Institutions and Capacity Building: The African Economic Development Potential Revisited

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Abstract: Risks faced in African agriculture and industry reduces the dynamic rate of return in these industries. Supply and demand constraints like scarcity of human capital and low effective demand further reduce the scope of industrialization. Institutions have to be developed to share the risks in consumption and production and thus achieve equity and efficiency. Capacity building through investment in the education, health and the public sector can bring about an efficient supply response. Monetary and fiscal intervention can ensure that such a supply response is met effectively and the benefits are passed to consumers, labor and entrepreneurs through a regulated market.

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1. Economic Development of Africa: The challenges and opportunities

While the late 1960s and the 1970s brought about high growth and optimism in African economies through high foreign aid and good terms of trade, the 1980s and early 1990s saw the substantially lower growth rates. This not only lowered per-capita income but also increased the inequality and the rate of poverty in such economies.

Table 1: Average Annual GDP growth in Africa

	1965-1969	1970-1979	1980-1989	1990-1994	1995-1999
Africa	4.5	4.2	2.5	0.9	3.5
North Africa	5.3	6.7	4.2	2.1	4.2
Sub-Saharan African	2.4	4.0	2.1	0.8	3.9

Source: UNCTAD (2001)

A recent study (UNCTAD (2001)) shows that despite the good growth in the late 1990s, per capita income of Sub-Saharan countries was 10% below the level attained by them in 1980 and the comparison gets worse if one goes back further to 1970. Industrial growth rate fell from the 1980s and has been negatively correlated with trade liberalization and the ratio of the private to public sector assets. Agricultural growth has been low and in approximately 50% of the cases have been accompanied by falling per capita output in agriculture.

Thus the challenges facing Africa in the new beginning of the New Century essentially consist of building mechanisms for increasing the rate of industrial growth, raising agricultural productivity and reducing inequality and poverty. The opportunities consist of foreign aid and loans that come with advise on how to build such mechanisms and also the forces of globalization that open new markets, and develop technologies (like IT).

2. The Design of Institutions and Capacity Building

Economic Theorists have been trying to explain the phenomena of Poverty, Wealth Distribution and Income Generation across time and space since the days of the "Wealth of Nations" (1776). There has been lot of progress from the Classical to the Neoclassical to the different Modern day Schools of Thought. Insights and Methodological Innovations notwithstanding, there remains a lingering and growing dissatisfaction: testable development models either are too simplistic and ignore too many variables or are too complex to be understood through logic and intuition. As a result, the older generation have increasingly pushed the research agenda towards doing empirical work. The Last ten years of empirical work have brought to attention many puzzling phenomena in the micro and macro level. These taken together with the earlier empirical work and the research output of old and new economic history gives us a big repository of facts, figures and historical knowledge base. An important result of this endeavor has been the insight that institutions matter in the allocation of resources and effectiveness of economic policy depends on the design of institutions. Another important result is that capacity building exercises are important not only in terms of investment, but also in terms of human capital, bureaucracy, management skills, workforce skills, and basic literacy and cognitive abilities.

Institutions are rules and governance structures that allow decision making in production decisions and wealth, consumption allocations. Law, judiciary, legislature, firms, markets, public enterprises, not for profit organizations, cooperatives are all examples of institutions. The efficient design of these institutions are thus of paramount importance. To some extent firms and markets are self-regulating and institutions evolve along a natural efficient path but there are exceptions and these exceptions justify policy research and appropriate design-interventions. A major source of inefficiency institutions arise from the free rider problem which arise because institutions are always to some extent concerned about public provision of goods and services (shareholder protection, consumer protection etc.)

Almost African economies are capacity constrained in the sense described above. It is not only a matter on spending on these items by a benevolent government but also how public expenditure is allocated among competing items in this category, and creating capacity to build capacity. Investment decisions not only have to address issues in the design of the education and health systems but in the development of civil service, management and industrial educational institutions etc.

3. Productivity Growth and Risk Sharing in Agriculture

The basic supply side concern has been with agricultural productivity, especially in regions with scarce water resources and low or highly uncertain rainfall. The policy orientation has thus evolved in a way so as to give increasing priority to developing and managing efficiently the water resources in African agriculture. Development of Irrigation capacity has a lot of potential as seen in (the Fadama Irrigation) in Nigeria, Zimbabwe and Angola (Sharma et. Al. (1996)).

Management of existing irrigation capacity depends on two things: the governance structure of contracts and property rights in water. Without property rights there may be free rider problems in maintaining minor canals leading to clogging problems and soil erosion. Allocation of property rights matter not only because the end users of irrigation facilities will accordingly take decisions on investment in land and other agricultural assets but also because property rights limit uneven allocation and exploitation.

The increase in productivity arising out of improving institutions and evolving capacity leads to increase in agricultural income and supply of food and industrial inputs from agriculture. The increase in income can lead to increase in demand for industrial products and services. There is an emerging consensus in the literature on development economics that such effects are important and warrant policy attention.

There are two risk-sharing effects of improved agricultural institutions. Increased investment in irrigation not increases productivity in agriculture but also offsets the risk arising out of uncertain rainfall. This can substantially enhance the welfare of farmers by improving consumption smoothing in the presence of borrowing constraints. Improved irrigation also allows efficient crop diversification which leads to export diversification potential thus hedging against domestic and export demand uncertainty in agriculture. Other institutional developments like development of marketing cooperatives complement this effect by increasing the returns and lowering the risks of diversification. The diffusion of knowledge regarding the beneficial effects of high yielding variety ofseeds and fertilizers can be spread through farmers cooperatives provided that such cooperatives serve equity and efficiency in procurement and distribution of these inputs. The institutions have to be designed in such a way that these goals are met through effective participation.

4. Industrialization Capacity

The basic constraint on African industrialization comes from the limited role of technology transfer and human capital accumulation. Technology transfer usually occurs better with accompanying investment by MNCs in LDCs. However, political risk and absence of high quality and low wage labor force is an impeding factor that limits the transfer of technology. Given this, human capital accumulation through improving skills of the labor force and quality of management becomes extremely important. Also it must be noted that the ability to diversify industrial products in tune with globalization will have a better chance to take place with improvement of human capital through education. Thus human capital development should not only be seen as an instrument of increasing the rate of growth but also an avenue of risk sharing.

Effective demand constraints on investment may be relaxed through the development of the financial sector that allows households to smooth their consumption by transferring wealth backwards and forward. This effect can offset the negative incentive of investment in the industrial sector arising out of low domestic demand and uncertain terms of trade. Regulation of industry has to be not only in terms of standards and prices and fiscal incentives but also in terms of demand management.

5. The Development of the Services Sector

From 1980 to 1997 the share of services sector in African GDP increased from 38.7% to 48.6% whereas the share of industry fell from 39% to 31.9%. One immediately tends to think of the two sectors being related as substitutes but this is not necessarily so. The services sector can play an important role in agriculture led industrial growth. Tourism, Entertainment and other services will grow with urbanization and create demand for products of the manufacturing industry both in terms of consumption as well as capital goods. These services are also less intensive in human capital in the early phases of industrialization and thus can develop easily if markets for these services are allowed to develop freely and not too tightly regulated.

Development of Health services will generate employment and income and increase productivity while increasing productivity. Development of the Education sector will also generate income and employment while developing human capital. Since both these sectors generate positive spillovers on the industrial sector that cannot be easily anticipated and internalized, therefore there will be under-provision of these two services by the private sector. A clear role for the public sector thus emerges in the context of these two industries. Thus these services can also reconciliate the two objectives of high growth and an equitable income distribution

6. Fiscal Policy Mechanism

Public Sector involvement in food price subsidies, procurement from farmers and distribution to consumers cannot be overestimated. The role of state enterprises in providing basic infrastructure services like health, education, irrigation, roads etc will remain important not only because there would be under-provision of these services by the private sector but also because there is a lack of effective demand for these services. Public investment is also warranted in case of private sector supplied goods in order to reduce demand uncertainty.

Fiscal decentralization can allow citizens like small farmers, entrepreneurs and dissatisfied consumers to participate in the governance decisions of local utilities. However the international experience suggests that local interest groups can capture such institutions in LDCs or the decision making process can become too complex leading to delay. Policy framework for a decentralized fiscal policy thus has to make an acceptable tradeoff between institutional efficiency and equity.

Given the important role of fiscal policy it is of utmost importance that public sector is efficiently and fairly governed. Accountability of the bureaucracy and political leaders has to be established regarding decisions on expenditure management, tax administration, fiscal regulation and fiscal devolution. Moral hazard is a natural disease in this context: delivery mechanisms of public services cannot be taken for granted (see Mookherjee (2004)) and have to be established through the presence of a strong media, independent judiciary and a strong democracy.

7. Money, Banking and Finance

The role of monetary policy in the context of LDCs is more important than developed economies since inflation and economic stagnation have more disastrous effects on the former group than the latter. A weak tax system coupled with a low savings rate has historically characterized the macroeconomic vulnerability in Latin American, Asian and African countries. The problem of financing public expenditure in such cases has always been shifted to Central Banks with disastrous effects: uncertain inflation and increased volatility of output. Autonomy of Central Banks in such countries is thus a natural welfare enhancing mechanism. However, this autonomy is extremely difficult to achieve in practice even in developed countries. Perhaps there is a substitute solution when an African or a Latin American country is forced to adopt a structural adjustment program by the IMF. But that does not ensure Central Bank autonomy but only restricts the unholy alliance between the Central Bank and the Fiscal Mechanism.

Autonomy is a necessary condition for efficiency but not a sufficient one. Efficient monetary policy and banking regulation requires expertise in open market operations, imposition of reserve requirements and interest rates. Containing inflationary pressure arising from food shortage or changes in the capital account is a challenge of the African economies. Efficient regulation of the banking sector and development of the financial markets are the next two challenges.

Banking institutions develop monetization, increase savings and make funding available for investments necessary for industrialization. In the early stages, banking develops more efficiently if banks are under State control since government ownership reduce the inequity in the allocation of credit. Also, nationalization implies a lower probability of banking crises since the public perception about repayments are better in case of government ownership. An important role is played by the civil service in charge of the public sector banks: they have to have expertise and accountability in decision making such as risk management, information processing, monitoring borrowers, providing quality service to depositors etc. Management capacity is a severe constraint in the case of African banks as much as in the case of industry. The State has a vital role to play in developing a knowledgeable, efficient and accountable bureaucracy who manages such public sector institutions.

Financial markets allow risk sharing and thus promote risky investment opportunities vital for dynamic efficiency and industrialization. But development of financial markets depend on the existing industrial framework and the thickness of potential demand for investible resources. Not all African countries today can hope to develop financially as South Africa since the demand for financial instruments will be lacking. However, the demand for insurance products by consumers, farmers and entrepreneurs are quite high. The State aided financial institutions can supply such insurance to share risks of life cycle consumption (life insurance, asset insurance), agricultural income (disaster insurance through agriculture credit subsidies) and bankruptcy protection. The creative design of such instruments will increase savings and investment and also permit a higher level of social welfare to be attained.

8. Law, Regulation and the Contractual Framework

Law arises from the Constitution, the passing of important bills through legislature and the common law evolved by the judiciary. Constitution design is important in protecting to basic human rights and economic rights. Legislature can bring equity and efficiency in the system through land reforms, protection of property rights and allowing fiscal incentives for capital accumulation. The judiciary plays a vital role in the interpretation of the existing laws and in modifying and developing them to suit the needs of the public. Developing the capacity of judiciary and legal professionals is an important objective in LDCs and especially in African countries since socio-political unrest can undermine the role played by Constitutional and Legislative mechanisms. Regulation of corporates, financial institutions, not for profit institutions like hospitals and universities can also play important role in mixing equity and efficiency.

9. Conclusion: Dynamic Efficiency and Evolving Equity

Promoting an efficient path of industrialization implies high warranted rates of savings, physical and human capital formation and growth in effective demand capacity. Management of financial and non-financial institutions to develop the supply side factors is essential step. So is the demand management role played by the State. The risks faced by African consumers, labor, and entrepreneurs have to be offset through risk sharing institutions and thus play a mediating role between supply and demand. Since the risk factor that needs to be addressed is primarily in agriculture, the efficient path of industrialization requires that such institutions in agriculture lead it.

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