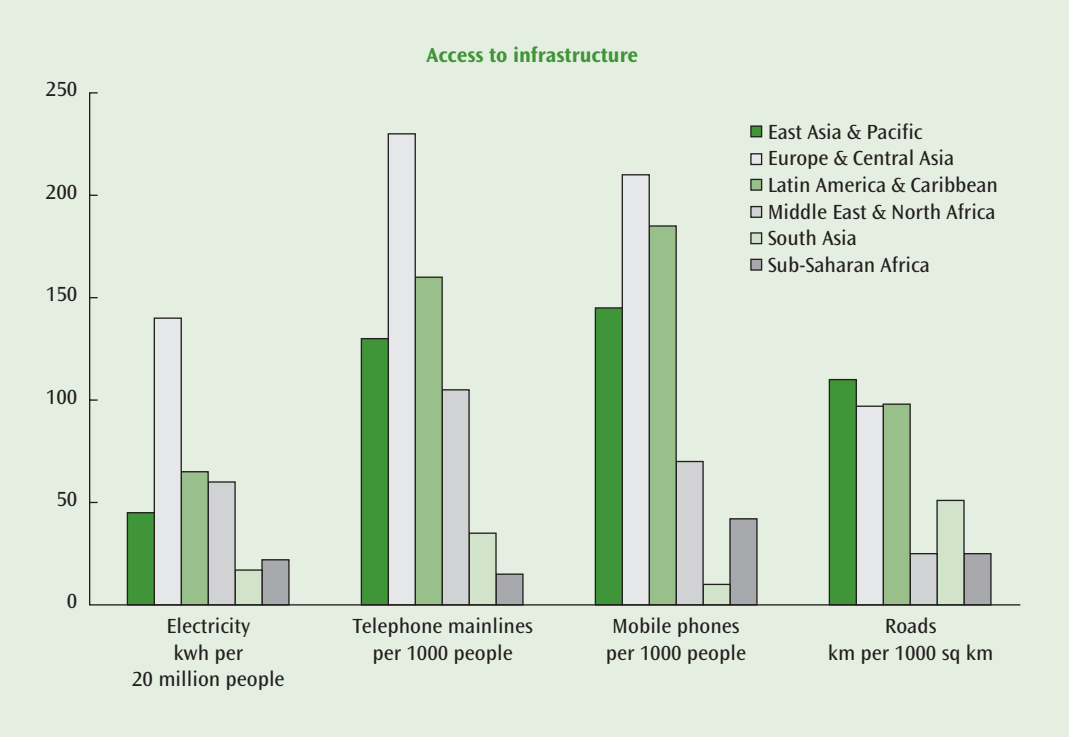
in survey responses across developing countries suggests that the severity of the constraints imposed on the private sector by inadequate infrastructure differs considerably.[48] In particular, in some countries a lack of sufficient maintenance, rather than a lack of infrastructure, is the more pressing issue.

Sub-Saharan Africa and South Asia have the lowest access to basic infrastructure such as water, electricity, communications, and roads (figure 2.17). Even when services are available, their quality tends to be quite poor. Moreover, the quality of electricity and roads declined during the 1990s.[49]

Estimates of infrastructure gaps for the developing world indicate sizable investment needs and large financing gaps. These gaps increased in many developing countries in the 1990s as public investment in infrastructure fell and private investment failed to rise sufficiently to take up the slack. Recent projections indicate that Sub-Saharan Africa has investment needs of $17–22 billion a year in 2005–15, including both capital and maintenance expenditures.[50] Estimates place current public infrastructure investment at about $6 billion a year (roughly half of which is donor-financed) and private commitments at about $4 billion a year. Thus the region's infrastructure financing gap is $7–12 billion a year, or 4.5 percent of GDP (figure 2.18).

Under current conditions it is unlikely that infrastructure projects involving private participation will fill a significant portion of Sub-Saharan Africa's financing gap. Due to its relatively low level of private involvement, the region escaped the retrenchment of private participation in infrastructure that occurred throughout the developing world in the late 1990s (figure 2.19). But

FIGURE 2.17 Weak access to infrastructure is a major constraint in Sub-Saharan Africa and South Asia

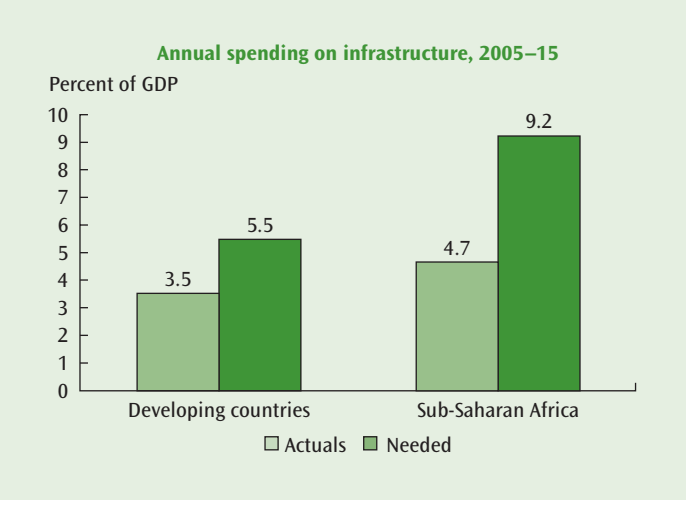


Source: World Development Indicators database.

Africa's initial experience with private participation was unsatisfactory in two key respects. First, private participation was below government expectations. Second, a number of contracts were subsequently renegotiated or cancelled. In general, private investors perceived a high level of operational and political risk, particularly because of the lack of reliable information on the operational and financial outlook. Moreover, the bulk of projects were implemented in South Africa.

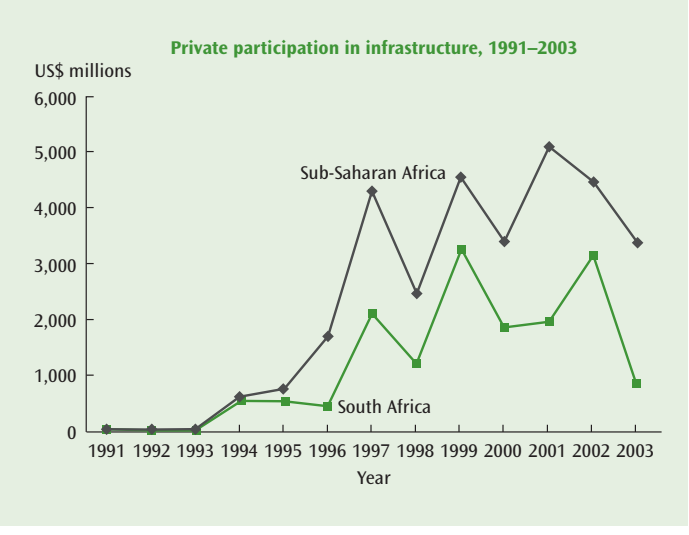
Long-term success will require ensuring an enabling regulatory environment for both private and public projects. In this respect, three challenges appear crucial. First, it is important to strike an adequate balance in government budgets between capital and recurrent spending. Politicians tend to find more satisfaction in opening new facilities—but throughout the developing world, a maintenance deficit tends to significantly shorten the lifespan of expensive equipment. Second, it is essential to ensure the financial viability of infrastructure projects, with a focus on full cost recovery. It is notable that South Africa, which has made enormous progress in expanding water and sanitation services, has a policy of full cost recovery. Third, it is essential that returns not be confiscated by the government. A major risk for private-public partnerships is that governments will renege on commitments to cost-recovering tariffs once fixed investments are sunk. Addressing these concerns requires careful design of the contracts and regulatory environments under which utilities operate.

FIGURE 2.18 Infrastructure spending fails to meet needs, particularly in Sub-Saharan Africa



Source: Estache and Yepes 2004.

FIGURE 2.19 Private participation in infrastructure remains low in most Sub-Saharan countries, and has recently fallen



Source: Private Participation in Infrastructure database (World Bank).

Public Sector Governance: The Role of Institutions

Public sector governance has a significant impact on economic outcomes, such as growth and poverty reduction, and on the achievement of the nonincome MDGs. In many ways improving governance is the biggest challenge facing developing countries. Building on the earlier discussion on the need for sound public financial management and an enabling environment for private sector activity, this section assesses progress in strengthening a broader set of institutions—economic and political—that affect economic outcomes.

Economic Governance

The perception that economic governance is weaker in Sub-Saharan Africa than in other regions is broadly supported by available indicators. For example, the Worldwide Governance Indicators, a comprehensive set of measures compiled by the World Bank and based on information from a wide set of sources, show weak performance in Sub-Saharan Africa on four critical governance issues—rule of law, voice and accountability, government effectiveness, and control of corruption—throughout the period covered, 1998–2004. The only exception is voice and accountability, where Sub-Saharan Africa slightly outperforms the Middle East and North Africa and South Asia. Country Policy and Institutional Assessments (CPIAs), developed by World Bank staff, paint a similar picture, with Sub-Saharan Africa rated lower than all other developing regions on property rights and rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilization, and quality of public administration.

Crucially for investment flows, the perceptions presented by these indicators are confirmed by the risk assessment services commonly used by private investors. For example, the composite risk index from the International Country Risk Guide (ICRG) rates Sub-Saharan Africa as the highest-risk region during 2000–3 (and consistently since the inception of the group's assessments in the 1980s).[51] This overall rating is consistent with the results of the previous section as well as low scores on key economic governance dimensions such as bureaucratic quality, corruption, and law and order.

Moreover, while there has been some improvement in recent years on a few indicators in some Sub-Saharan countries, econometric evidence confirms that the region's countries tend to underperform on governance, relative to their income levels. Recent claims to the contrary suggesting that the perception of weaker governance in Africa is due entirely to low income levels assume that higher income leads to better governance; these claims ignore the effect of potential causality from governance to income levels. Yet empirical evidence suggests that the stronger causality effect is from governance to income and, once that is accounted for, most African countries have governance scores lower than would be expected on the basis of their income levels (box 2.12).

Within this general assessment, disaggregation of the previous indexes by income level reveals important differences across African countries. While low-income countries in Sub-Saharan Africa are assessed as having weaker performance than their counterparts elsewhere, the eight middle-income Sub-Saharan countries outperform other middle-income countries. This result holds for the Worldwide Governance Indicators and the CPIA scores, as well as the ICRG risk assessments.[52]

Political Governance and Accountability

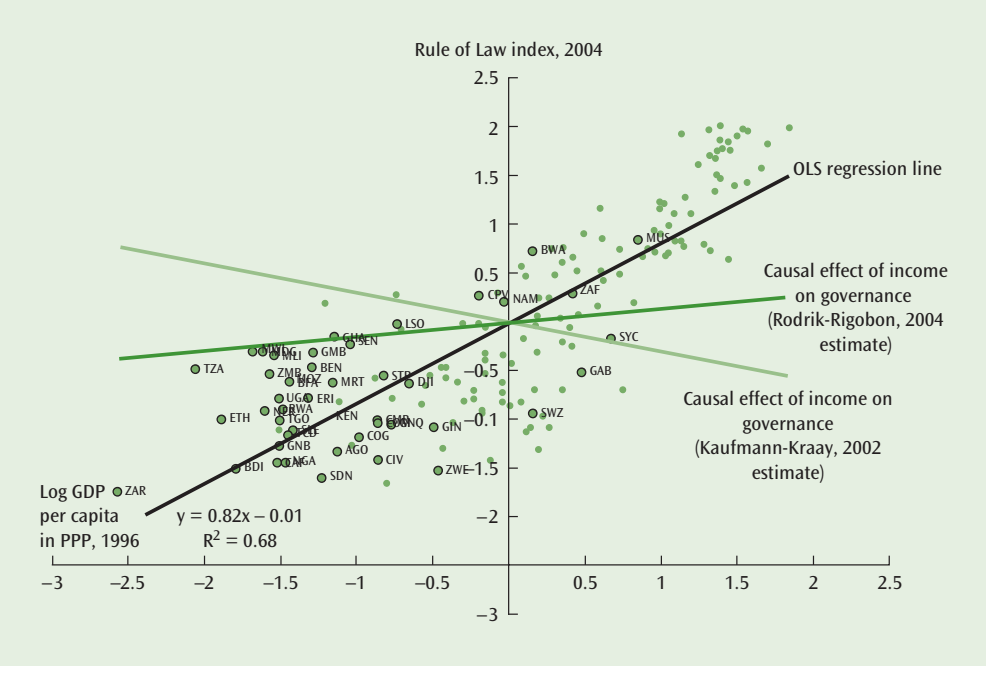
On political governance, Sub-Saharan Africa's performance is stronger, with indicators generally ranking it ahead of some other developing regions. For example, on Freedom House's 2005 rankings of political rights and civil liberties, Sub-Saharan Africa is rated "more free" than the Middle East and North Africa and South Asia. More impressively, the Database on Political Institutions maintained by the World Bank shows that by 2002, Sub-Saharan Africa attained a higher percentage of countries with chief executives selected through competitive multiparty elections than the average for other developing regions (figure 2.20). Finally, the African Governance Indicators, compiled for the United Nations Economic Commission for Africa's 2005 *African Governance Report*,[53] confirm the region's higher scores on the political dimension and lower scores on economic governance (box 2.13).

On press freedom, a key indicator of political accountability, the picture is similar. A well-informed citizenry has been called the "ultimate constraint on a democratic government,"[54] and recent evidence points to the role of the media in promoting

BOX 2.12 How does governance affect per capita incomes in Africa, and vice versa?

A recent paper argues that weak governance is not a major factor in Africa's poor growth performance (Sachs and others 2004). The argument is that, once their (low) level of income is accounted for, Sub-Saharan countries do not have particularly poor governance indicators. This point is illustrated in the figure below, which plots the rule of law measure from the Worldwide Governance Indicators (on the vertical axis) against the logarithm of real per capita GDP in the mid-1990s (on the horizontal axis). Sub-Saharan countries are identified by green dots outlined in black. A striking observation is that more than half (27 of 46) of the countries in the region fall above the (ordinary least squares, or OLS) regression line, shown in black. The conclusion drawn by Sachs and others (2004) is that, with more than half of the countries in the region performing better on governance than would be predicted by their income, the perception of weak governance in Africa is simply a reflection of low income levels.

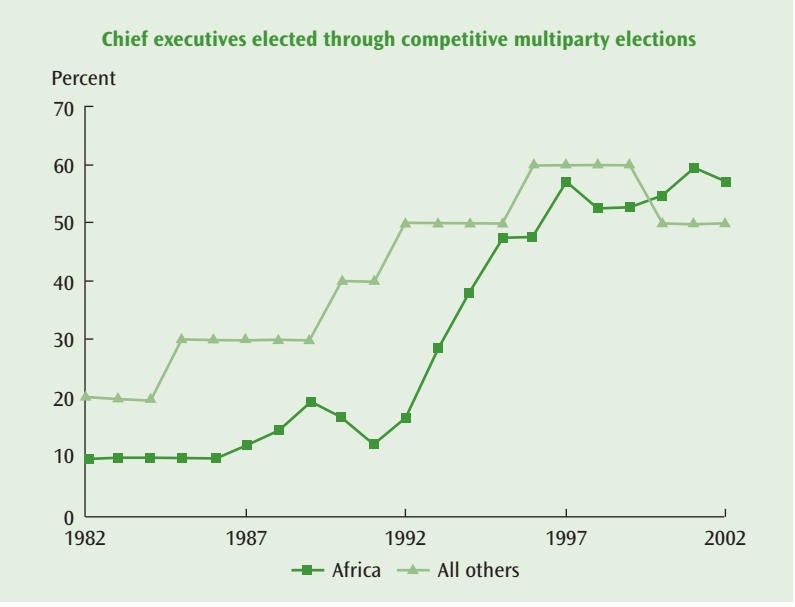
But the simple correlation portrayed by the OLS regression line does not imply causality. The above argument assumes that higher income leads to (or causes) better governance. Intuitively, however, causality could run in the opposite direction, with better governance leading to higher income—or, more likely, in both directions. In either case, the OLS results do not isolate the different directions of causality and do not support any conclusion on the causal relationship between governance and income.



On the other hand, the green lines are drawn from two attempts to effectively identify the direction of causality. The upward-sloping green line is from Rigobon and Rodrik (2004) and the downward-sloping green line from Kaufmann and Kraay (2002). Although the two estimates use different approaches to identification, the conclusions are similar: Very few countries (7 and 6, respectively) fall above the regression line. Thus the evidence suggests that governance in Sub-Saharan Africa is not as good as one might expect given the level of per capita income.

Source: Kaufmann, Kraay, and Mastruzzi 2005.

FIGURE 2.20 Participatory processes are improving in developing countries, but most rapidly in Africa



Source: World Bank Database on Political Institutions.
Note: The index measures the percentage of country leaders elected in multiparty elections with less than 75 percent of the vote. The category "all others" includes developing countries in all other regions except Europe and Central Asia (for lack of comparable data for that region for the early part of the period covered).

good governance and holding governments responsive and accountable.[55] For 2004 the Freedom House indicator of press freedom ranks Sub-Saharan Africa (with 50 percent of countries ranked as "not free") ahead of both the Middle East and North Africa (100 percent) and South Asia (75 percent).

Is Governance Improving?

On economic governance, there is little evidence of regionwide improvement. The Worldwide Governance Indicators do not provide any evidence of a relative improvement over the period covered, 1998–2004.[56] Similarly, the most common ICRG indicators (bureaucratic quality, corruption, law and order) show no improvement over time, while the CPIAs show only marginal improvement.[57] The same pattern of stagnation holds for both low- and middle-income Sub-Saharan countries.

On the other hand, there have been substantial improvements in political institutions across Sub-Saharan Africa. Since 1990 Freedom House indexes on political rights and civil liberties in Africa have outpaced the general trend toward more inclusive and open political systems; similar indications are provided by the polity index on democracy. As noted, equally positive has been the progress suggested by the World Bank's Database on Political Institutions, according to which Sub-Saharan Africa has made impressive strides since the mid-1990s.

Can Policy Spur Institutional Reform?

Although institutions tend to persist, they are not predetermined.[58] Economic institutions have improved considerably in Chile and the fast-growing countries of East Asia, and there is evidence of recent improvements in political institutions across Sub-Saharan

BOX 2.13 The Economic Commission for Africa's governance indicators and agenda

The African Governance Indicators, compiled as part of the United Nations Economic Commission for Africa's (UNECA's) *African Governance Report 2005,* offer interesting insights on the strengths and weaknesses of different governance dimensions in Africa. Based on surveys of 25 Sub-Saharan countries, the figure below shows that, on average, the highest scores are given for indicators of political representation: the credibility of the electoral process, the freedom of political parties, and the distribution of political power. Average scores were lower for the effectiveness of institutions in all three branches of government (executive, judicial, legislative). Scores were lower still for the efficiency of government services, the control of corruption, and the transparency and accountability of the civil service. Scores were lowest for the decentralization of government structures and corruption in the tax system. Generally, these assessments are consistent with the thrust of the earlier discussion on economic and political governance.

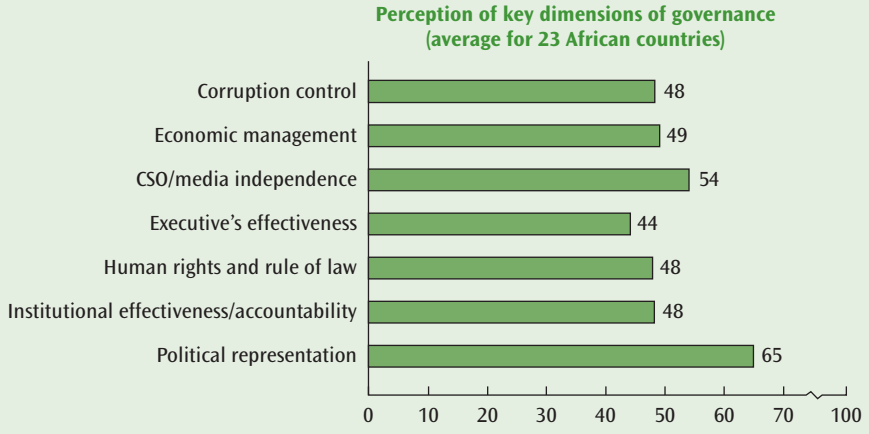
The report identifies 10 priority areas in building capable and accountable states:

- Strengthening the capacity of parliaments to perform their core functions, including providing checks and balances on the executive. Parliamentarians and their support staff need training and access to libraries and databases.
- Deepening legal and judicial reforms, including through protection and enforcement of the autonomy of the judiciary and modernization of the judicial process. The judiciary needs independent funding. Reforms must also cover the police force and public prosecutors.
- Improving public sector management through long-term, sustained efforts, tailored to country needs—for example, reducing red tape, accelerating improvements in pay and other incentives, and using in-country, regional, and international knowledge hubs.
- Improving the delivery of public services, through effective channels of accountability between public providers and their clients. Options include decentralizing and encouraging greater choice and competition.
- Removing bottlenecks to private enterprise, to improve national and regional investment climates. This requires macroeconomic stability, consistent policies and regulations for business entry, protection of property rights, and enforcement of contracts.
- Tapping the potential of information and communication technologies for promoting transparency, openness, and knowledge exchange in the affairs of government. Due to high costs, a strategic approach to e-governance is needed.
- Fostering credible and responsible media that report accurate information and stimulate debate in an environment of freedom. Training is needed to support professionalism and effective self-regulation by the media.
- Maximizing the contribution of traditional modes of governance. Traditional authorities must be enabled to complement the resources of government in providing public goods and services, including for conflict prevention and resolution.
- Confronting the governance dimension of HIV/AIDS, which requires strong national leadership to reduce the effects of the pandemic on institutional structures and to manage the resources and mechanisms needed for societywide responses.
- Getting partners to live up to their commitments for more and better aid through harmonized procedures, budget support, and predictable disbursements. Policies on aid, trade, and debt must be consistent with African efforts to achieve the MDGs.

This ambitious reform agenda will require considerable contributions in the area of political commitment and supporting actions from donors, including assistance for capacity development. On every dimension, international financial institutions, in concert with bilateral donors, have launched initiatives to assist steadfast reformers push ahead.

BOX 2.13 The Economic Commission for Africa's governance indicators and agenda *(continued)*

Stronger performance on political representation; weaker performance on public sector management and institutional effectiveness



Source: UNECA (2004).
Notes: The scale is from 0 to 100, where scores close to 100 reflect good governance as perceived by the survey respondents.
CSO = Civil Society Organizations.

Africa. At times, crises or changes in leadership have led to institutional change, but these are not amenable to policy guidance. More applicable is the possible role of policy in promoting improvements in economic or political institutions.

In general, policies that open up economic opportunities to a circle wider than the initially entrenched elite tend to be conducive to institutional improvement. An improved investment climate tends to spur demand for wider institutional reforms because as "investors, whether domestic or foreign, come forward, they tend to demand more effective institutions, greater security, and constant improvements in the provision of public goods, which further enhances the quality of the investment climate."[59] Along the same lines, a number of studies have found that strengthening competition, including through trade openness, can be conducive to institutional improvement.[60] Opening up new markets may reduce the rents derived from the prevailing economic and institutional arrangements and thus weaken vested interests.

There is also evidence that the wide availability of independent sources of information tends to encourage accountability. Where ownership of press outlets is monopolized by the government, political and economic freedom tends to be lower and corruption higher—and when there is more information available on policy choices and outcomes, governments tend to be more responsive.[61] In a prominent case, Amartya Sen drew a link between the impact of transparency on the relative incidence of poverty and famine in China and India.[62] The combination of higher transparency of public decisions and press freedom to stoke the public debate tends to constrain the options available to policymakers and reduce the scope for institutional failure.

In some cases external anchors may also contribute to institutional change. In combination with domestic commitment to reform, external incentives, constraints, and agreements may help in breaking through entrenched interests and other domestic impediments to reform. This has been true in the case of accession to the European Union for new members in Central and Eastern Europe, to the North American Free Trade Agreement (NAFTA) for Mexico, and to the World Trade Organization (WTO) for China. In Africa the New Partnership for Africa's Development (NEPAD) aims to use collective commitments and peer pressure to promote institutional reform (see below). Concessional loans and technical assistance from international financial institutions are also geared to improving the policy and institutional framework in borrowing countries.

Priorities for Building Capable and Accountable States in Africa

Across Sub-Saharan Africa there is growing recognition of the critical role of good governance, and a renewed resolve to improve performance on the ground. Under the aegis of NEPAD, African states have agreed to improve their economic and political governance. The work of regional development agencies is focusing more on governance, and the United Nations Economic Commission for Africa's 2005 *African Governance Report* represents a major contribution to the buildup of a critical mass of country-specific data and analysis on governance achievements and challenges. On the ground, NEPAD continues to advance with the African Peer Review Mechanism (APRM), its innovative approach to improving governance.

Already, 23 countries—containing about three-quarters of the population of Sub-Saharan Africa—have acceded to the APRM, a key objective of NEPAD since its inception in 2001. Under the APRM, African countries volunteer to "open their books" on political governance, economic governance, corporate governance, and socioeconomic development. The underlying objective is to foster the adoption of policies, standards, and practices that lead to political stability, high economic growth, sustainable development, and accelerated subregional and continental economic integration through sharing of experiences and reinforcement of successful and best practice.

In 2004 NEPAD heads of state approved Ghana, Kenya, Mauritius, and Rwanda as the first countries to be exposed to the APRM reviews. The second group of countries to be reviewed will include Algeria, Mali, Mozambique, Nigeria, Senegal, and South Africa. The four countries that have started the review process have established focal points (at ministerial level or higher) for the APRM as well as national coordinating mechanisms to secure widespread consultations through all APRM stages. The extended design of the APRM process emphasizes learning and seeks to build more inclusive processes than are typically found in, for example, poverty reduction strategy (PRS) formulation and implementation.

Recent changes in approach have considerably lengthened the process, and the focus has changed from the regional to the country level. With the limited capacity of the APRM secretariat to prepare background analyses of countries and to promote substantive, political discussions on governance problems in the individual countries as well as in the Peer Review Panel and Forum, the APRM faces the challenge of moving beyond formal consultations and extended processes. These are critical challenges for the APRM as the most innovative and potentially influential component of NEPAD.

In the period ahead, it will be essential to translate the recent improvements in political institutions to similar enhancements in economic institutions, particularly in rule-based governance and protection of property rights. Extending reforms to these critical dimensions of governance would begin to set in motion a virtuous circle consisting of renewed incentives for better policies, a more favorable environment for private investment, and rising living standards. Better policies can play a role in

spurring institutional development, including by helping to overcome resistance to change from entrenched interests. In practice, political commitment will be key in ensuring that reforms extend beyond mere changes of formal laws to more fundamental transformations of daily practice, including informal rules of behavior and the impact of vested interests.

Notes

1.The scenario presented is based on current trends and primarily useful as a reference point.

2.The tsunami that hit Indian Ocean countries in December 2004 caused a human tragedy of epic proportions. The quick humanitarian and financial response of the rest of the world helped the affected countries quickly launch the recovery and reconstruction process and also helped limit the economic and financial costs of the tragedy. Based on initial assessments, the macroeconomic impact is expected to be modest for India, Indonesia, Sri Lanka, and Thailand. Although the impact on growth and inflation will also be modest in the Seychelles, the economy was not as robust as in the other countries prior to the disaster, and there may be increased pressure on the fiscal position and the balance of payments in 2005. In the Maldives, where the physical destruction was also significant, the macroeconomic impact may be more pronounced, with initial estimates suggesting that output in 2005 may be lower than forecast by some 5 percentage points of GDP. Somalia was also affected by the disaster, but the relative lack of information and absence of an internationally recognized government operating in the country have slowed the pace of assessments, which are currently under way.

3. In addition, for some regions the $1 a day poverty line may underestimate the extent of poverty. Using a $2 a day definition of poverty, the headcount measure for East Asia and Pacific would be 69.9 percent for 1990 and 11.3 percent for the 2015 forecast, for Europe and Central Asia it would be 4.9 percent and 5.2 percent, and for Latin America and the Caribbean it would be 28.4 percent and 19.6 percent.

4. This section draws on IMF (2005b).

5. The figure excludes Europe and Central Asia, for which membership has varied considerably across the period covered, and Middle East and North Africa, where heavy reliance on oil complicates regional comparisons. In either case, the relevant conclusions are robust to their inclusion.

6. Equatorial Guinea should also be included in this group, but its period average growth rate has been heavily influenced by spectacular oil-led growth since the mid-1990s.

7. The estimates of inequality and the argument on the political economic consequences of observed patterns across Africa are both from Artadi and Sala-i-Martin (2003). The same study points out that most of the inequality in Africa can be accounted for by inequality within countries rather than across countries.

8. The major oil producers in Sub-Saharan Africa are Angola, Cameroon, Chad, Republic of Congo, Equatorial Guinea, Gabon, and Nigeria.

9. Bosworth and Collins (2003, p. 8).

10. See Bosworth and Collins (2003) and Tahari and others (2004). Growth in total factor productivity reflects not just changes in economic efficiency, but also the influence of growth determinants not otherwise included in measured changes in physical or human capital, including political instability and conflicts, droughts and other exogenous shocks, and changes in government policies and institutions.

11. While HIV/AIDS prevalence rates differ widely across countries, ranging from 1 to almost 40 percent, average life expectancy across the region has fallen over the past 15 years, largely due to HIV/AIDS. The primary effect of HIV/AIDS is an increase in mortality and a deterioration in health, primarily among young adults. In turn, HIV/AIDS affects most of the common indicators of living standards, such as income, health standards, and access to education—and success in combating HID/AIDS, along with other communicable diseases, is one of the MDGs. The channels through which the disease affects economic growth are not well understood. Studies focused on disruptions to the production process, and additional health expenditures tend to find modest effects. On the other hand, studies that have attempted to capture some of the microeconomic impacts associated with the disease find a larger effect on economic growth owing, for example, to disruptions in the process of accumulating human capital (Haacker 2004).

12. The earlier spotlight on unique drivers of African growth has given way to a more complex explanation as the empirical relevance of the "African dummy" has been eliminated and a more policy-relevant dialogue has focused on the

underlying determinants of economic outcomes. See, for example, Hoeffler (2002).

13. Satyanath and Subramanian (2004) attribute the causes of long-run macroeconomic instability to the incidence of conflict, lack of openness to trade, and ineffective political institutions. This raises the general question of the extent to which macroeconomic policy is a function of deeper determinants and thus not an independent driver of growth. It is clearly the case that macroeconomic performance is partly driven by deeper political, economic, and structural factors. But a variety of evidence, including case studies and experience, suggests that there is an important role for macroeconomic policy itself. In any case, both macroeconomic policy and underlying institutional policies must be addressed simultaneously.

14. Artadi and Sala-i-Martin (2003); Tsangarides (2005).

15. The impact of foreign aid on recipient countries has been a controversial question in the academic literature, with earlier results often found not to be robust to changes in sample or specification. Recently, Clemens, Radelet, and Bhavnani (2005) found that economic aid raised growth in Sub-Saharan Africa, but they also found evidence of diminishing returns to aid. By their estimates, raising aid to Sub-Saharan Africa from current levels to the point at which marginal returns diminish to zero, at close to 17 percent of GDP, would raise growth in the region by 0.4 percent per year. Rajan and Subramanian (2005) find no evidence that aid is associated with growth.

16. See Collier, Hoeffler, and Soderbom (2004) on duration, Collier and Hoeffler (2004a) on the costs, and Staines and others (2005) on the macroeconomics of recovery from conflict.

17. Growth accelerations are defined in box 2.6.

18. The lower incidence of growth accelerations in Sub-Saharan Africa does not seem to be attributable to the region's higher proportion of low-income countries. Measured by the percentage of country years spent in acceleration episodes, the incidence of growth accelerations has been unrelated to either the initial level of income per capita or the initial savings rate—a result that holds for both the overall sample of countries and for those in Sub-Saharan Africa.

19. The cutoff at 1998 is imposed to allow calculation of the post-episode five-year average.

20. Hausmann, Pritchett, and Rodrik (2004) find that statistical models tend to have modest explanatory power but that political regime changes, macroeconomic stabilizations, and positive terms of trade shocks tend to be statistically significant predictors of accelerations, and that sustained booms tend to be associated with economic reform rather than external shocks.

21. World Bank (2005).

22. In heavily indebted poor countries, debt sustainability is closely linked to the attainment of the completion point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. In addition, successful implementation of the new Bank-IMF forward-looking debt sustainability framework for low-income countries will be critical. This in turn will require an adequate supply of grant financing. These issues are discussed in chapter 5.

23. The fragility of fiscal sustainability with respect to domestic financing is illustrated by several African countries that saw sharp increases in domestic real interest rates as domestic debt levels rose from very low levels to amounts that would not typically be considered excessive in more developed economies. The examples of Ghana, Malawi, and Zambia show how even what look like relatively small increases in domestic debt can sharply increase real interest rates.

24. There is no universal definition of a successful stabilization (that is, a post-stabilization) country. Adam and Bevan (2005) suggest that inflation rates lower than 15 percent for at least two years are sufficient for qualification as a successful stabilization. Gupta and others (2002) propose a combination: fiscal deficits under 2 percent of GDP and inflation rates under 10 percent. A forthcoming IMF study advances a more comprehensive measure: some degree of internal macroeconomic balance, proxied by positive per capita growth rate and low inflation; a fiscal stance that is sustainable over the medium term, proxied by restricted domestic financing of the budget deficit; and robustness to external shocks, proxied by the level of international reserves.

25. IMF (Forthcoming).

26. Using the alternative indicators of the fiscal balance to assess progress in Sub-Saharan Africa would tend to reduce the number of countries considered successful stabilizers.

27. Despite the caveats mentioned in the text on the applicability of overall fiscal deficits to assess the sustainability of fiscal positions in Sub-Saharan Africa, it is worth noting that empirical estimates of the deficit-growth nexus yield a substantively similar conclusion in suggesting that some African countries could boost growth with a reduction in fiscal deficits. Recent studies indicate

that post-stabilization countries with low deficits may not benefit from further fiscal consolidation. However, most countries in Sub-Saharan Africa have a fiscal deficit higher than the threshold of 1.5–2.5 percent of GDP (Adam and Bevan 2005). At the end of 2003 there were 25 countries in Sub-Saharan Africa with a fiscal deficit, including grants, higher than 2.5 percent of GDP, with 13 countries exceeding 5 percent. Among the latter group, the growth rate per capita was 0.9 percent in 2003, compared with the regional average of 1.2 percent.

28. As of April 2004 this group included Botswana, Cape Verde, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, Swaziland, and South Africa.

29. World Bank (2005, chap. 3, p. 16).

30. Within Sub-Saharan Africa the pattern of relative underallocation toward capital expenditures and the social sectors is particularly striking in the oil economies, which tend to underinvest relative to other countries in the region.

31. The data, contracts, and audit reports are available at http://www.mefb-cg.org.

32. Le Houerou and Taliercio (2002, p. 35).

33. IMF (2005a).

34. IMF (2003).

35. Tax reform could also contribute to policy stability by helping to moderate the relatively large variance of revenue ratios in African countries. This tendency for greater variability effectively reduces the level of sustainable debt, among other things.

36. As noted, sustainable policy configurations, by promoting private investment and economic growth, can be an effective source of fiscal space.

37. Bulir and Lane (2002) document that aid has been up to seven times more volatile than domestic fiscal revenue, and that aid disbursements have not been well predicted by aid commitments.

38. See, for example, Levine and Renelt (1992) on the robustness of investment in cross-country regressions, and Collier and Gunning (1997) on the conclusion that investment in Africa is low.

39. For example, Devarajan, Easterly, and Pack (2001) and, more recently, Eifert, Gelb and Ramachandran (2004). Arguably, the reported high level of capital flight from Sub-Saharan Africa could be seen as a rational response to the lack of profitable investment opportunities at home (Collier, Hoeffler, and Pattillo 1999).

40. The Investment Climate Surveys and the assessment of business regulations in *Doing Business* 2005 were conducted by the World Bank in collaboration with local partners. There have been 8 surveys completed by countries in Sub-Saharan Africa, in a total of 53 across all developing regions, and 8 more are planned over the next year. The goal of the exercises is to assess the impact of the investment climate on firm performance, and to measure business regulations across the world and benchmark best practices. *Doing Business* 2005 covers 145 countries, including 32 in Sub-Saharan Africa.

41. The ease of doing business index is the simple average of country rankings (from 1-135) in each of the seven measures included in *Doing Business 2005,* with higher values indicating more efficient regulation and stronger protection of property rights.

42. Labor regulation rigidity is the average of the difficulty of hiring index, rigidity of hours index, and difficulty of firing index. This indicator ranges from 0-100, with higher values indicating more rigid regulation.

43. Djankov, McLiesh, and Ramalho (2004).

44. Doing Business in 2005.

45. This a key message of World Bank (2004b).

46. Hanson and Ramachandran (2004).

47. Doing Business database.

48. There are, of course, other good reasons to prioritize investments in infrastructure, such as enhancing service delivery and accessibility in line with the nonpoverty goals of the MDGs; these are discussed in chapter 3.

49. Estache and Goicoechea (2004).

50. Estache and Yepes (2004).

51. The International Country Risk Guide (ICRG) economic risk index is a weighted average of measures on political, economic, and financial risk components, with the values ranging from 0-100, where a higher score indicates lower risk. During 2000-3 the median rating for Sub-Saharan Africa was 59, followed by South Asia at 62, Latin America and the Caribbean at 67, East Asia and the Pacific, Europe and Central Asia, and the Middle East and North Africa at 70, and high-income countries (OECD and others) at 82.

52. On the ICRG economic risk index, low-income countries in Sub-Saharan Africa have a risk assessment of 31.0, compared with 33.5 for other low-income countries (where a lower score implies a higher risk). On the other hand, the same index rates middle-income countries in Sub-Saharan Africa at 36.5, compared with 35.5 for other middle-income countries.

53. United Nations Economic Commission for Africa: Striving for Good Governance in Africa. Synopsis of the 2005 African Governance Report (Prepared for the African Development Forum IV, Addis Ababa, October 2004; http://www.uneca.org/agr/).

54. McMillan and Zoido (2004, p. 87).

55. Besley and Burgess (2004); Djankov and others (2003).

56. These indicators are not, strictly speaking, designed to show progress over time, but they do indicate whether a region is making progress relative to others over time.

57. The improvement in CPIAs during 1999-2003 is marginal in two senses: relative to the average improvement in other regions and, statistically, relative to the standard deviation.

58. This section draws on IMF (2003).

59. Stern (2001).

60. See, for example, Ades and Di Tella (1999), Berg and Krueger (2003), Djankov and others (2001), Wei (2000), and World Bank (2002).

61. See, for example, Djankov (2002), Adserà, Boix, and Payne (2003), and Brunetti and Weder (2003) on the relationship between the press and governance, and Besley and Burgess (2002) on the relationship between government responsiveness and newspaper circulation.

62. Sen (1995).