

Chapter 1 :

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

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

Historical Evolution

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

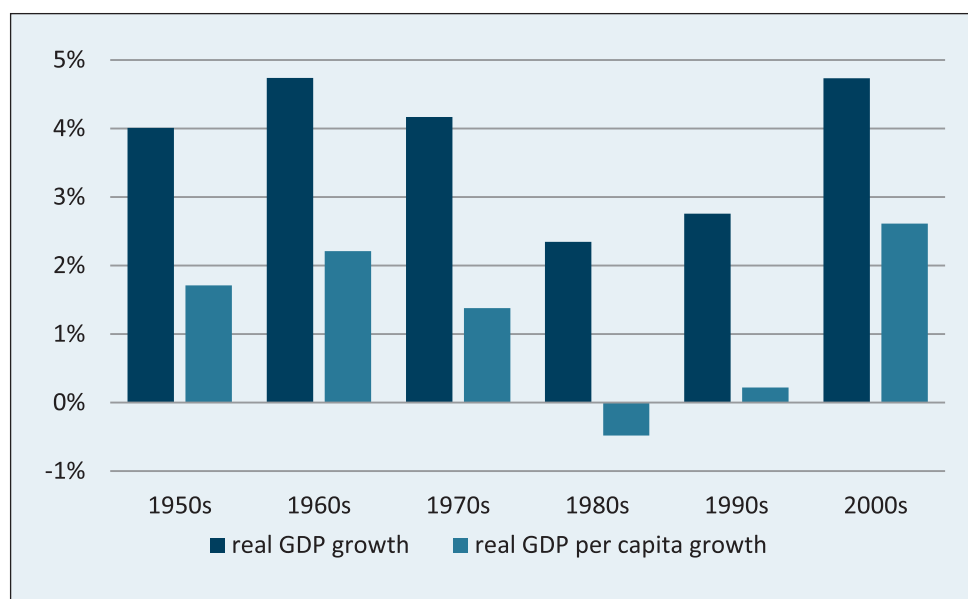
State-led economic development proved to be unsustainable. Agricultural output and productivity stagnated, as price controls diverted resources to industrial sectors.¹ Protected from competitive pressures, state-owned enterprises failed to innovate, relied on inappropriate capital-intensive technologies, and became dependent on imported inputs. As a result, exports were never competitive, and instead contributed to fiscal and trade deficits, with severe and prolonged economic implications. This was exacerbated by the several commodity shocks in the 1970s² and resulted in economic

stagnation. The continent's real GDP growth averaged only 4.5 % per annum over 1960–1980, with real per capita income growing on average by only 1.7 % over the same period (Figure 1.1).

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

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

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

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

Source: OECD database and AfDB Data Platform.

Africa's initial growth following independence, its protracted decline up until the mid-1990s and its subsequent revival indicate that the structural reforms undertaken were transformative and had their intended effect. Countries in other regions going through similar transitions were rewarded with comparable outcomes. Canada and Japan in the 19th century, for instance, adopted a similar path of state-led growth, which resulted in economic stagnation (Box 1.1). Following economic liberalization, economic growth in both countries recovered and accelerated at the beginning of the 20th century. Several Latin American countries and the Soviet Union also adopted a state-led capital accumulation until their economies stagnated in the 1970s³, following which economic liberalization helped revive their economic fortunes. Finally, both India and China undertook structural reforms in the 1990s that removed restrictions against private sector participation in a number of sectors, which eventually contributed

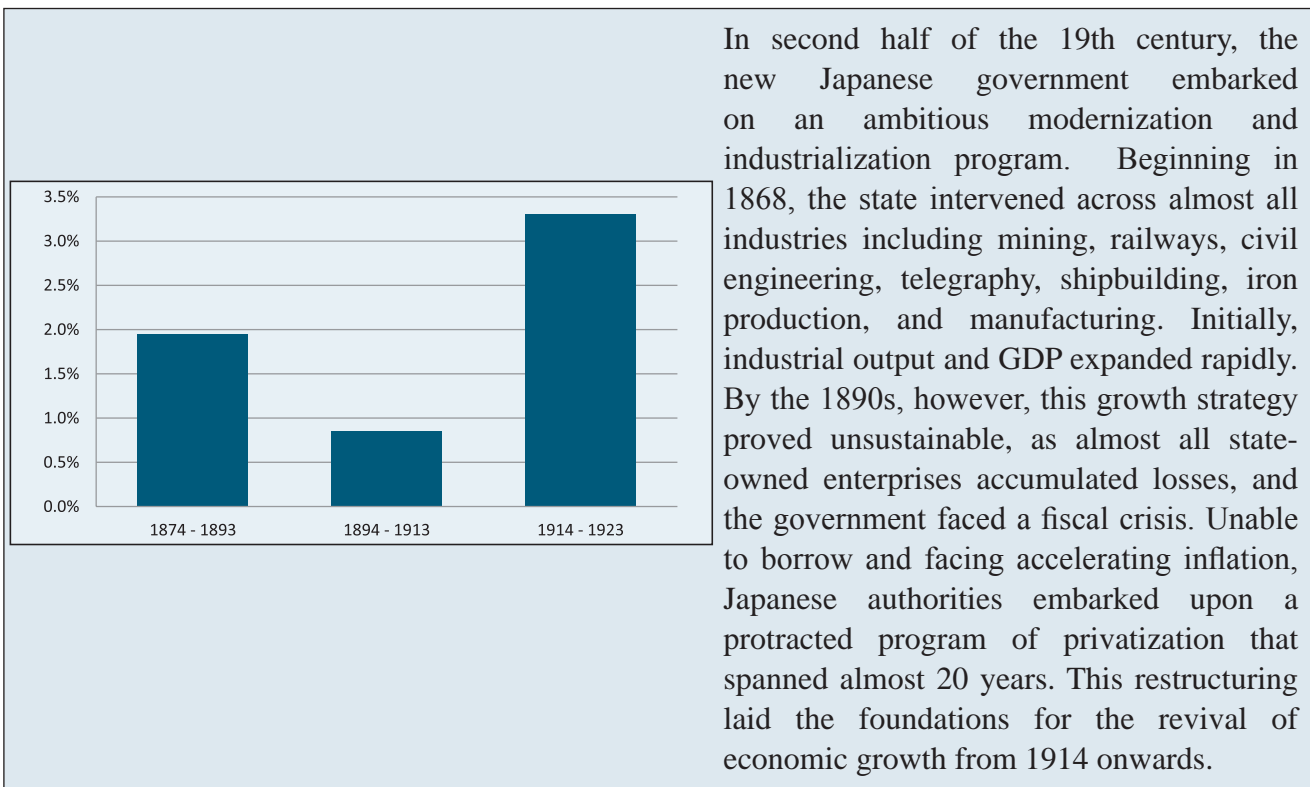
to the acceleration of growth rates to almost 10% per annum⁴. While the recent commodities boom contributed to Africa's economic performance in the 2000s, prudent macroeconomic management and private sector liberalization accounted for over two-thirds of the continent's economic expansion⁵. Moreover, these policies underpinned a GDP growth that proved sustainable in the face of the international economic crisis and the collapse of commodity prices in 2008 and 2009. While most African countries experienced rising real GDP per capita during the 1970s commodity boom (1.4% on average), their performance during the recent boom was not only better (2.6%) (Figure 1.2), but also less volatile (Figure 1.4). Although the commodity boom was more pronounced in the 1970s than in the 2000s (Figures 1.2 and 1.3), many African economies subsequently contracted, while real GDP per capita still expanded by 3.8% in 2008 and 3% in 2009.

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

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

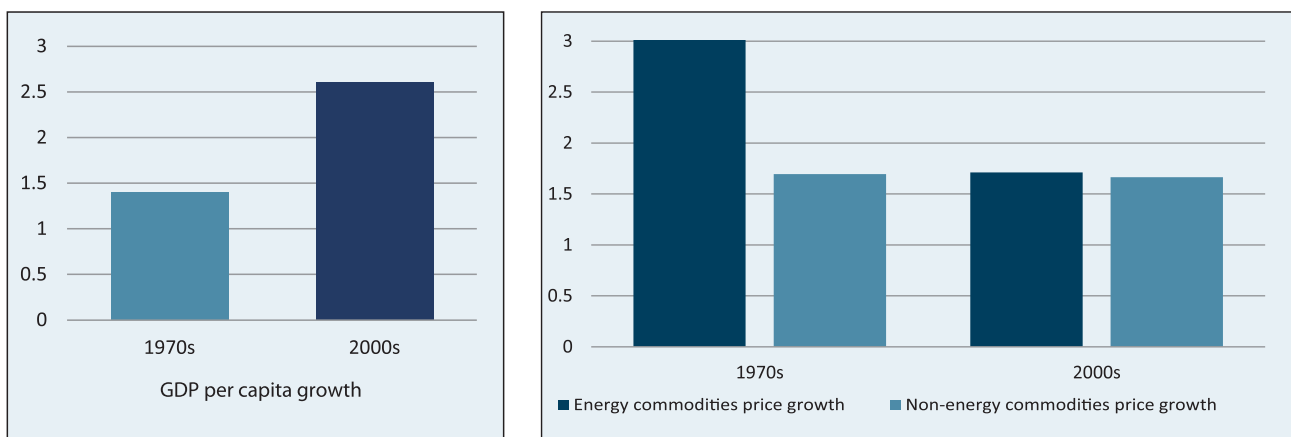
5 Recent reports (McKinsey, 2010) and peer reviewed studies (Beny and Cook, 2009) also reached the same conclusion.

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



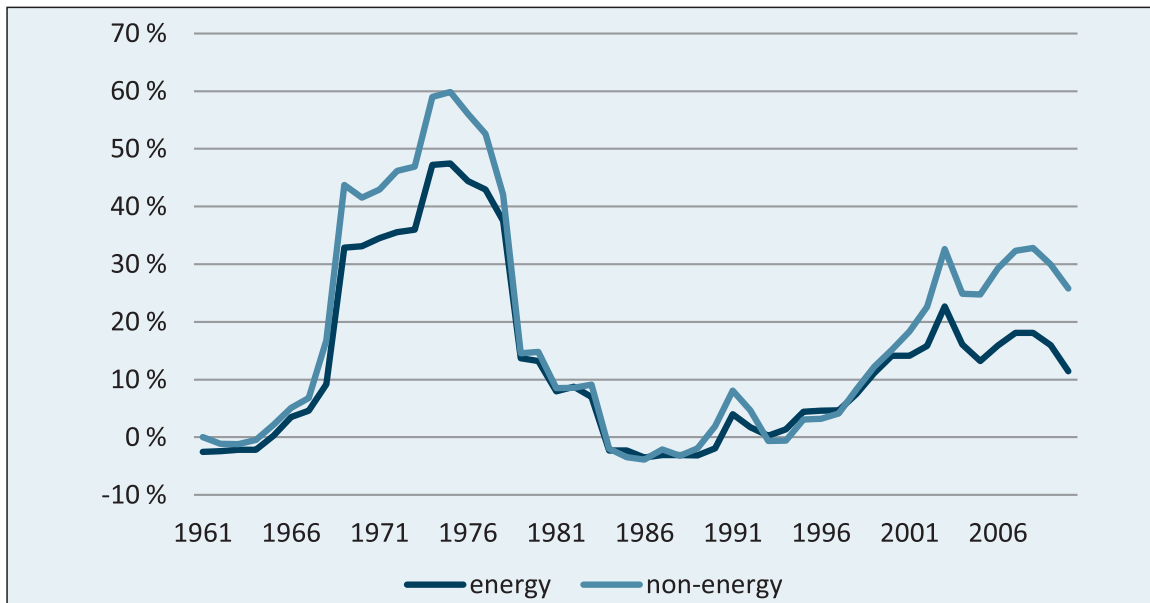
Source: League of Nations, Annual Statistics (various years).

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



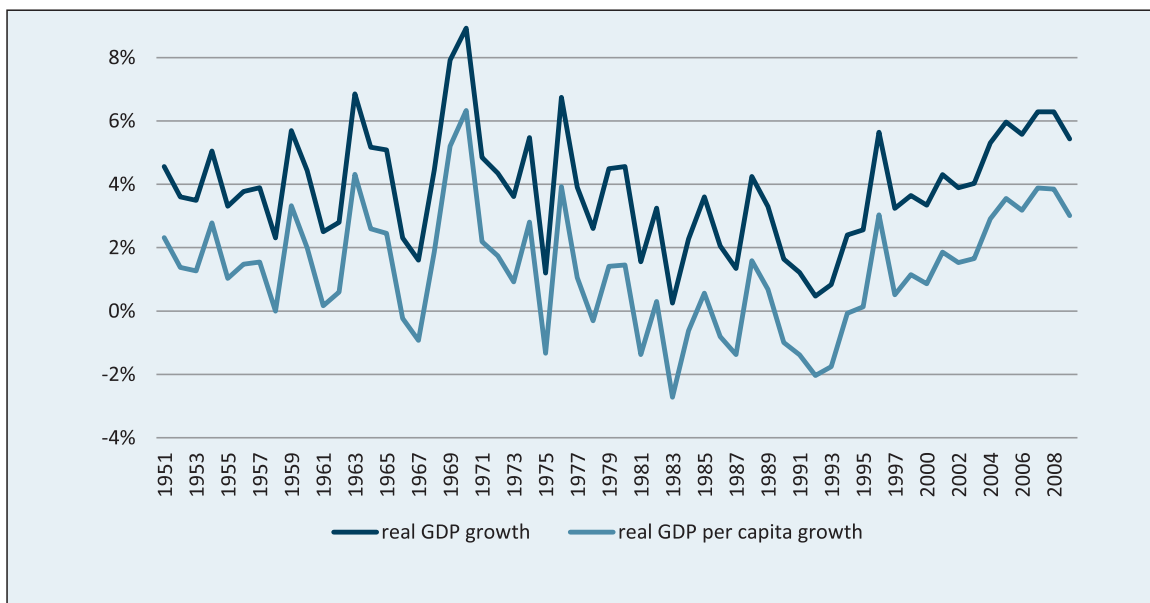
Source: GDP from OECD and AfDB data platform; commodities prices from World Bank.

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



Source: World Bank Commodities Price Data.

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



Source: OECD and AfDB data platform.

Africa's economic expansion over the past decade has been accompanied by a significant reduction in poverty across the continent that reached even the poorest segment of the population⁶. Following

two decades (1980-2000) of economic stagnation during which 70 % of the population was poor⁷, the poverty rate declined from 66 % to 61 % over the past decade. Over the same period, the transition

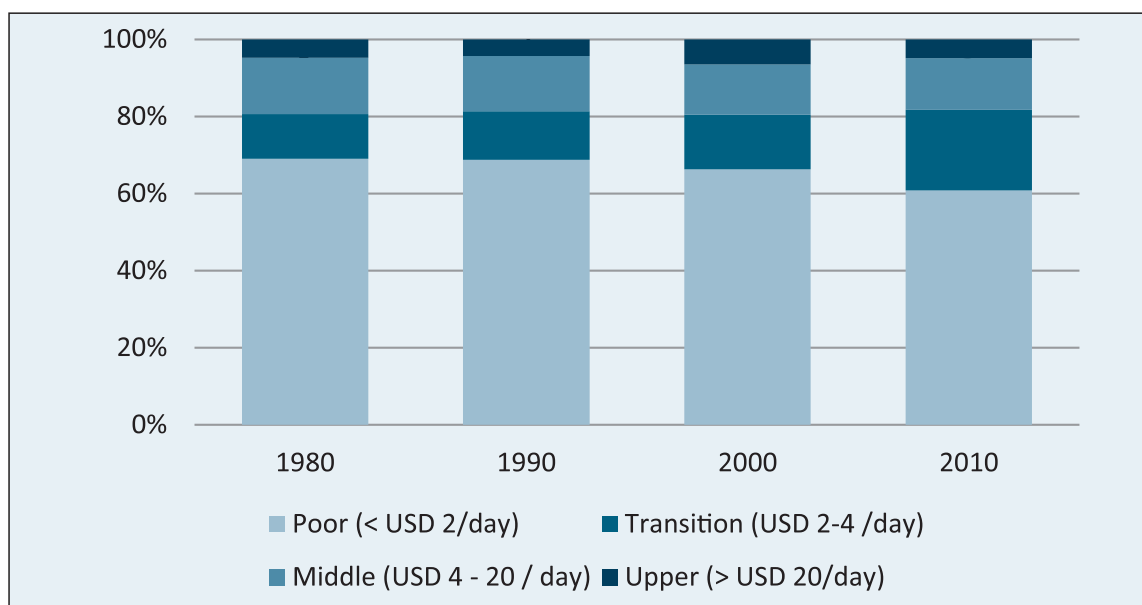
⁶ Sala-i-Martin and Pinkovskiy (2010) reach a similar conclusion.

⁷ The poor are defined as those earning less than US\$2 a day.

class—defined as those earning between US\$2 and US\$4 per day—grew from 14% to 21% of the population (Figure 1.5 and Table 1.1)⁸. While the impact of the past decade's economic expansion on poverty has been somewhat disappointing, it has

nevertheless resulted in the growth in the number of non-poor (an additional 117 million people) outpacing that of the poor (73 million) for the first time in 30 years.

Figure 1.5: Distribution of Income Classes



Source: AfDB Statistics Department; and World Bank data.

Table 1.1: Size of Income Classes in Africa

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

Source: AfDB Statistics Department and World Bank data.

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

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

Profile of Africa's Private Sector

Statistics on Africa's private sector are limited. National accounts statistics do not include data on private sector production in the formal sector, which must instead be derived indirectly from private consumption and investment⁹. Similarly, informal private sector data have to be inferred. This is also the case for data on small- and medium-size enterprises, which can only be estimated

from surveys often based on different country classifications and methodologies.

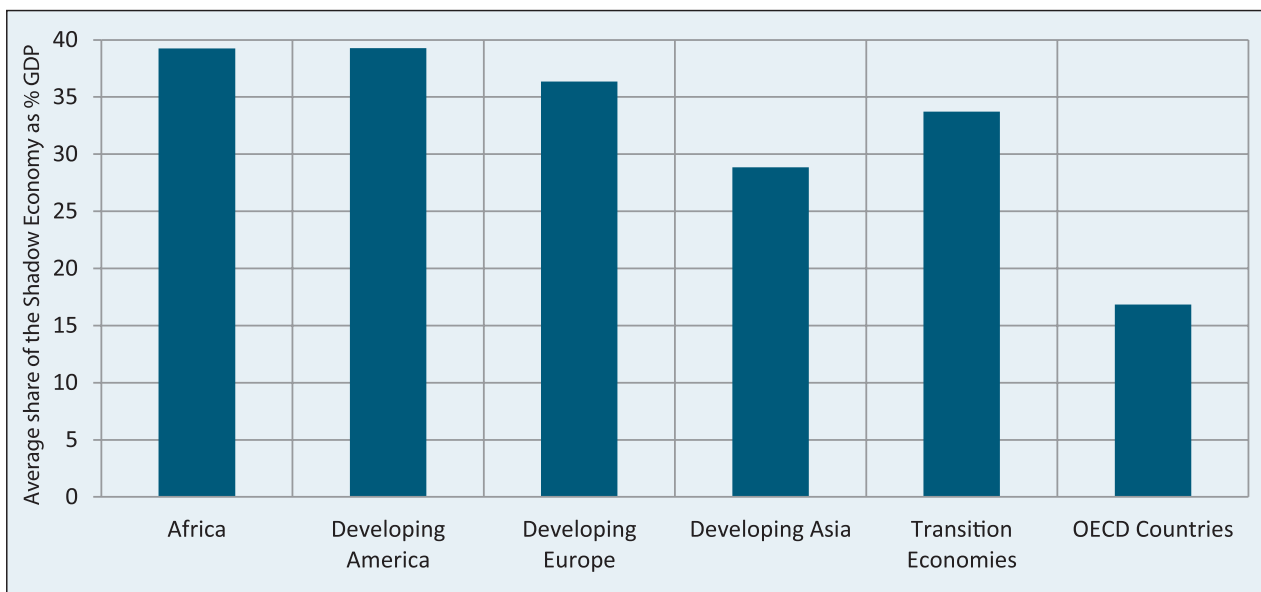
Subject to these limitations, this report analyzes Africa's private sector using an income-based classification separating low-income or ADF countries, including Fragile States, from middle-income or ADB countries, with additional

breakdowns by sub-regions (North, Southern, East, West, and Central) and by oil status (importers vs. exporters). An alternative country classification scheme recently developed by Bank staff but not yet officially adopted ranks countries based on their level of development and/or attraction of their financial markets to foreign investors. It broadly covers the above-mentioned income categories, but disaggregates low-income countries into three sub-categories (pre-transition, transition, and frontier markets as indicated in the Methodology Note¹⁰).

Informal Sector

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

Figure 1.6: Size of Informal Sector across Countries, 2006



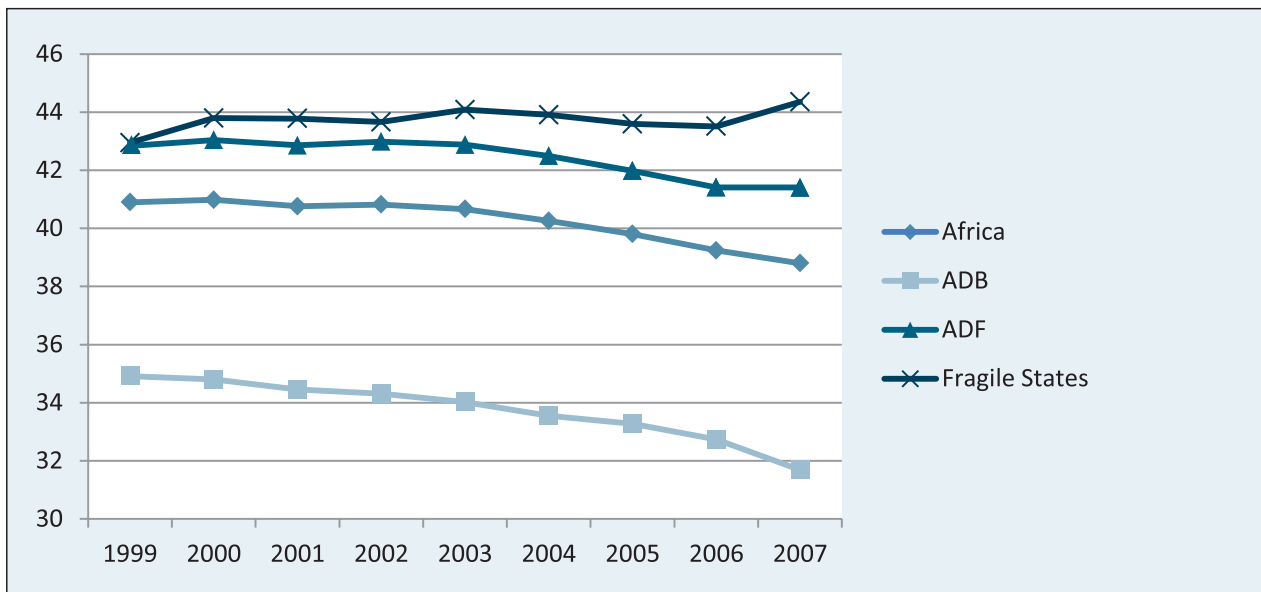
Source: AfDB calculations based on the data presented in Schneider and others (2010).

Within Africa, Fragile States and low-income countries have the largest informal sectors, averaging 44 % and 42 % of GDP, respectively, over the past decade. Moreover, the informal

sector increased slightly over the past decade in the Fragile States, while it contracted in the rest of the region (Figure 1.7).

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

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

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

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

Although there is no single definition, informality is understood as all economic activities that are not registered, covered by formal arrangements and captured by the tax net (Box 1.2). There are generally four steps that a firm needs to take to operate in the formal economy: (i) getting the company name approved; (ii) registering with the

government institution responsible for commercial activities; (iii) obtaining a trade license and/or registering for a general business license; and (iv) obtaining a tax number. There is a continuum of informality, as firms may complete one or more of these steps, but not all (Figure 1.8). The main reasons for informality in Africa are in Figure 1.9.

Box 1.2: Informality and the Entrepreneur

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

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

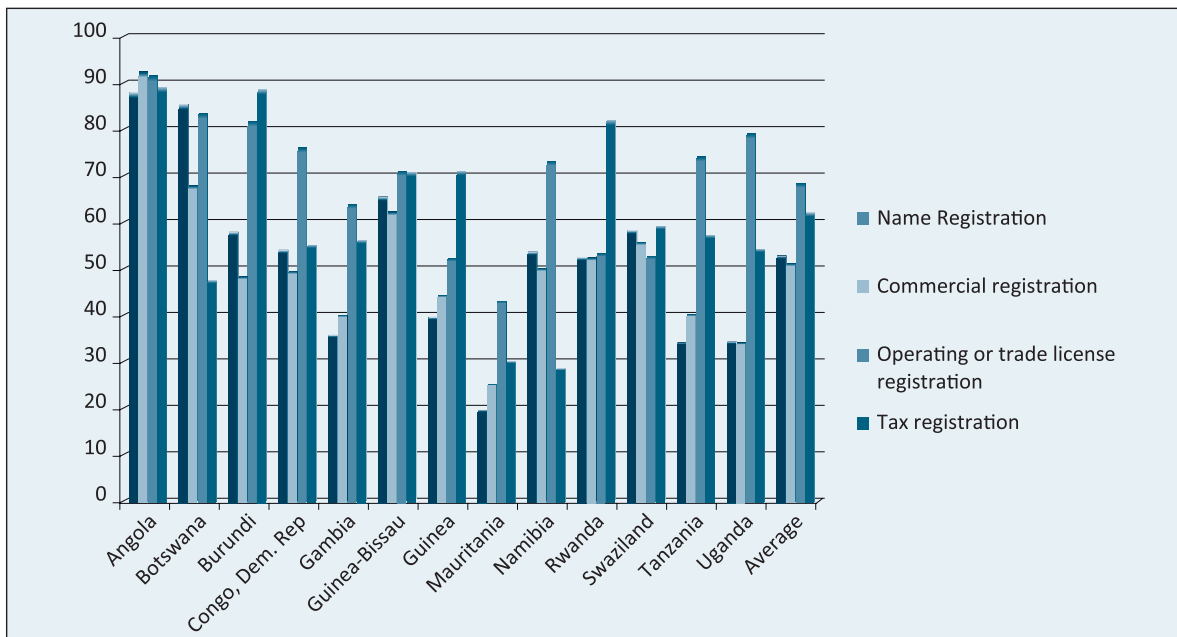
According to the World Bank’s Informal Enterprise Survey¹¹, the main reasons why informal firms in Africa chose not to register was fear of having to pay taxes, lack of information on how to register, the cost of registration procedures, and the general perception that there was nothing to be gained from being registered.

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

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

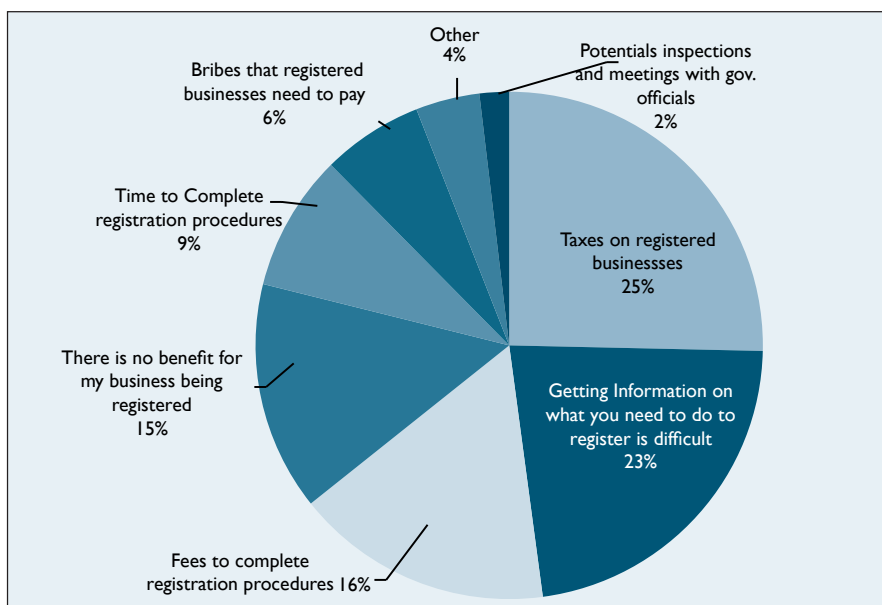
Source: UNIDO and GIZ 2008.

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



Source: AfDB calculations based on World Bank Microenterprises Surveys.

Figure 1.9: Main Reasons for Informality



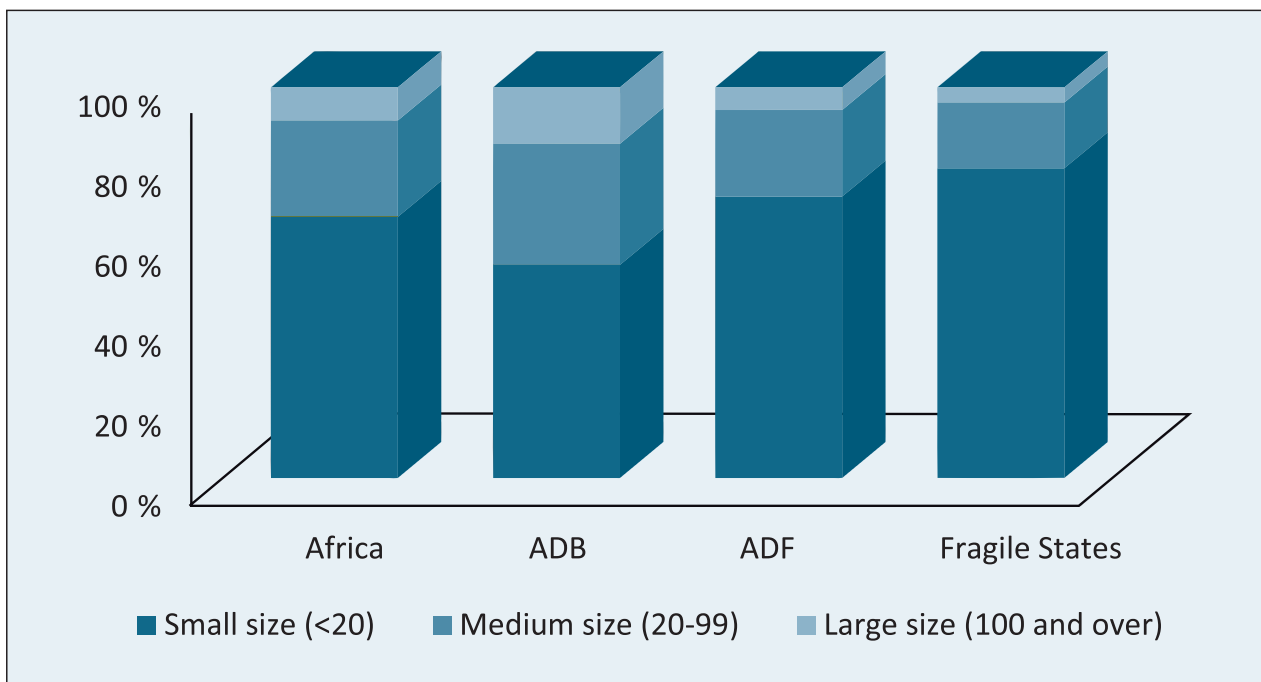
Source: AfDB calculations based on World Bank Informal Enterprise Surveys data.

Formal Sector

Small firms dominate the formal sector in Africa, particularly in Fragile States and low-income countries (Figure 1.10). Although more prevalent

in middle-income countries, Africa's medium and large firms account for only a third of all businesses, and by comparison, much less than in other parts of the world.

Figure 1.10: Size of Enterprises in Selected Countries



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

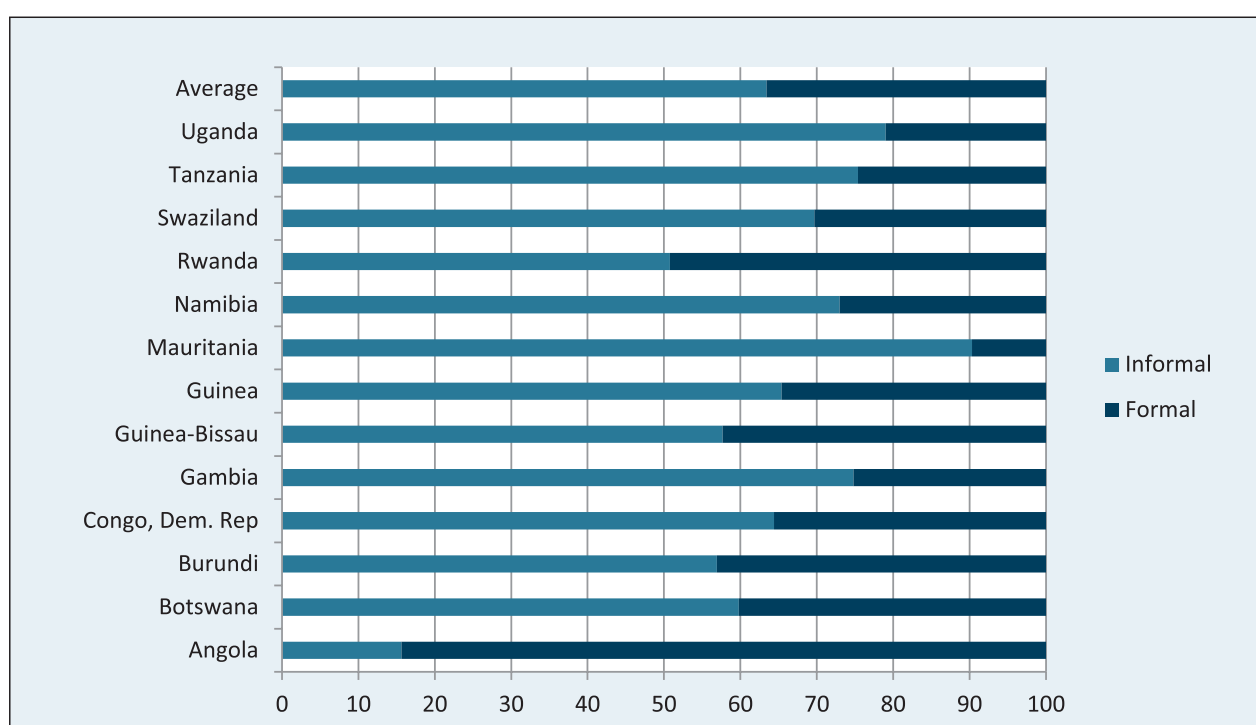
Although their contribution to total production is marginal, micro and small enterprises (MSEs) constitute the largest number of businesses in Africa and are also the main source of employment and income for the poor. While the majority of micro and small size enterprises are located in the informal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

Medium-size firms are underrepresented in Africa relative to other regions. The ratio of medium-size firms to large-size firms is 2 to 1 for Africa's middle-income countries and 4 to 1 in its low-income economies and Fragile States. This implies that there is a "missing middle" regarding the size distribution of businesses across Africa. The apparent difficulty to transition from small- to medium-size businesses is most likely due to

barriers to exit/entry throughout the transition from small to medium to large firms regarding costs associated with taxation and administrative compliance. More dynamic economies are characterized by a persistent high inflow of new entrants, an ongoing consolidation into medium-size firms, and the exit of weaker competitors. This competitive pressure drives productivity and employment in the MSME sector, which in turn feed economic growth.

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

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



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

small shares of total market capitalization. Their weight is expected to grow over the next decade, however, as reforms in banking, power, and hydrocarbons in Nigeria and economic integration in the East African Community gain momentum. Although the hydrocarbon and solid mineral sectors continue to dominate the operations of Africa's largest companies, telecommunication, banking, construction, and retail firms are gaining ground. The total market capitalization of Africa's largest 250 companies stood at US\$848 billion in March 2010, 33 % higher than in 2009¹².

The Private Sector, Engine of African Economies

The private sector dominates Africa's economy. It accounted for over 80 % of total production, two-thirds of total investment, and three-fourths of total credit to the economy over the period 1996-2008 (Figures 1.12, 1.13)¹³. It also gave

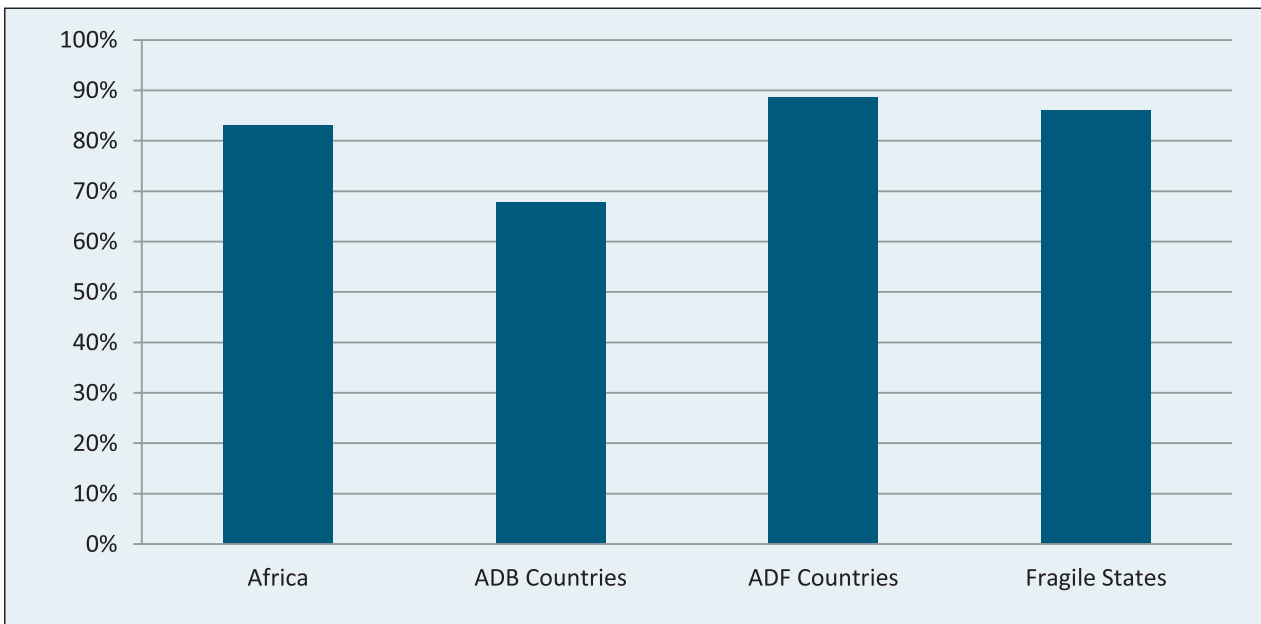
jobs to about 90 % of the employed working age population (Figure 1.14). Domestic credit to the private sector as a share of GDP was 59 % of GDP in Sub-Saharan Africa compared to 30 % in Latin America and Caribbean, 32 % in South Asia, 42 % in Middle East and North Africa and 145 % in OECD member countries.

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

¹² African Business Magazine 2011.

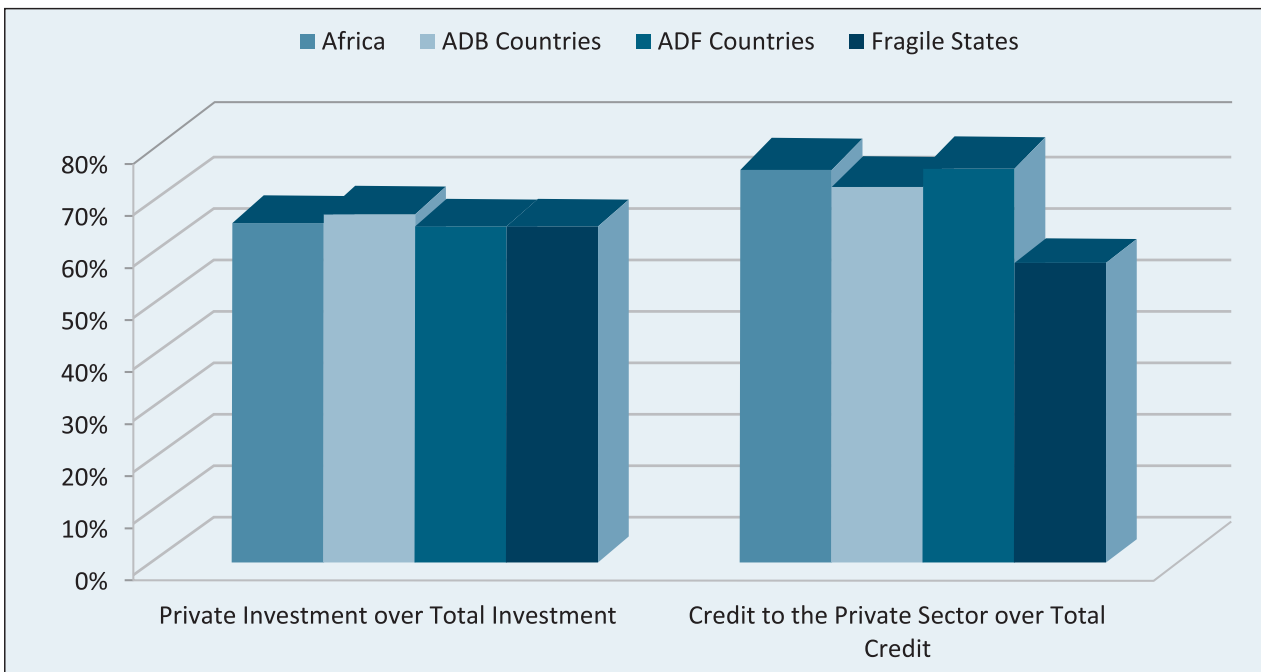
¹³ See Stampini and others (2011) who present detailed evidence on the size of the private sector.

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

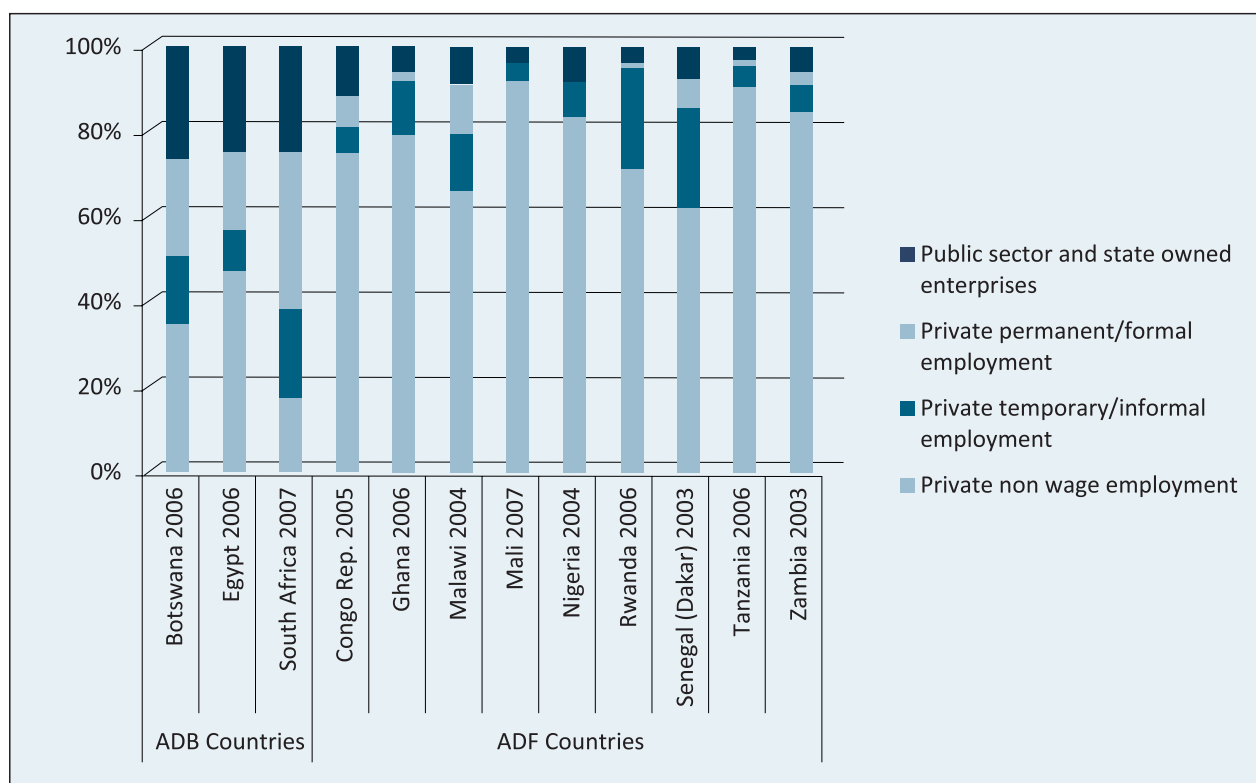


Source: AfDB calculations based on African Economic Outlook data for 50 countries.

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



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

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

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

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

The private sector in low-income countries accounts for a higher proportion of jobs (90%) than in middle-income countries, as noted above. Private sector employment in these countries, however, is principally informal or temporary, with less than a tenth of these workers holding a permanent or formal job. Moreover, nonwage activities—mainly self-employment or involvement in a family business—account for the bulk of private sector employment¹⁴. The shares of private investment and credit, however, are in line with regional averages.

In Fragile States, a few large formal companies generally dominate the private sector, generating most of the value added and formal employment.

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

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

Private Sector Productivity

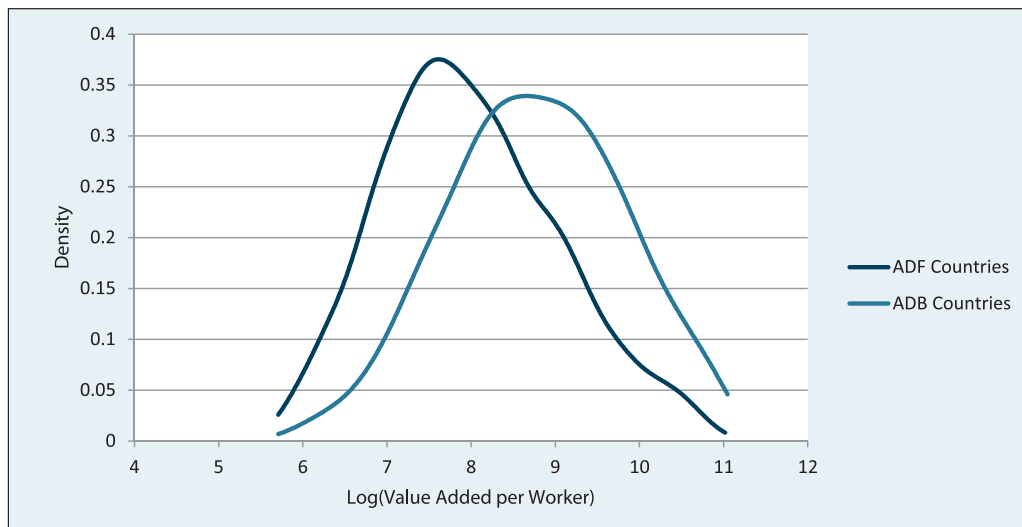
Average productivity in Africa is lower than other regions, however there are wide variations

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

across the continent. For example, while labor productivity rates in private firms are very low for most low-income countries, a few economies (Cameroon, Kenya, and Zambia) have rates in line with middle-income countries (Figure 1.16). Labor productivity also varies across middle-income countries, with South Africa, Namibia, and Algeria having significantly higher rates than their peers.

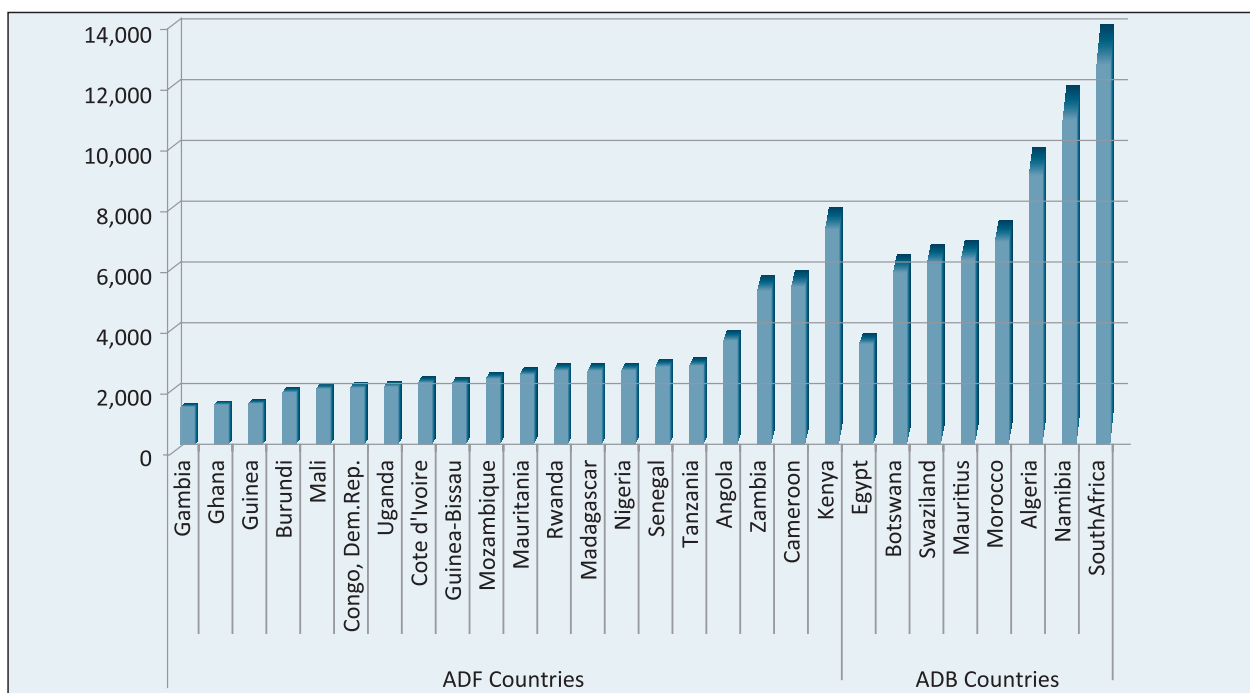
Income level does not appear to be a significant determinant of labor productivity, as many firms in low-income countries appear to be as efficient as those in middle-income economies (as illustrated in the overlapping curves in Figure 1.15). Levels of total factor productivity, however, are significantly lower for businesses in low-income countries than elsewhere.

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



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

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



Source: World Bank Enterprise Surveys, 2006-2010.

Yet the steady improvement of labor productivity over the past ten years, following two decades of decline and stagnation, is encouraging. It is mainly due to the expansion of the private sector and productivity gains in agriculture, which employs about half the population in sub-Saharan Africa, and has resulted in the general recovery in per capita GDP across most African countries. Similarly, a recent study found that total factor productivity in Sub-Saharan Africa, which improved by only 0.4 % per year from 1978 to 1993, recorded growth rates of 2.3 % in the subsequent decade, following policy reforms¹⁵.

Underemployment and the misallocation of labor, due in part to market inefficiencies, weigh on Africa's productivity. These problems are particularly acute in the region's middle-income

economies. Unemployment in South Africa, for example, stubbornly stands at around 25 %, with about 4.3 million persons looking for and unable to find work; yet behind high unemployment statistics lays an even deeper underemployment problem, as only 45 % of working-age South Africans are employed. This is significantly below the 60–70 % observed in many fast-growing developing economies and Organization of Economic Cooperation and Development (OECD) countries, which would translate into an additional 6.2–9.5 million more jobs in South Africa. Tunisia, where unemployment was 26 % in 2007, suffers from similar underemployment¹⁶. Unemployment amongst university graduates stands at an astounding 40 % (Table 1.2) and at 32 % for science graduates having completed a state-sponsored professional integration program.

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

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

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

This suggests that alleviating labor market inefficiencies could potentially yield large gains in labor productivity. Such inefficiencies include matching skills to jobs to more fully utilized workers. If the large pool of unemployed and underemployed university graduates is reduced, their participation in the labor force would substantially raise overall wages and consequently, aggregate labor productivity. A university degree in developing countries translates into a wage premium higher than the 25–90 % observed in OECD countries for graduates able to secure jobs.

This suggests that once the labor market mismatch is solved, skilled labor is effectively used. In Ghana, for instance, a high-school education means a 27 % salary bump, but employed university graduates earned almost three times more than workers having completed high school (Table 1.3). A South African university graduate can expect to earn 11 times more than someone with a high school degree. In Egypt, on the other hand, the financial reward for a university education is much lower than elsewhere in the region.

¹⁵ See the survey of the empirical literature in Block (2010).

¹⁶ Stampini and Verdier-Chouchane 2011.

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

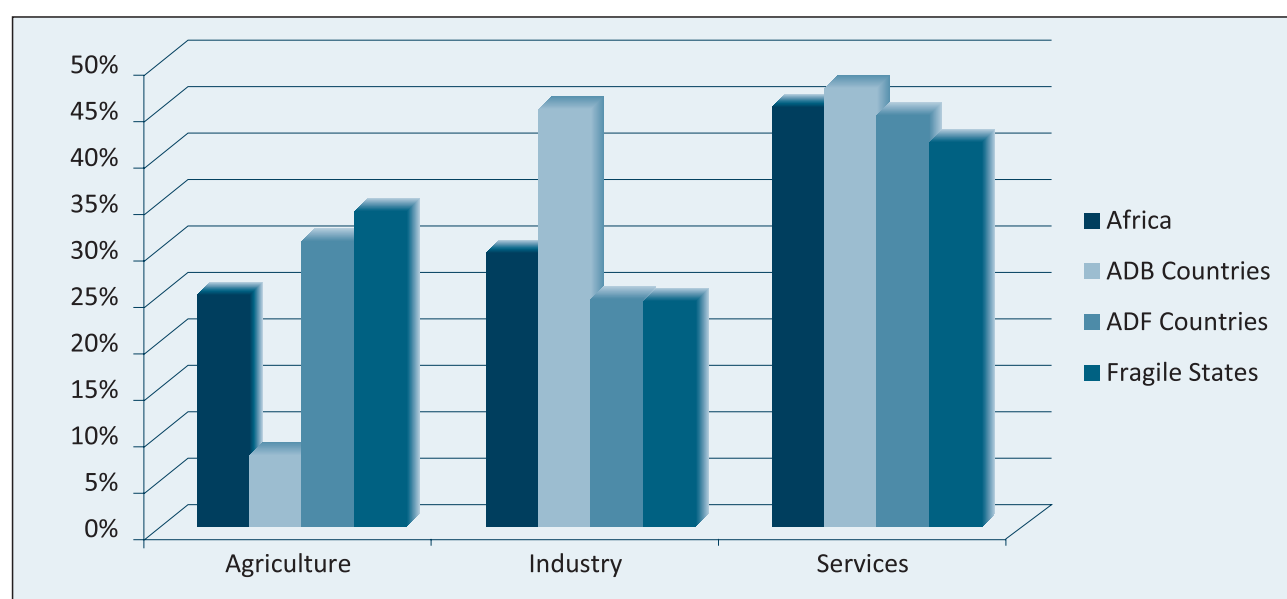
		Primary to Secondary	Secondary to Vocational	Secondary to University
Ghana	2006	27%	28%	297%
Nigeria	2004	32%	-11%	59%
Egypt	2006	37%	-17%	22%
Egypt	1998	63%	-32%	14%
Egypt	1988	57%	-23%	28%
S. Africa	2000	240%	413%	6751%
S. Africa	2007	168%	527%	11005%
Uganda	2006	88%	6%	862%
Rwanda	2006	60%	-33%	1230%

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

Sectorial Analysis

The private sector in Africa is active in all economic areas. As a percentage of total GDP, agriculture contributes on average 25 %, industry contributes 30 %, while services are largest contributor at 45 % (Figure 1.17). This sectorial distribution is characteristic of almost all African countries. ADB countries are more developed than ADF

countries, with a higher share of their value-added derived from industry and services. Although the national accounts data do not disaggregate private production in these sectors, employment data implies that the private sector constitutes the majority share of activity in each of these sectors, with the exception of the large role that government and state-owned enterprises play in oil and mineral exporting countries.

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

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

Agriculture

Private activity in agriculture is crucial in Africa. Over 40 % of the continent's population lives in rural areas, and more than half the labor force is involved in formal or informal agricultural production. Although it generates less than a third of GDP, agriculture plays a key role in alleviating poverty through its significant contribution to employment, food security, and consumer price stability. Some nine out of 10 Africans involved

in agriculture are subsistence farmers, who are particularly vulnerable to weather and other shocks. They often have to supplement their income through informal microenterprise activities, which provide a vital buffer against shocks. Small farm size is one of the leading causes of low agricultural productivity in developing countries¹⁷ (Table 1.4). Sustaining labor productivity growth in Africa requires increasing the acreage per farmer and labor migration into manufacturing and other higher value-added sectors.

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

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

Source: Adamopoulos and Restuccia 2010.

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

Only 2 % of total investment in Africa's agriculture is private, compared to 50 % in more advanced agricultural sectors worldwide. Agriculture in most African countries captures only 10 % of FDI or

less, with the share in 17 countries being less than 1 %¹⁸. Most of the little FDI going into agriculture is channeled into export-oriented cash crops, such as cocoa and cut flowers, or staple foods such as cereals.

Manufacturing

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

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

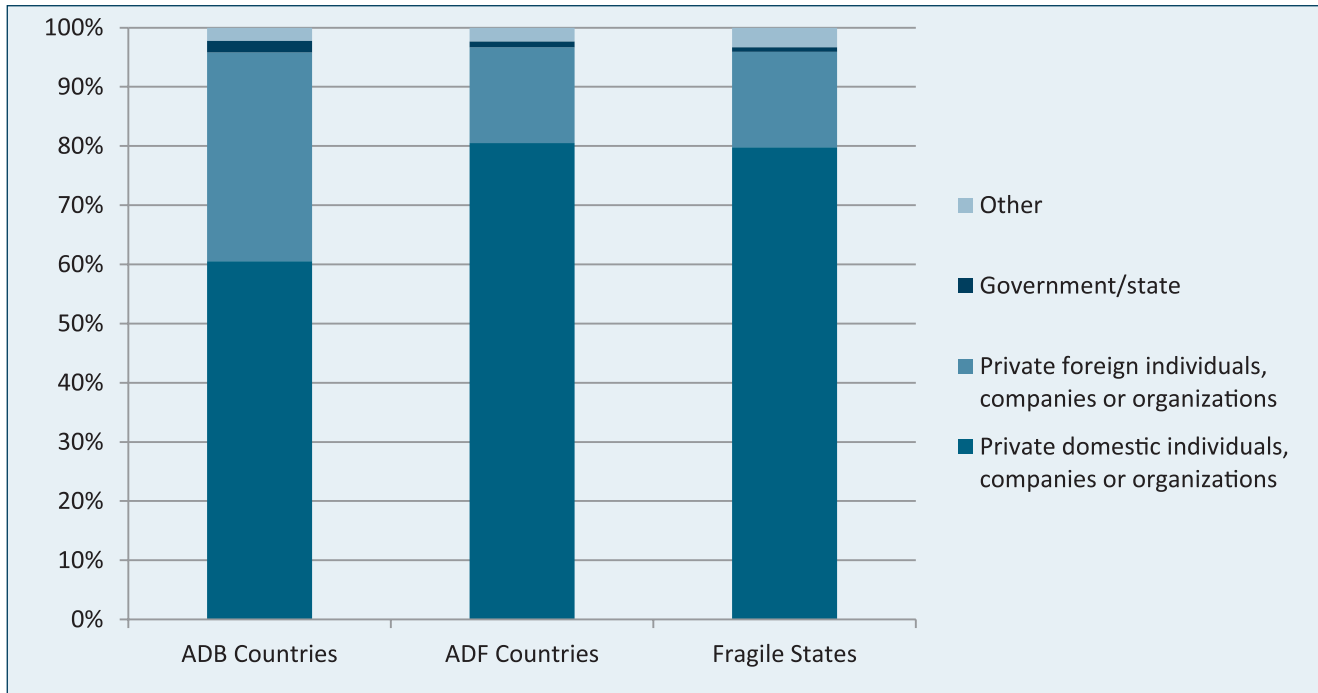
18 UNCTAD 2009.

19 World Bank Enterprise Surveys 2006-2010.

sluggish, and the rate of failure high, particularly amongst the smallest businesses²⁰. The main regional variation has to do with foreign ownership,

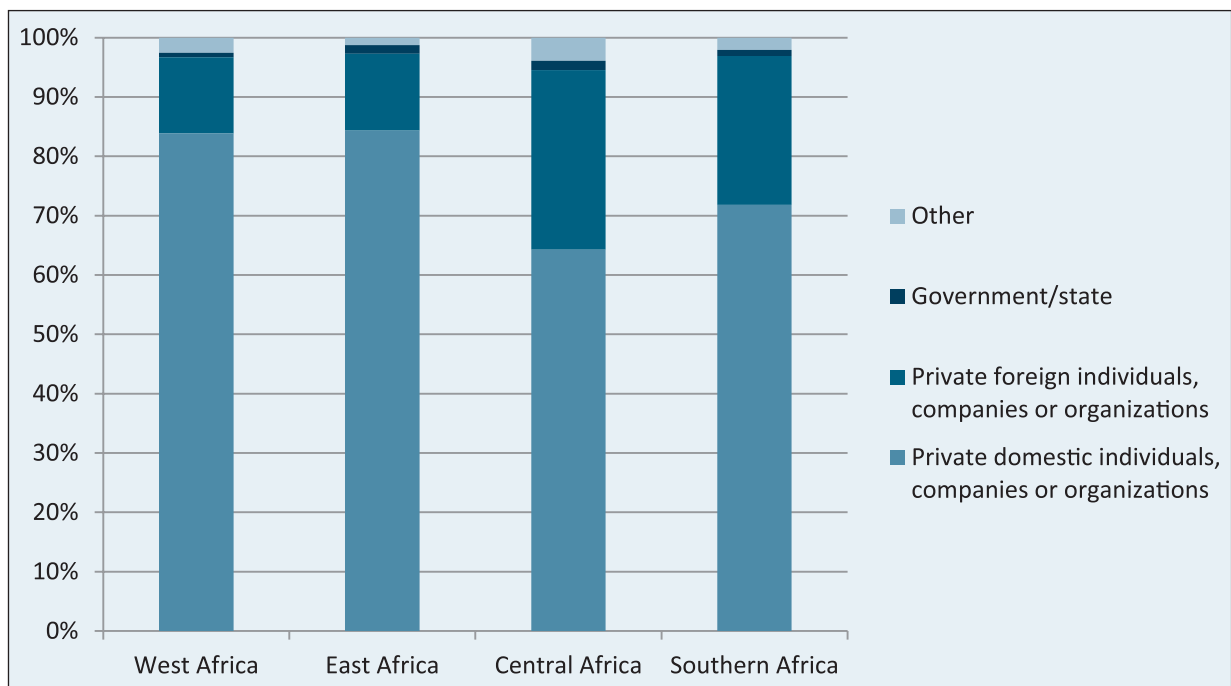
which is more pronounced in Central and Southern Africa (Figure 1.19).

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



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

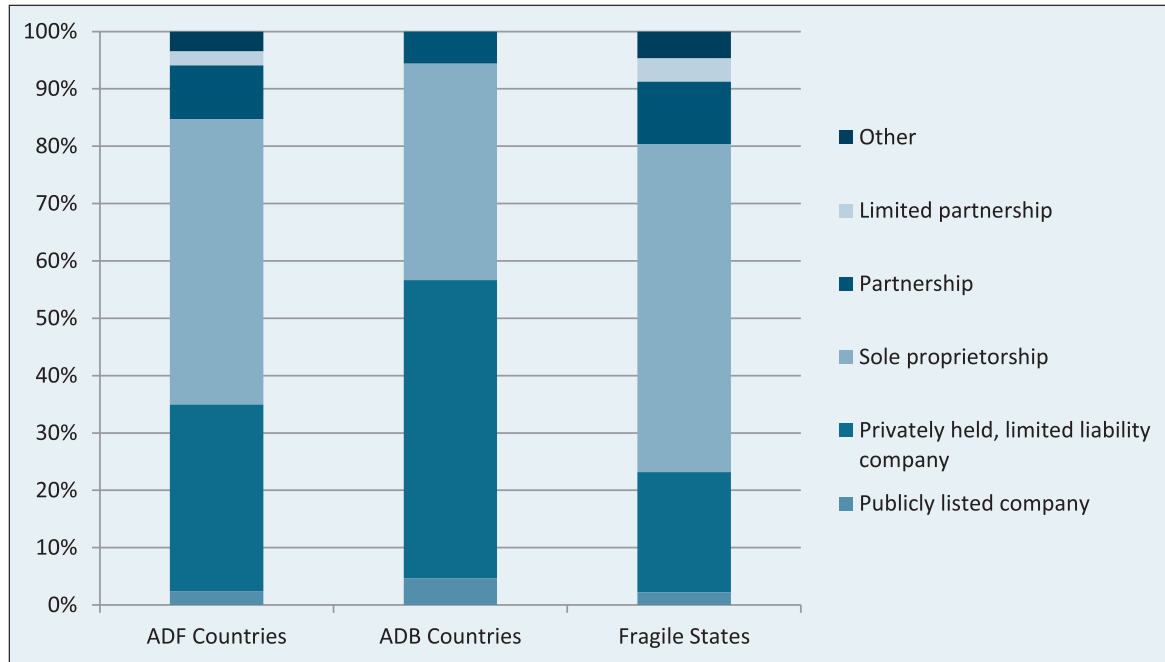
Figure 1.19: Ownership Structure of Manufacturing Firms by Regions



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

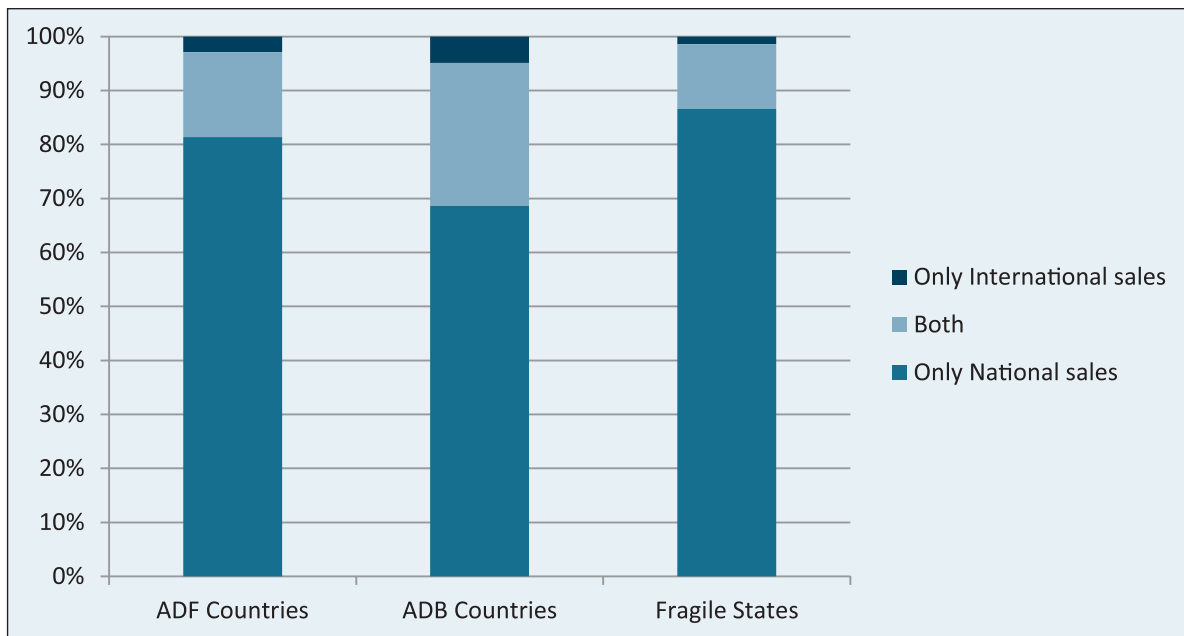
²⁰ Fafchamps 2001 and Fisman 2001. Several other researchers, including Ramachandran and Shah (1999) as well as Sleuwaegen and Goedhuys (2002), have found a more positive relationship between growth and small and young manufacturing firms than with large and old ones, although others have found no such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

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



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

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



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

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

With few exceptions, most of the continent's private manufacturers are involved in the

processing of natural resources or in the production of basic consumer goods. Most firms are neither technologically efficient nor involved in foreign trade (Figure 1.21).

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

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

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

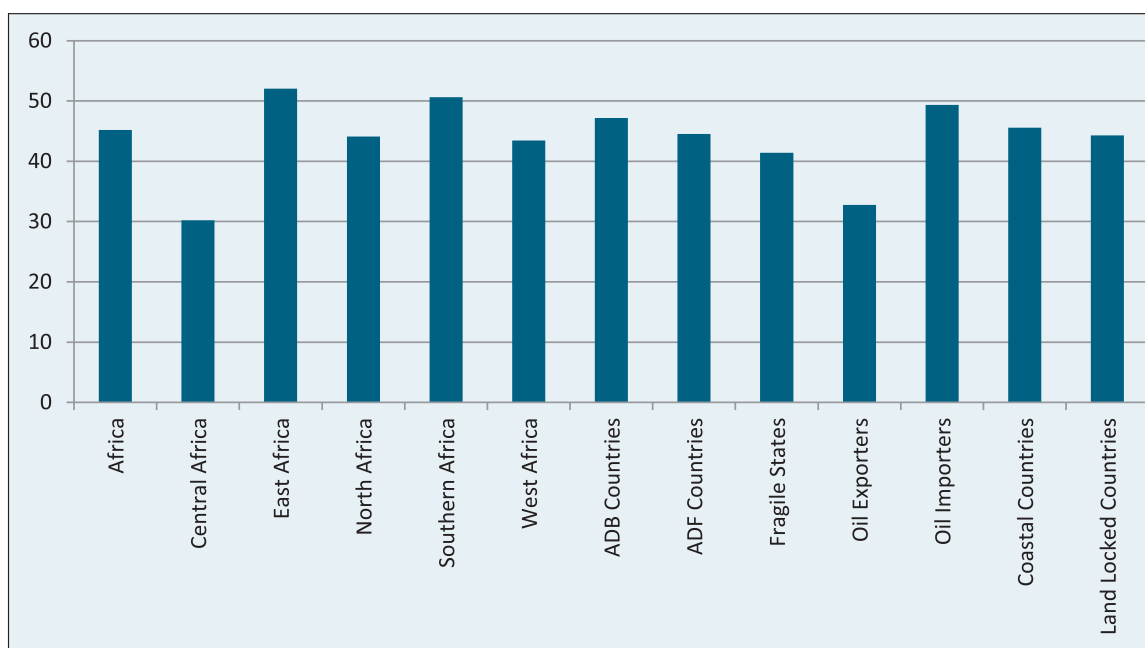
Services

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

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

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

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



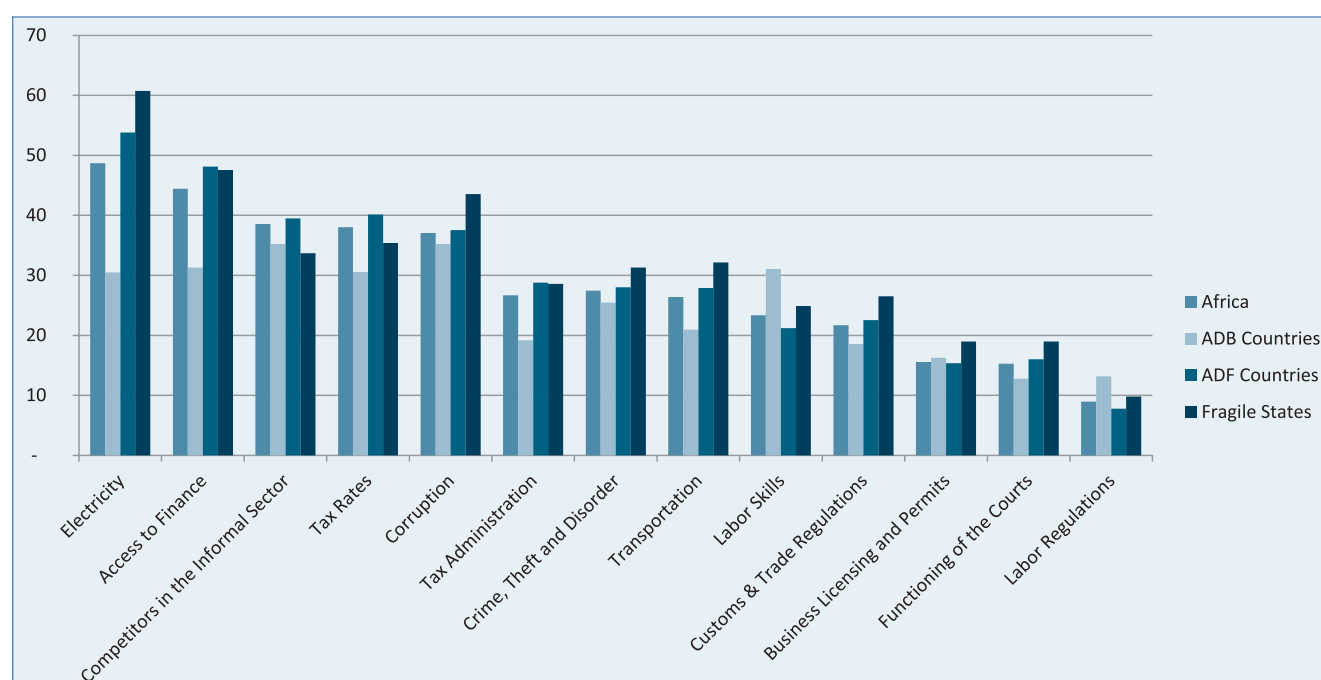
Source: AfDB calculations from World Development Indicators database.

Constraints to Private Sector Development

Although the private sector in African countries faces a common set of challenges, certain constraints are more binding depending of the country's level of economic development (Figure

1.23). While the top-two constraints in Fragile States and ADF countries are electricity and access to finance, these factors are much less of a problem in ADB countries. In addition, the only two constraints which appear to be more binding in ADB countries than in ADF countries and Fragile States are skills shortages and labor regulations.

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



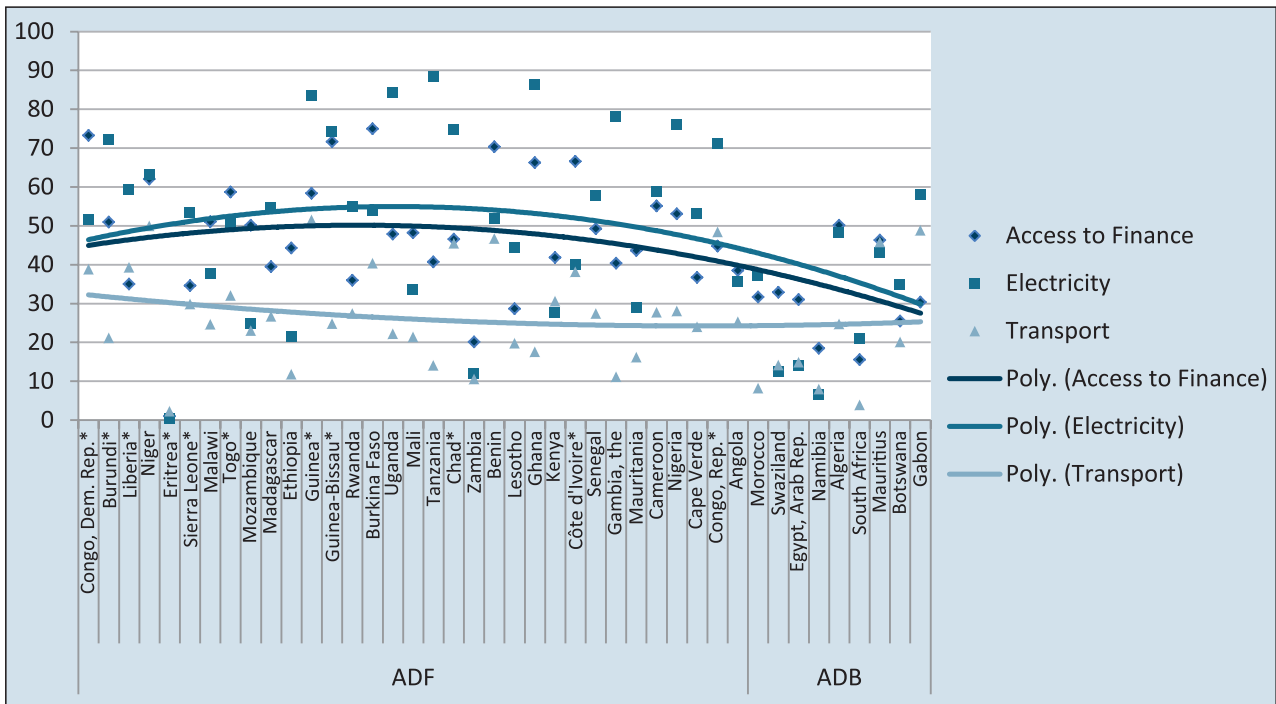
Source: AfDB calculations based on World Bank Enterprise Surveys for 41 African countries.

Given the wide range in the level of income and PSD that exists within the classification based on ADB and ADF countries and Fragile States, we have refined further the constraints analysis using three other classification schemes based on income levels, competitiveness and economic development. The analysis based on income levels confirms that business constraints vary by stages of economic development. Fundamental constraints involving insufficient transport networks and lack of access to power and finance are most critical in Fragile States and lower income ADF countries, while governance constraints regarding high tax rates and poor tax administration are relatively more binding in higher-income ADF countries (Figures 1.24, 1.25 and Box 1.3). In ADB countries,

policy-related constraints are most important and include skills shortages and labor regulations (Figure 1.26). Hence, as countries move up the development ladder, basic constraints generally begin to be addressed and governance and policy constraints become more binding.

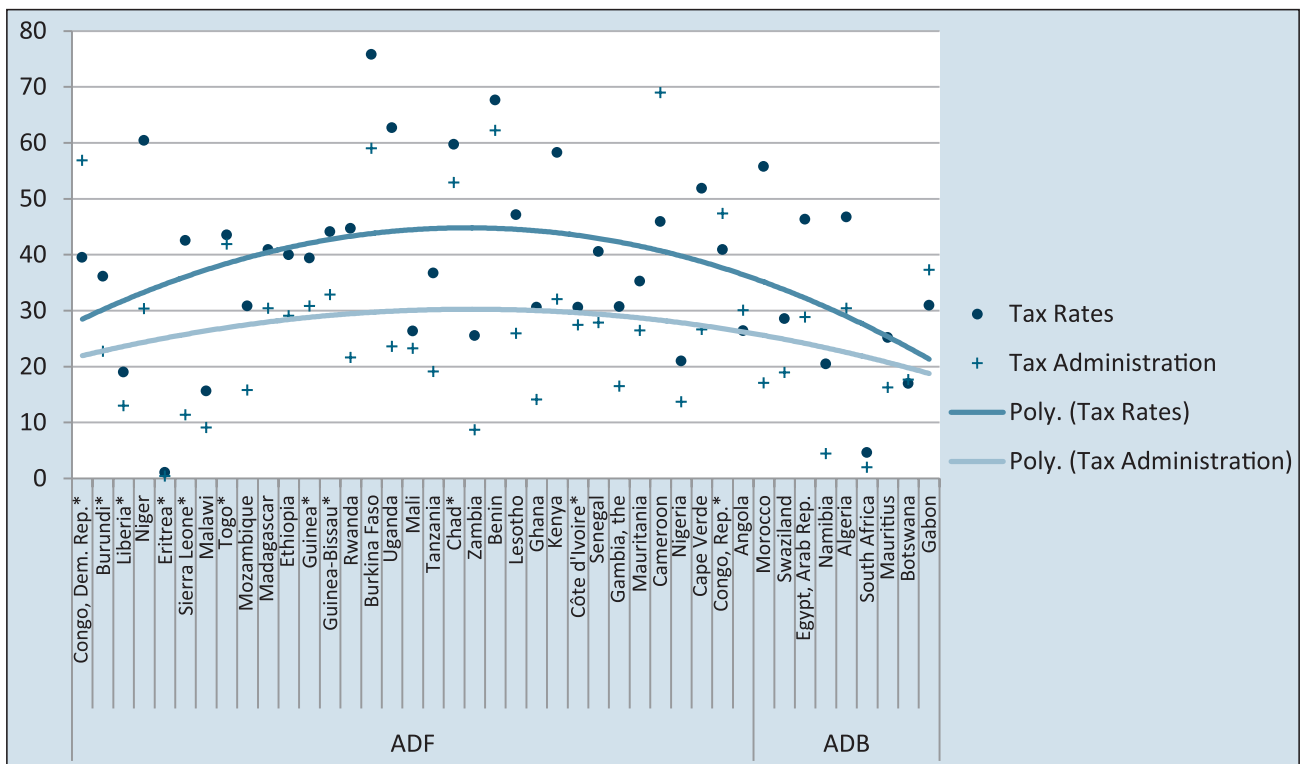
Constraints to private sector development also differ by type of firm. Large firms are more concerned about corruption, skill shortages, and labor regulations, while export-oriented firms place tax administration at the top of their list. These systemic factors are of less importance for small firms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

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



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

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



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

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

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

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

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

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

Source: Gelb and others 2007.

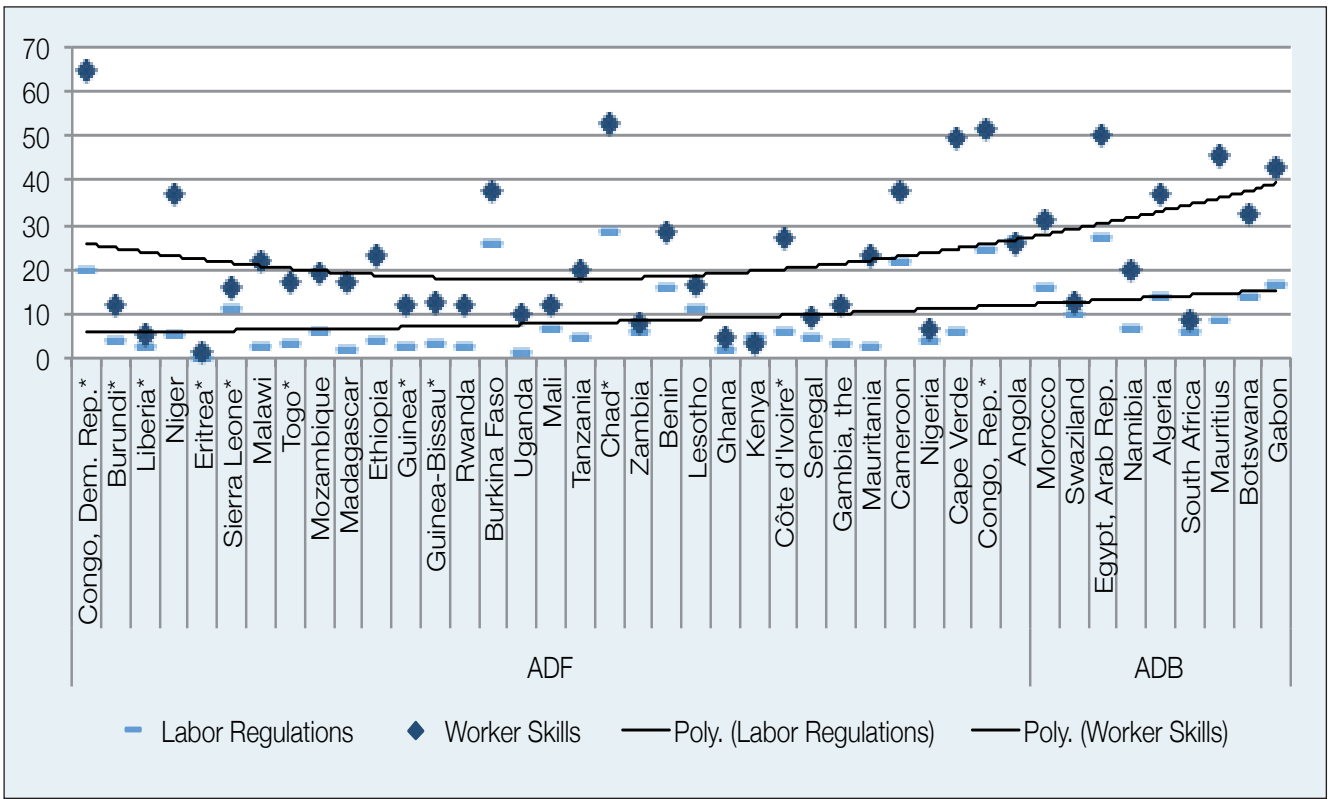
and accounting skills to be more binding. The most severe constraint faced by microenterprises in both middle- and low-income countries is access to finance (Figure 1.27). Microenterprises in middle-income countries also tend to be severely constrained by business licensing procedures, which may be a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

The relative importance of individual constraints to PSD also varies with regard to African countries' level of competitiveness as measured by their rankings on the global competitiveness index. The results are similar to those based on rankings by income level. Some constraints decline in

importance as countries' economies become more competitive. This set of constraints include access to transportation, access to finance, public order, tax administration, business licensing, corruption, customs and trade regulations, and the judicial system.

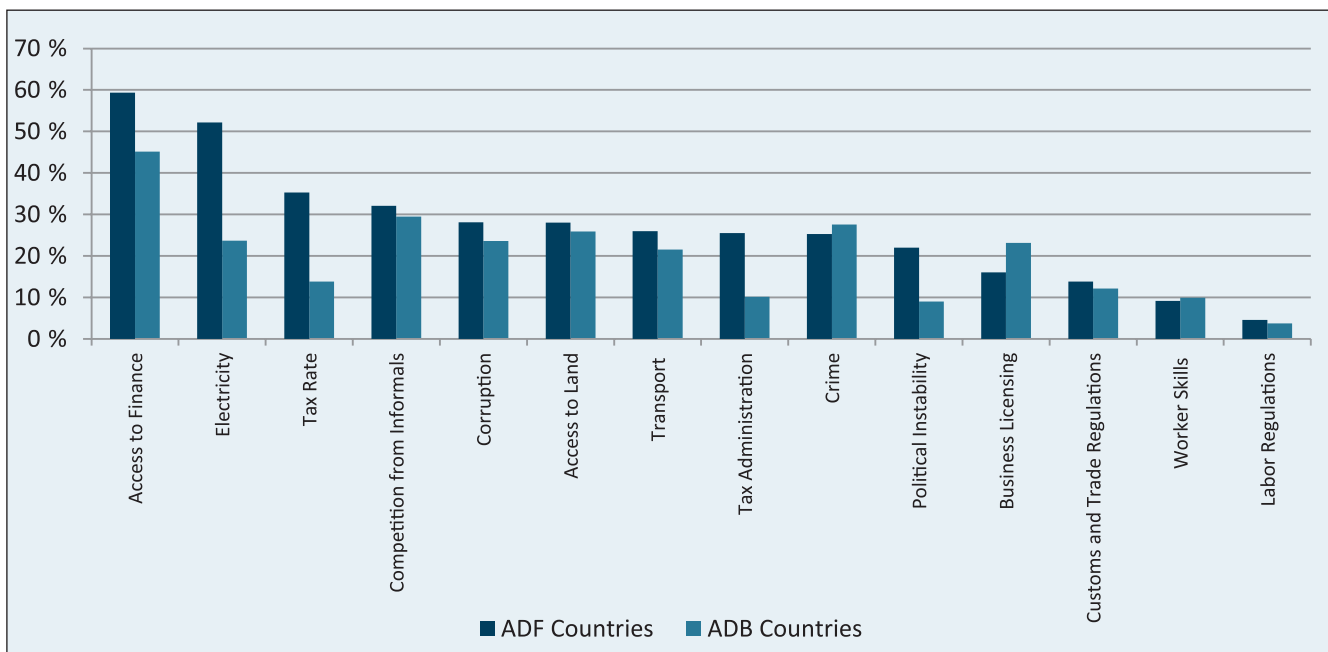
Tax rates and access to electricity become more constraining to businesses as countries' competitiveness improves. As a country moves from a low level of competitiveness to a middle level, more and more businesses register and greater concerns about tax rates arise. Similarly, more businesses are investing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

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



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

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



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

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

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

The results are similar using the more disaggregated alternative classification scheme. Access to finance and electricity are perceived to be the most severe constraints across all country groups, except for ADB countries. In ADB countries, however, taxes, corruption and social stability are equally important. In the transition and pre-transition low-income countries, key constraints facing businesses are of relatively equal concern, with the exception of corruption²¹. Businesses' main concerns in resource-rich countries are similar to those in middle-income countries: with the exception of corruption, the share of businesses worried about electricity, access to finance, tax rates and competition from the informal sector is about 40 %, not much higher than the 35 % average observed in middle-income countries; that corruption is perceived as more of a problem in resource-rich countries is consistent with evidence

on the adverse effects of resource booms on governance.

Conclusion

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

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

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

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

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