



UNITED NATIONS  
ECONOMIC COMMISSION FOR AFRICA



**Capacity building workshop on “Enhancing the capacity of  
member States to achieve macroeconomic policy  
convergence in Southern Africa”**

**Pretoria, South Africa  
23-26 September 2008**

**Reading Material 11:  
Economic Policies and the MDGs**

# **Economic Policies and the MDGs:**

## **The Implications for Growth, Employment and Poverty Reduction in Sub-Saharan Africa**

**Terry Mckinley**

### **7.1 The Background**

UNDP has carried out extensive policy-oriented research on Economic Policies and Poverty Reduction since mid 2001. This research has already covered 25 developing countries, starting in Asia-Pacific with a regional programme on the Macroeconomics of Poverty Reduction in nine countries (Bangladesh, Cambodia, China, Indonesia, Mongolia, Myanmar, Nepal, Sri Lanka and Vietnam) and extending more recently to four other countries (India, Iran, Pakistan and Samoa) (See McKinley 2003).

Thereafter, a similar regional programme was undertaken in the Arab States (Egypt, Morocco, Syria, Sudan and Yemen) and country studies were conducted in Eastern Europe and the CIS (Armenia, Kyrgyz Republic, Moldova and Uzbekistan). In sub-Saharan Africa, employment-focused studies are being completed in Ghana and South Africa (and another has just begun in Kenya). Also, a study on growth, employment and poverty reduction is nearing completion in Zambia.

The new regional programme in sub-Saharan Africa on Economic Policies in Support of MDGs and Poverty Reduction, which has started in Chad, Mali, Rwanda, Sierra Leone, South Africa and Tanzania, can build on this extensive body of previous research.

The chief focus of this previous research has been on achieving 'pro-poor growth', namely, on the dynamics of growth, inequality and poverty reduction. Within this context, the research has concentrated on the impact of macroeconomic and adjustment policies on poverty. This has included fiscal, monetary and exchange-rate policies (macroeconomic policies) and financial liberalization, trade liberalization and privatization (adjustment policies).

The complementary focus of this research has been on enhancing the impact of such macro policies by 'augmenting the entitlements' of the poor. This has implied

improving the ‘supply side’ conditions of poor households, namely, their access to economic opportunities, such as productive assets, resources, credit and employment.

As the research has progressed, two new focus areas have emerged: 1) a greater focus on employment as an explicit policy objective and 2) a greater focus on public finance (enhancing ‘fiscal space’). Employment generation has become a major topic because the studies have found that employment at decent wages is the main nexus between growth and poverty reduction (see Osmani 2004). Public finance has become important because of the need to mobilize more revenue to finance public investment and the provision of essential public services.

The chief problem that this research has addressed is the lack of consistency between the objectives of National Poverty Reduction Strategies and their economic policies. Having remained focused on macroeconomic stabilization, these policies have not succeeded in generating rapid growth and employment creation. Moreover, because most economic policies have been driven by external conditionalities, there has been little ‘national ownership’.

The ultimate objective of this research has been to provide practical recommendations to make the economic policies of National Poverty Reduction Strategies more pro-poor, and more pro-growth. The associated objectives have been to open up and broaden the policy dialogue on pro-poor policy options and develop autonomous national capacities on research and policymaking. Without enhanced policy dialogue and genuine policy choice, there can be little national ownership of economic policies.

## 7.2 The New Context for the Africa Regional Programme

The new context confronting the Africa Regional Programme on Economic Policies in Support of MDGs and Poverty Reduction is the imperative to ‘operationalize’ the MDG framework, and, more specifically, to determine the policy implications of this framework for National Poverty Reduction Strategies.

MDG-based Poverty Reduction Strategies need to be more ambitious than the ‘first generation’ of Poverty Reduction Strategy Papers (PRSPs). Reaching the MDGs requires a dramatic scaling up of public investment, which will need financing at a level well above that provided to most current PRSPs. Highlighting this issue has been the contribution of the U.N. Millennium Project through its work on Needs Assessments. This project has begun the process of assessing the public investment needs of low-income developing countries that are required to reach the 2015 targets.

If substantial public investment programmes are implemented, what will be the implications for economic policies, and for the macroeconomic framework in particular? How will economic policies have to be modified in order to become consistent with achieving the MDGs? The economic policies of most ‘first-generation’ PRSPs have focused on macroeconomic stabilization, rarely providing viable broad-based growth strategies (see McKinley 2005a).

In order to mobilize the financing needed to reach the MDGs, Official Development Assistance will have to play a decidedly more important role. In fact, the U.N. Millennium Project has advocated for a substantial scaling up of ODA in order to provide a ‘big push’ to public investment programmes.

These issues raise a number of MDG-related challenges. For example, how will we guard against greater aid dependence when the process is so aid-intensive, particularly in the early stages? Related to this, how will we improve the mobilization of domestic resources? And having mobilized such resources, how will we ensure that they are channeled to productive public and private investment?

A major concern is that a large influx of ODA into the poor countries of sub-Saharan Africa will destabilize their economies. This commonly takes the form of worrying about a ‘Dutch Disease’, namely, a sharp increase in inflation and an appreciation of exchange rates (if they are not freely floating). Since most ODA will be channeled through government expenditures, this might cause excessive demand for non-tradable goods and thus drive up their prices. Since non-tradable goods are inputs into a country’s exports, this could lead to an increase in the prices of exports. As a consequence, exports could become less competitive—unless the exchange rate were devalued in response.

There is also a larger concern that an increased inflow of ODA will dampen efforts to mobilize domestic resources. Thus, there could be little net gain in resource mobilization. The danger is that the countries receiving additional ODA will not be able to graduate from aid dependence and establish a sustainable domestic process of capital accumulation.

An integral part of domestic capital accumulation is public investment. However, most low-income countries need to create more ‘fiscal space’, namely, mobilize more public revenue to finance essential public infrastructure. The governments of low-income countries that export highly valued natural resources, such as oil or diamonds, are able to mobilize substantial revenue. But most other governments in low-income countries lack sufficient revenue to function effectively.

A common problem in many developing countries is that they have been encouraged to rapidly liberalize their trade. However, a significant proportion of their total revenue comes from tariffs. Since they lose this revenue when they liberalize, they have to find alternative sources. For this purpose, the standard recommendation has been to rely more heavily on a Value Added Tax (VAT), which is considered by many orthodox tax specialists to be an efficient form of taxation.

In low-income countries with large informal sectors and weak tax administrations, the VAT has not proven to be very effective. A recent IMF research paper has found that for low-income countries, the VAT has recouped, on average, only about 30 percent<sup>1</sup> of the revenue lost from lowering trade barriers (Baunsgaard and Keen 2004). Thus, government total revenue has declined in the wake of trade liberalization.

A broader problem that many developing countries face is how to mobilize more domestic savings. This is a critical issue because such savings are used to finance private investment as well as public investment. In addition to drawing on retained earnings (which are part of savings), private businesses can borrow from commercial banks to finance their investment. Governments can also borrow from such sources for public investment. But to have funds available, banks need to be effective in mobilizing savings from households.

### 7.2.1 Gross Domestic Savings and Investment

Gross domestic savings has been stagnant in sub-Saharan Africa since 1990. As a percentage of GDP, it was 18 percent in 2003, down slightly from 19 percent in 1990. By comparison, gross domestic savings for all low-income countries was 20 percent in 2003 (Table 6.1), up from 18 percent in 1990. These statistics raise concerns that the development of sub-Saharan Africa is hamstrung by a ‘savings trap’—namely, that its income is too low to generate enough savings for self-sustaining growth (Sachs *et al.* 2004).

Table 7.1: Savings and Investment in Growing African Economies

Country	GDP Growth (% per year) 1990-2003	Gross Domestic Savings (% of GDP) 1990	Gross Domestic Savings (% of GDP) 2003	Gross Capital Formation (% of GDP) 1990	Gross Capital Formation (% of GDP) 2003
Benin	5.0 (2.3) <sup>a</sup>	2	5	14	18
Botswana	5.2 (2.9)	43	38	37	27
Burkina Faso	4.2 (1.8)	5	4	18	19
Ethiopia	4.3 (2.0)	7	1	12	20
Ghana	4.3 (2.0)	5	11	14	23
Guinea	4.2 (1.8)	18	7	18	10
Mali	4.9 (2.4)	6	19	23	23
Mauritania	4.4 (1.8)	5	3	20	45
Mauritius	4.1 (4.1)	23	25	31	23
Mozambique	4.8 (4.8)	-6	11	22	28
Senegal	4.0 (1.4)	9	8	14	20
Sudan	5.7 (3.4)	--	25	--	21
Tanzania	3.7 (1.1)	1	10	26	19
Uganda	6.8 (3.9)	1	7	13	21
Sub-Saharan Africa	2.8 (0.3)	19	18	17	19
Low-Income Countries	4.7(2.7)	18	20	21	23

Source: World Bank, *World Development Indicators 2005*, Tables 2.1, 4.1, 4.9.

Notes: ‘a’: statistics in parentheses are per capita growth rates.

Table 7.1 list 14 countries that achieved rates of economic growth during 1990-2003 that would be rapid enough to halve extreme income poverty by 2015 should they be sustained. This threshold growth rate is about 1.5 percent per year in income per person. Although most of the growth rates listed in the table are not spectacular, they have been maintained over 13 years, and would need to be maintained until 2015 in order to reach the MDG target.<sup>1</sup>

An examination of the columns for domestic savings and investment highlights some of the general factors behind the performance of the 14 countries. Gross domestic savings does not correlate well with these countries' above-average growth rates. As a ratio to GDP in 2003, savings varies from 38 percent for Botswana and 25 percent for both Mauritius and Sudan to four percent for Burkina Faso, three percent for Mauritania and one percent for Ethiopia.

There is much a closer correlation between growth rates and investment rates (expressed as gross capital formation). As a ratio to GDP, gross capital formation is above-average among these countries. With one exception (Guinea), investment rates are about 20 percent or higher in 2003. In the majority of the countries, gross capital formation increased from 1990 to 2003. Ghana, Senegal and Uganda scored the most impressive increases. In Ghana the investment rate increased from 14 to 23 percent and in Uganda from 13 to 21 percent. In five of the countries, investment rates declined but, with one exception (Guinea), the rate for 2003 remained about 20 percent of GDP or above.

The glaring problem is that many of these countries do not have the domestic savings rates to back up their investment rates. A few countries do: Botswana, Mauritius and Sudan. But this can be explained partly by export of rich natural resources (or an aggressive export-led strategy in the case of Mauritius). However, other countries, such as Ethiopia, Mauritania, Mozambique, Tanzania and Uganda, which have low domestic savings rates, rely heavily on ODA to finance their investment. Some of the countries with low domestic savings, such as Mali and Mozambique, are also able to draw on significant foreign direct investment.

In general, the pool of external savings provided by ODA and FDI has filled in for the lack of domestic savings in many of these growing economies. This could be a cause for distress or hope, depending on how one views the relationship between aid and development. Botswana and Mauritius, two middle-income countries, can be excluded from consideration because aid has not played a major role in their economies. For the remaining eleven countries with data, six countries experienced increases in domestic savings rates between 1990 and 2003 while five countries experienced decreases. For some of the countries with increases, the results were marginal: Benin increased its rate from two to five percent and Uganda from one to seven percent. For some other countries, such as Ghana, Mozambique and Tanzania, the increases were more substantial but their 2003 savings rates remained only 10-11 percent.

What is even more worrisome is that savings decreased for some countries that already had very low rates in 1990: Burkina Faso's rate declined from five to four

percent, Ethiopia's from seven to one percent and Mauritania's from five to three percent. For almost all the countries that performed poorly with regard to mobilizing domestic savings, ODA accounted for about 10-20 percent of their GDP.

This simple analysis is revealing. The implication is that unless the development strategies of these countries are transformed, continuing high levels of ODA—if not increasing levels—will be necessary to underwrite their growth. Clearly, ODA is not being converted into enhanced capacities to mobilize domestic resources. This is not, however, an argument for reducing ODA, but for redirecting it.

### 7.2.2 Net National Savings

If net current transfers are added to produce a measure of gross national savings, then the ratio of savings to gross national income becomes 23 percent for all low-income countries. But for sub-Saharan Africa, the ratio declines to 17 percent. This means that its net current transfers are negative. If net national savings, which includes the depreciation of capital, is calculated for sub-Saharan Africa, the ratio drops to only six percent (less than half the average of 14 percent for all low-income countries) (Table 6.2).

Table 7.2: Net National Savings in Sub-Saharan Africa

Country	Net National Savings % of GNI in 2003	Country	Net National Savings % of GNI in 2003
Angola	11.2	Malawi	-13.2
Benin	-3.4	Mali	7.6
Burkina Faso	-1.0	Mauritius*	15.4
Burundi	16.5	Mozambique	5.2
Congo, Rep.	17.9	Namibia*	19.3
Cote d'Ivoire	5.6	Nigeria	11.1
Eritrea	-2.5	Rwanda	5.0
Ethiopia	12.5	Senegal	5.4
Gabon*	23.5	South Africa*	3.0
The Gambia	1.0	Sudan	13.5
Guinea	2.3	Swaziland	4.8
Kenya	5.1	Tanzania	2.0
Lesotho	-9.3	Togo	-5.9
Madagascar	4.4	Uganda	10.3
Sub-Saharan Africa	6.3		
Low Income Countries	14.2		
Middle Income Countries	17.8		
East Asia & Pacific	32.6		
South Asia	15.9		

Source: World Bank, World Development Indicators 2005, Table 3.15

Note: Net National Savings = gross national income + net current transfers – public and private consumption – consumption of fixed capital. \* is a middle-income country

Some countries, such as Benin, Lesotho, Malawi and Togo, have negative net national savings. Those countries that have rates above 10 percent are mostly either middle-income countries (Gabon, Mauritius or Namibia) or big exporters of natural resources, such as oil (Angola, Nigeria or Sudan). But even in the case of oil exporters, net national savings remain below the average of low-income countries. These statistics on net national savings underscore the problem of low savings rates in sub-Saharan Africa.

Financial institutions in sub-Saharan Africa are unable to mobilizing much domestic savings. Even when they succeed in mobilizing it, they remain reluctant to lend for long-term investment. Shunning the risk involved in doing so, they prefer to lend for working capital for businesses, for consumer durables purchased by rich households or for short-term, risk-free government securities (see Chapter 4). Real rates of interest remain high in sub-Saharan Africa. In many countries, they are 10 to 20 percent. And the spread between deposit and lending rates of interest has risen since the early 1990s. This spread was about eight percentage points in 1990 but rose to over 12 percentage points in 2003.

### **7.3 Some General Policy Directions for UNDP's Work**

How should UNDP respond to the MDG-related challenges outlined above? The overriding challenge is to develop a coherent 'Post-Stabilization, MDG-Oriented Policy Agenda'. The 'first generation' of Poverty Reduction Strategy Papers has fixated on stabilization and safety nets. Their economic policies have not been successful in developing viable strategies to foster more rapid and more broad-based growth.

Macroeconomic stabilization has not proven sufficient for stimulating rapid economic growth, which is based on an accelerated and self-sustaining accumulation of domestic capital. And, as stabilization has been restrictively defined, it may not even be necessary for growth. As a recent World Bank report has suggested, many economies have been 'over-stabilized' (World Bank 2005b). When stabilization is identified with the maintenance of very low inflation rates, such as 3-5 percent per year, and the main safeguard of such price stability is high real interest rates that choke off investment, seeking to achieve such stability is likely to dampen growth prospects.

What would be the main components of a 'Post-Stabilization, MDG-Oriented Policy Agenda'? Below we outline five such components: 1) creating more 'fiscal space' to finance essential public expenditures 2) formulating more public investment led fiscal policies 3) backing up fiscal policies with more flexible monetary policies 4) restructuring financial policies to promote domestic savings and foster productive private investment and 5) maximizing the equity and employment impact of growth by broadening the access to economic opportunities.

An MDG-Oriented Policy Agenda has to emphasize mobilizing domestic resources and financing public and private investment. Almost all countries that have achieved

rapid rates of growth in the last 20-30 years have pursued a development strategy that has been built, first and foremost, on the rapid accumulation of capital, both public and private. And they have also ensured that the benefits of rapid growth have been broadly shared, particularly through expanding economic opportunities.

### 7.3.1 Expanding Fiscal Space

UNDP should emphasize the importance of helping governments expand their ‘fiscal space’ for pro-growth and pro-poor policies. This includes several dimensions. One is concentrating on the expenditure side of the public budget, which would involve identifying the room for the re-allocation of expenditures, on the basis of either a more efficient or more equitable use of revenue.

More importantly, this effort would involve expanding the revenue base to finance more pro-growth, pro-poor public expenditures, particularly public investment. The revenue base of many countries in sub-Saharan Africa is too small. Table 6.3 lists statistics on government revenue for 20 low-income countries for which relevant recent IMF data are available. With the exception of three countries (Burundi, Cameroon and Kenya), the revenue base is less than 20 percent of GDP. For some countries, the revenue base is abysmally low: eight percent for Chad, 10 percent for Madagascar, 11 percent for Burkina Faso and Guinea and 12 percent for Tanzania. The unweighted mean of total revenue for all 20 countries is 16.4 percent of GDP. In order for governments to finance badly needed public investment and provide essential public services, this average will have to be raised above 20 percent of GDP. A priority is to expand the revenue base of governments that command revenue lower than 15 percent of GDP.

Table 7.3: Government Revenue (% of GDP)

Country	Total Revenue	Tax Revenue	Non-tax Revenue
Benin (2001)	17.0	15.3	1.7
Burkina Faso (2001)	11.1	10.5	0.6
Burundi (2002)	20.3	18.0	2.3
Cameroon (2000/1)	20.6	12.6	7.8 <sup>a</sup>
Chad (2002)	7.9	7.1	0.8
Ethiopia (1999/2000)	18.3	12.5	5.8
Gambia, The (2001)	15.1	13.0	2.1
Ghana (2000)	17.7	16.2	1.5
Guinea (2001)	12.0	8.7	3.4 <sup>b</sup>
Kenya (2001/2)	21.6	17.6	4.0
Madagascar (2001)	10.0	9.6	0.4
Malawi (2001/2)	17.2	15.3	1.9
Mali (2002)	16.6	13.8	2.8
Mozambique (2002)	14.2	12.5	1.7
Senegal (2000)	18.0	17.3	0.7
Sierra Leone (2002)	14.2	14.0	0.2
Sudan (2003)	16.8	6.1	10.7 <sup>a</sup>
Tanzania (2001/2)	12.1	10.9	1.2
Uganda (2003/4)	12.6	11.7	0.9
Zambia (2003)	18.1	17.4	0.5

Source: IMF, Statistical Appendices, various years. Notes: ‘a’ is mainly oil revenue; ‘b’ is mainly Mining

In low-income countries, such as in sub-Saharan Africa, it is difficult to mobilize substantial public revenue. Income taxes have limited coverage because formal sectors are often small. This characteristic also limits the effectiveness of consumption taxes, such as the Value Added Tax. Nevertheless, much can be done to strengthen tax administrations. And taxes focused on specific categories, such as excise taxes on luxury items, can be used to supplement revenue from broad-based taxes on expenditures.

Table 7.4 focuses on changes in tax revenue over a period of time for the same 20 countries listed in Table 6.3. Fourteen of the 20 countries increased their ratio of tax revenue to GDP. Because of the limitations of data, the span of years for comparison varies by country. Nevertheless, it is clear that some countries significantly augmented their tax revenue. However, for almost all of these, their original level of revenue was low. Sierra Leone gained 6.8 percentage points of GDP in tax revenue but from a low base of 7.2 percent of GDP. Uganda gained five percentage points but from a base of only 6.7 percent of GDP. The story is similar, though less dramatic, for Cameroon and Ethiopia. However, while Ghana had a qualitatively higher original level of tax revenue, namely, 12.4 percent of GDP, it still managed to increase this level by almost four percentage points, to 16.2 percent of GDP.

Table 7.4: Tax Revenue (% of GDP)

Country	Tax Revenue Earlier Year	Earlier Year	Tax Revenue Later Year	Later Year
Benin*	12.6	1996	15.3	2003
Burkina Faso*	12.1	1998	10.5	2001
Burundi	16.6	1994	18.0	2002
Cameroon	8.7	1992/3	12.6	2000/1
Chad	4.7	1994	7.1	2002
Ethiopia*	8.3	1992/3	12.5	1999/2000
Gambia, The	16.8	1998	13.0	2001
Ghana*	12.4	1991	16.2	2000
Guinea*	6.7	1994	8.7	2002
Kenya	19.5	1991/2	17.6	2001/2
Madagascar	7.7	1994	9.6	2001
Malawi	14.6	1996/7	15.3	2001/2
Mali*	11.1	1993	13.8	2002
Mozambique*	10.4	1994	12.5	2002
Senegal*	15.6	1990/1	17.3	2000
Sierra Leone	7.2	1998	14.0	2002
Sudan*	7.0	1994/5	6.1	2003
Tanzania*	12.5	1991/2	10.9	2001/2
Uganda*	6.7	1991/2	11.7	2003/4
Zambia	19.9	1990	17.4	2003

Source: IMF, Statistical Appendices, various years

In general, these trends provide hope that poor countries can indeed significantly augment their tax revenue by 4-6 percentage points of GDP over a period of 5-10 years. While raising more revenue is critical, doing it in an equitable way is also important. Orthodox tax reforms frequently neglect the importance of vertical equity in tax systems. Such equity implies that those taxpayers with greater ability to pay (because of greater income or wealth, for example) should be taxed at higher rates. This is the principle that underlies the progressive structure of many tax systems in industrial countries. However, it is difficult to implement such structures in poor countries, because of weak administrations or opposition from rich elites. But this is not an excuse to weaken the progressive structure of existing tax systems. In this regard, governments in sub-Saharan Africa should avoid lowering top marginal tax rates on personal and corporate income. Recent research has already demonstrated that lowering such rates does not have an appreciable impact on expanding overall tax revenue (see, for example, Stepanyan 2003).

Borrowing, either domestically or internationally, is appropriate in some cases for expanding vital public investment. This depends on the condition of the primary budget—namely, whether current revenues roughly cover current expenditures. Table 6.5 presents aggregate statistics on fiscal deficits in Africa. It shows that the primary deficit has been reduced from about 3.6 percent of GDP during the 1980s to about 1.6 percent in 1990-2002. The problem is the overall deficit includes debt payments. During 1990-2002, this deficit was still about five percent of GDP though it had decreased from about 6.5 percent in the 1980s.

Table 7.5: Fiscal Deficits as a Percentage of GDP

	Primary Deficit 1979-1989	Primary Deficit 1990-2002	Overall Deficit 1979-1989	Overall Deficit 1990-2002
Africa	-3.58	-1.63	-6.45	-4.99

Source: Rogoff 2003.

This indicates that dramatic debt relief is imperative in order to expand the ‘fiscal space’ of many African countries to finance MDG-related public investment. In some cases, outright debt cancellation should be considered. This will be necessary to enable an acceleration of progress towards the MDGs. This should be supplemented by additional inflows of Official Development Assistance, which represented about six percent of gross national income in sub-Saharan Africa in 2003.

Domestic borrowing is a limited option for many poor countries. If the government securities offered for purchase are short-term and provide a high real rate of interest, then repayments will exert considerable pressure on the budget. Developing longer-term securities with low risk would be desirable. Another option is monetization of deficits. The criticism of this option is that it will likely increase inflation. As long as such inflationary pressures are not excessive, governments could benefit from an ‘inflation tax’. Governments in low-income countries often resort to such indirect forms of resource mobilization because of the difficulties in raising revenue from economic activities in the informal (unrecorded) sector. A recent research paper

estimates that seignorage income accounts for 10-15 percent of all revenue in low-income countries (Gordon and Li 2005).

In general, public revenue in low-income countries in sub-Saharan Africa needs to be boosted, on average, by 5-6 percentage points of GDP. Debt relief can account for an increase in fiscal space of about two percent of GDP. Restoring ODA to its 1990 level would add another two percent of GDP (Weeks 2005). And moving more concertedly to boost domestic revenue could realistically add another 2-3 percent.

### **7.3.2 Deploying Public Investment**

In addition to helping countries mobilize more public revenue, UNDP should be focusing attention on the need for more public investment. Poor countries in sub-Saharan Africa should be encouraged to implement public investment led fiscal policies. This would include investment in economic infrastructure as well as social infrastructure. A broad working definition of public investment should be used, however—one encompassing investment, for instance, in common environmental assets and government ‘absorptive capacity’. There is a large capacity development agenda involved in implementing MDG-based PRSPs to which UNDP can make a substantial contribution.

The role of public investment is central to the success of MDG-based PRSPs. Public investment can perform three essential functions: 1) stimulate aggregate demand (the traditional ‘Keynesian’ function) 2) expand the productive capacity of an economy (the ‘development function’) and 3) focus resources on poor households (the ‘Poverty Reduction’ function). Most orthodox studies do not separate out the impact of public investment from that of other forms of public expenditures. While such investment can indeed stimulate aggregate demand—in the same way that other forms of public expenditures do—it can make an additional contribution by expanding public and private productive capacity. It does this directly, through expanding economic and social infrastructure, and indirectly, through the effect of such infrastructure on stimulating private investment. This indirect effect is called ‘crowding in’.

A major challenge for stimulating growth is to ensure that public investment will indeed be well designed to stimulate private investment. Neoliberalism often assumes that public investment will tend to ‘crowd out’ private investment. But most studies have found, instead, a positive relationship between the two (Levine 2005 and Weeks and Roy 2004). In sub-Saharan Africa, public investment is low, when it should be high. In poor countries, public investment should be a higher percentage of GDP than in middle-income or high-income countries, mainly because of the need to lay an adequate foundation of economic and social infrastructure.

An additional reason that public investment should be high is that it has been in decline for decades. As a ratio to GDP, public investment declined from 4.7 percent in the 1970s to 3.3 percent in the 1990s (Table 7.6). As a result, public capital has become old and depleted. This implies significant replacement costs to rehabilitate the existing infrastructure even before new infrastructure is built.

Table 7.6: Public Investment Trends in Sub-Saharan Africa (Percent of GDP)

	1970s	1980s	1990s
<b>Sub-Saharan Africa</b>	4.7	3.6	3.3

Source: Levine 2005. Note: The table captures central government capital expenditure

Public investment can play a critically important role in jumpstarting growth and sustained poverty reduction in sub-Saharan Africa. On average, it should be boosted, at least, above 5 percent of GDP in low-income countries. In many cases, however, investment falls below this threshold. In response to these problems, UNDP should be giving greater attention to Public Investment Programmes (PIPs), ensuring that they are well funded and integrated across sectors. Because of the synergies among various dimensions of human development (such as among achievements in nutrition, health and education), public investment strategies need to rely on ‘complementary and mutually reinforcing interventions’ (U.N. Millennium Project 2005, p. 94).

The ‘needs assessments’ advocated by the U.N. Millennium Project help specify the contents of Public Investment Programmes, based on the sequencing of various forms of public investment over the ten years remaining until 2015. Once these needs assessments are fed into Public Investment Programmes, the latter should be integrated with Medium-Term Expenditure Frameworks, in order to ensure that budget allocations are determined accordingly.

### 7.3.3 More Flexible Monetary Policies

In order to implement more ambitious and more investment-focused fiscal policies, it will be necessary to make monetary policies more flexible and more accommodative of fiscal policies. Neoliberal economic policies favor, instead, the supremacy of monetary policies and the maintenance of low inflation. According to this perspective, fiscal policies should concentrate on constraining budget deficits since these are considered the primary source of expansions in the money supply. Excessive growth of the money supply (relative to money demand) will generate rising inflation. In response, this approach would raise real rates of interest in order to squelch inflation.

The monetary regime preferred by deflationary policies is based on ‘inflation targeting’. In practice, this often means targeting an inflation rate of 3-5 percent per year. However, in many instances, such low rates can be achieved only by maintaining high real rates of interest. And these, in turn, dampen private investment and, through making public borrowing more expensive, deter public investment (See Chapter 3).

The adoption of such policies, either explicitly or implicitly, has led to a marked decline in inflation in developing countries. Inflation is currently at a historically low level—i.e., 5.7 percent during 2000-2003 (Table 6.7). By contrast, inflation was about 53 percent during 1990-1994. In Africa, inflation dropped from almost 40 percent to under 12 percent during this same period. While inflation in Africa was lower than the developing-country average during the 1980s and early 1990s, it dropped more slowly than the developing-country average during the late 1990s and early 2000s. In 2004, average CPI inflation in Africa had dropped to 7.9 percent. And during 2003-2004,

six African countries experienced deflation (AfDB and OECD 2005). Such trends suggest that African economies are being ‘over-stabilized’ (World Bank 2005b).

There is little empirical evidence that inflation rates below five percent are correlated with growth. Instead, moderate rates of growth (in the range of 5-15 percent) are more closely associated with growth (Chowdhury 2004; Bruno and Easterly 1998). Even the IMF’s own in-house researchers have found that inflation begins to have a negative impact on growth only when it reaches 11-12 percent (Khan and Sendhadji 2001).

Table 7.7: CPI Inflation Rates (% per year)

	1980-84	1985-89	1990-94	1995-99	2000-03
Africa	16.8	17.9	39.8	20.6	11.8
Developing Countries	31.4	48.0	53.2	13.1	5.7

Source: Rogoff 2003

Demand-push inflation is no longer the principal macroeconomic problem in sub-Saharan Africa. Inflation is likely to rise in the coming period, but cost-push factors, such as rising oil prices, will be the main cause. Much of Africa’s inflation is still tied, on a recurring basis, to supply-side factors, such as weather-related downturns in agriculture or terms of trade shocks. Restrictive monetary policies are ill-suited to address such causes, particularly if they contribute to stagflation. While monetary policy should remain relatively tight in response to stagflation, substantially raising real rates of interest, in an ill-fated effort to squash what is believed to be demand-push inflation, will only worsen stagnation and recession.

Monetary policies should be supportive of more growth-oriented fiscal policies, particularly with regard to promoting more public and private investment. Attempting to bring average inflation in sub-Saharan Africa below five percent would be ill advised. This would serve mainly to dampen investment and slow growth. Central Banks should be encouraged to gear monetary policies to a range of macroeconomic targets, including real variables such as growth, employment and reduction of income poverty (Epstein and Heintz 2005 and Pollin *et al.* 2005).

If inflation rates rise above five percent, or above 10 percent, they would no doubt exert a downward pressure on the exchange rate of countries in sub-Saharan Africa. If such rates were fixed, this would represent a potentially serious problem. However, flexible exchange-rate regimes are not a desirable option either. One reason is that the exchange rate is not likely to be ‘market-determined’ in many countries: a significant proportion of their flows of foreign exchange, such as ODA and debt payments, is not market related (Weeks 2005).

Under such circumstances, an intermediate exchange-rate system, such as a managed float or a crawling peg, would be the optimal choice. Gradual, controlled depreciations of the exchange rate would help maintain the competitiveness of Africa’s exports. However, regulation of the capital account is likely to be a necessary

complement to such exchange rate management. Otherwise speculative attacks on exchange rates and the ensuing increases in real interest rates will erode macroeconomic stability.

It is imperative for national policymakers to have an adequate arsenal of policy instruments in order to stimulate economic growth as well as maintain macroeconomic stability. If exchange rates are completely flexible and capital accounts are completely open, then only two policy instruments, namely, monetary and fiscal policies, are available to policymakers to maintain price stability and external balance. Since the interest rate and exchange rate are rigidly linked to each other, monetary policy becomes fixated on maintaining external balance. Fiscal policy is then chained to maintaining price stability (by controlling government deficits). The result: there is no policy instrument that can be deployed to stimulate economic growth (Bradford 2004). As a consequence, there is an inherent deflationary bias to economic policymaking.

In contrast, if policymakers have four policy instruments, namely, fiscal, monetary and exchange-rate policies and some capital-account regulation, they can pursue four policy objectives, namely, price stability, current account balance, capital account balance and growth. Our recommendation is that fiscal policy—and public investment in particular—concentrate on fostering growth. Monetary policy would focus on price stability, exchange rate policy on current account balance and capital management techniques on capital account balance.

Since the 1990s, there has been a great deal of financial instability in the global economy. Developing countries that have maintained an open capital account have been subject to huge swings in capital flows. These swings have destabilized their exchange rates and compelled them to substantially raise their real rates of interest in order to contain capital flight. They have paid a heavy cost because such high rates have deterred domestic investment. But their policies have been subject to an additional deflationary bias. Because of such financial instability, countries have been advised to hold large stockpiles of foreign-exchange reserves. The reserve holdings of many countries now far exceed what is needed to cover imports shocks or short-term debt obligations (Stiglitz and Charlton 2005).

Such a system is deflationary because developing countries could be using such reserves to finance domestic investment. In order to build up such reserves, they have to run sizeable current account surpluses. The counterpart to such surpluses is that they are exporting excess savings (because domestic savings exceeds domestic investment). Since about 70 percent of reserves are held in U.S. dollars, they are financing the huge current account deficit of the United States. Thus, the U.S. has ready access to cheap credit to finance its excessive consumption (which is five percent above its level of income). This is, in effect, a large regressive transfer of resources from poor countries to rich.

### 7.3.4 Financial Policies Geared to Capital Accumulation

UNDP should take a broader view of financial systems than it has in the past. For the most part, it has concentrated on microfinance, as has much of the donor community. But microfinance has a limited impact in reducing poverty. And it does not address the broader problems of mobilizing substantially more domestic savings and boosting private investment (See Chapter 4).

Financial institutions are essential to capital accumulation. More research needs to be focused on why commercial banks in sub-Saharan Africa are not able to mobilize domestic savings. Part of the explanation is, no doubt, the concentration of banks in large urban centers. Another part of the explanation is that potential depositors of savings do not have confidence in banks or do not receive adequate rates of interest on their savings. Partial solutions to these problems would involve providing some form of deposit insurance and ensuring that deposit rates of interest are higher (Epstein and Heintz 2005).

At the same time that commercial banks are unable to mobilize domestic savings, they are reluctant to lend to the private sector. Table 6.8 provides statistics on credit provided by financial institutions to the private sector in 15 countries in sub-Saharan Africa. While some countries, such as Cameroon, Kenya and Senegal, provided credit to the private sector that was above the average of low-income countries in 1990, none of the fifteen countries provided above-average credit in 2003. Even such countries as Ghana, Guinea and Uganda, which have been among the fastest growing in Africa and have increased credit to the private sector, still provided very low levels in 2003.

Table 7.8: Domestic Credit Provided to the Private Sector  
Percentage of GDP, 1990 and 2003

Country	Domestic Credit to the Private Sector 1990	Domestic Credit to the Private Sector 2003
Benin	20.3	14.5
Burkina Faso	16.8	14.0
Cameroon	26.7	10.2
Chad	7.2	5.9
Ghana	4.9	11.8
Guinea	3.5	4.0
Kenya	32.8	21.3
Madagascar	16.9	8.8
Malawi	10.9	7.7
Mali	12.8	19.2
Mozambique	17.6	2.2
Senegal	26.5	20.8
Tanzania	13.9	7.6
Uganda	4.0	6.9
Zambia	8.9	6.7
All Low Income Countries	22.3	27.0

Source: World Bank, World Development Indicators 2005, Table 5.1

In order to promote more private investment, governments need to play a more pro-active role in providing regulations or incentives to motivate banks to lend to the private sector and to lend long-term. Partial loan-guarantee schemes are one option. Another is differential asset-based reserve requirements, which would release liquidity for lending for long-term investment in certain sectors.

A third option is to create specialized financial institutions, such as development banks or agricultural or SME banks. Development banks were established in the past in many countries in order to correct the ‘market failure’ of banks to assume the risk of long-term lending. Agricultural banks were established in order to ensure lending to agriculture, which is an inherently risky economic activity. SME banks have helped broaden access to credit beyond what is often a small preferred clique of large corporations, which not infrequently is closely linked to the banks providing them with loans. Such measures would help foster a more rapid process of domestic capital accumulation in sub-Saharan Africa, as well as promote broader and more equitable access to credit (See Chapter 4).

### 7.3.5 Maximizing the Equity and Employment Impact of Growth

It is now commonly recognized that many National Poverty Reduction Strategies do not have viable strategies for sustained economic growth. They import policies of macroeconomic stabilization from IMF agreements and add on social safety nets and social funds, but they do not offer a set of economic policies that can succeed in accelerating economic growth.

This is one reason that since 1990 there has been a process of de-industrialization in sub-Saharan Africa. In 1990, industry accounted for 34 percent of GDP whereas by 2003 this share was down to 31 percent (Table 6.9). There was a similar trend for manufacturing, which declined during the same period from 17 to 14 percent of GDP. These trends have to be reversed. But this will require much more pro-active and concerted public measures to support the development of industry and manufacturing. Success in this endeavor will require a more dynamic set of policies that can accelerate and sustain a more rapid process of domestic capital accumulation.

Table 7.9: Industry and Manufacturing  
(% of GDP) 1990-2003

	Industry 1990	Industry 2003	Manufacturing 1990	Manufacturing 2003
Sub-Saharan African Countries	34	31	17	14
--South Africa	40	31	24	19
--Nigeria	41	49	6	14
Low-Income Countries	26	27	15	14

Source: World Bank, World Development Indicators 2005, Table 4.2

### **7.3.6 The Equity Impact**

It is important not only to accelerate the rate of capital accumulation and economic growth in sub-Saharan Africa but also to ensure that the benefits of growth are broadly shared. This attaches special importance to policies that expand access to economic opportunities, such as access to jobs, productive assets and technology.

Greater equity and faster growth are no longer regarded as inherently contradictory. In the long term, equity and prosperity are likely to be complementary (World Bank 2005b) since broader access to economic opportunities should stimulate growth. The art of national policymaking is to identify the complementarities between greater equity and faster growth in the short- and medium-term.

Increasing equity is critical to achieving the 2015 MDG targets. While helping countries mobilize substantially more resources for widespread public investment programmes is a large part of the solution, distributing them more equitably—to the people who most need them—also matters greatly. An additional benefit: greater equity in people's access to essential public services and infrastructure enables them to more effectively contribute to—as well as benefit from—economic growth. Thus, growth and greater equity are mutually reinforcing means for attaining the MDGs. But in order to maximize this synergy, achieving greater equity needs to be 'front-loaded' in poverty reduction strategies. This will increase the income share of the poor much earlier in the development process, broaden the basis for sustained growth and lower the resource cost of reaching the MDGs.

The U.N. Millennium Project's global MDG plan, 'Investing in Development' (UN Millennium Project 2005), advocates MDG-based National Poverty Reduction Strategies that center on ambitious scaling-up of integrated public investment programmes. Much of this strategy is implicitly equity-focused. But concentrating on the equitable distribution of resources should become a more explicit component of national MDG-based Poverty Reduction Strategies. By making private investment more productive (e.g., by providing economic and social infrastructure and more skilled workers), such public-investment-led strategies will accelerate economic growth as well as ensure that its benefits are broadly shared. An early 'big push' to boost equity would indeed imply that MDG strategies need less investment to halve extreme income poverty by 2015 than equity-neutral strategies—and certainly much less than equity-worsening strategies (Kakwani and Son 2005). The basic reason is that more resources will reach the poor, and reach them sooner.

### **7.3.7 The Employment Impact**

Many National Poverty Reduction Strategies lack viable employment strategies. Implicitly, they assume that if growth is rapid enough, it will generate broad-based employment. But this depends on the pattern or character of growth. It is also important to recognize that accelerating growth will not have a substantial impact on poverty unless poor workers gain greater access to employment opportunities. In order to ensure a strong nexus between growth and poverty reduction, it is necessary

to implement a range of macroeconomic, sectoral and microeconomic policies that foster employment.

First of all, it is necessary to implement more growth-oriented macroeconomic policies. As this paper has already outlined, the priority is to implement investment-focused fiscal policies, supported by accommodative monetary policies, and supplemented by appropriate management of the exchange rate and regulation of the capital account. This is a precondition for generating broad-based, remunerative employment.

Microeconomic policies also play an important role in broadening the access of poor workers to employment opportunities. Included among such measures is improving access to credit or entitlements to land. Public investment in infrastructure can not only enhance private-sector investment and growth but can also provide temporary employment. An example is employment guarantee schemes, as pioneered in India. However, such public investment programmes, even if very labour-intensive, cannot solve the problems of widespread unemployment and underemployment that plague many poor countries.

Broader sectoral initiatives have to be mounted in order to address the magnitude of these problems. Active trade-promotion programmes will be part of this effort. 'Industrial' policies should be pursued, to a limited extent, at least in order to promote more diversified sources of growth. As already suggested, financial policies can also be utilized in order to motivate commercial banks to channel resources into long-term productive investment, and into sectors with the greatest growth and employment-generation potential.

A recent UNDP-supported study in South Africa on 'An Employment-Targeted Economic Program' is an example of such policies (Pollin *et al.* 2005). It tried to identify viable alternatives for monetary and financial policies that could generate more employment-intensive public and private investment. Unemployment remains a major problem in South Africa. Part of the problem is that the employment intensity of the country's output has been steadily declining. Under current projections, unemployment could well rise to affect about one third of the workforce. In order to counteract this trend, the study recommends that the Reserve Bank of South Africa lower its prime lending rate about two percentage points in order to make monetary policy more expansive. This reduction, the study argues, should give some boost to growth and employment. It also endorses the government's intention to moderately increase its fiscal deficit as a stimulus to aggregate demand. However, it argues that the centerpiece of the Government's employment strategy, its Expanded Public Works Program, is too modest in scale to be able to substantially reduce unemployment. Its public infrastructure component is likely to produce only 80,000 new jobs a year, reducing the official unemployment rate from 27.8 percent to only 27.3 percent.

Relying on public investment alone to generate jobs will obviously not solve South Africa's large unemployment problem. Generating a large number of jobs in the

private sector will be needed. Thus, the study also focuses on building up the country's financial sector and providing it with incentives to help stimulate growth and employment generation. For example, it recommends that credit at concessionary terms should be provided to sectors of the economy with above-average employment multipliers.

It provides three options for doing so: 1) substantially expanding the lending activity of the country's eight development banks 2) obliging banks to hold 20 percent of their assets in loans to employment-intensive sectors and 3) enlarging the country's loan guarantee scheme. The study estimates that its proposals for the loan guarantee scheme (including assumptions about the expected default rate) should obligate no more than 1-2 percent of the government's fiscal budget.

The report acknowledges that such expansionary measures are likely to raise South Africa's inflation rate. However, the increase is not expected to be more than moderate. If inflation threatens to accelerate beyond a moderate level, the report advises the Government to institute an incomes policy and weaken the monopolistic pricing power that exists in some sectors of the economy (which is partly to blame for maintaining high prices). As a means to ensure stability of the exchange rate, the report also recommends the use of capital management techniques. Such measures will guard against volatility in capital flows as a result of any precipitous change in the perceptions of portfolio investors.

The chapter on "Monetary and Exchange-Rate Policy" in the UNDP-supported study in Zambia on "Growth, Employment and Poverty Reduction" makes similar points (Saad Filho 2005). It argues that a pro-poor development strategy in Zambia will require providing incentives for investment in priority sectors, particularly agriculture, non-traditional exports, housing and infrastructure. This will involve providing incentives for credit flows through tax rebates, the reduction of compulsory reserve requirements, adjustments in the calculation of risk-weighted capital in order to favor long-term investment in socially desirable sectors, loan protection to deflect part of the cost of loan defaults in priority sectors away from the banks, and funding of a specialist agency that can trade in priority loan packages. Such a package of incentives is likely to be necessary not only to provide rewards to banks to lend to priority sectors but also to protect them against the possible higher risk of doing so.

## Notes

---

<sup>1</sup> The per capita growth rate for Tanzania is low, i.e. 1.1 percent, but it is included in the table because its more recent growth rate has been higher. Countries with recent high growth rates such as Chad could eventually join the group of 14 countries. Also, other much smaller economies, such as Cape Verde and Equatorial Guinea, could have been included now in the table. But lack of comparable data for these countries posed a problem in examining their experiences.