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Creating an enabling environment for private sector development in sub-Saharan Africa



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Federal Ministry
for Economic Cooperation
and Development

Creating an enabling environment for private sector development in sub-Saharan Africa



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for Economic Cooperation
and Development



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Foreword

The key role played by the private sector in spurring economic development, often referred to as “engine of growth”, has since long been common knowledge. Private sector development (PSD) has thus received increasing attention by policy-makers in the developing world and by the development community alike. In this context, the creation of an enabling business environment through business environment reforms has been acknowledged as an important pre-requisite for unleashing a private sector response that leads to dynamic growth, and ultimately employment and income generation. A debate is ongoing, however, as to the relative merits and development impact of improvements of various dimensions of the business environment on the one hand, and of targeted public policy interventions in support of PSD on the other.

The present study by the German Development Institute (GDI), Bonn, offers a contribution to this debate. Taking a closer look at the reasoning and results of a set of regulatory reforms in sub-Saharan Africa—focusing on easing business registration, the provision of property rights and the simplification of labour regulations—the study advocates a balanced approach. It argues that while constituting a necessary condition, business environment reforms alone will ultimately not be sufficient to foster enterprise development in sub-Saharan Africa in a broad way, and hence require supplementary action at other fronts.

The study has been jointly commissioned by the United Nations Industrial Development Organization (UNIDO) and the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) on behalf of the German Ministry for Economic Cooperation and Development (BMZ).

GTZ and UNIDO have for a considerable time been actively engaged in PSD issues, both in their respective technical cooperation and related research—or “global forum”—activities. Both agencies have also been members of the Donor Committee for Enterprise Development (DCED), particularly the DCED’s Business Environment Working Group (BEWG). Established in 1979, the DCED consists of a number of bilateral donors, development banks and international agencies. Seeking to develop best practice guidelines, and based on the experiences of its members, the Committee serves as a forum for information exchange and the identification of innovative approaches towards poverty alleviation through enterprise and private sector development (www.enterprise-development.net).

The study has been prepared as a joint GTZ/UNIDO input to the “DCED/BEWG Africa Regional Consultative Conference: Creating Better Business Environments for Enterprise Development—African and Global Lessons for More Effective Donor Practices”, held in Accra, Ghana, in November 2007.



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Abbreviations

AfDB	African Development Bank
AGI	Association of Ghana Industries
BDS	Business Development Services
DCED	Donor Committee for Enterprise Development
ECBP	Engineering Capacity Building Programme (Ethiopia)
ECP	Entrepreneurship Curriculum Programme (Mozambique)
EPZ	Export processing zones
FAO	Food and Agriculture Organization
GDP	Gross domestic product
GTZ	Gesellschaft für Technische Zusammenarbeit
HIV/AIDS	Human immunodeficiency virus/Acquired immune deficiency syndrome
ICT	Information and communication technology
IFC	International Finance Corporation
ILO	International Labour Organization
MDG	Millennium Development Goal
MSTQ	Metrology, standardization, testing and quality assurance
NEPAD	New Partnership for Africa's Development
NISCO	National Informal Sector Coalition (Kenya)
OECD	Organisation for Economic Cooperation and Development
PSD	Private sector development
R&D	Research and development
RPED	Africa Regional Programme on Enterprise Development
SBP	Single Business Permit (Kenya)
SME	Small and medium-sized enterprises
SSA	Sub-Saharan Africa
UN	United Nations
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
UNIDO	United Nations Industrial Development Organization
WTO	World Trade Organization

Executive summary

This report discusses how the business environment in sub-Saharan Africa can be improved in order to foster enterprise development. Past efforts to boost private sector development have shown disappointing results. This holds especially for the orthodox structural adjustment programmes of the 1980s and 1990s. But also the wide array of support schemes by governments and donors aimed to strengthen specific industries, groups of enterprises, or supporting institutions have rarely had a significant impact. Although a few remarkable project successes exist, these mostly remain isolated events with no country-wide outreach and no measurable effect on aggregate economic growth.

Against this background a new paradigm is now receiving considerable public attention. The World Bank/IFC has highlighted the importance of unnecessary government regulations as well as difficult access to property titles as some of the most important growth constraints, claiming that these reforms increase growth substantially and benefit the poor in particular. Since 2004 it publishes annual Doing Business Reports providing detailed and comparable data on the administrative cost of doing business, thereby creating pressure on governments to spur property rights reforms and cut red tape. Donors are urged to help creating an undistorted “level playing field” for enterprises rather than providing support for specific industries or groups of enterprises. Other donors however continue to emphasize the relevance of support schemes to address specific constraints, e.g. to encourage entrepreneurship, foster business linkages, or enhance export competitiveness.

This study provides an analytical framework to compare the different approaches, making their underlying assumptions explicit and proposing a terminology to distinguish different notions of the “business enabling environment”. It shows that the Doing Business agenda is embedded in a neo-classical framework assuming that markets work reasonably well if property rights and competition are guaranteed. The agenda thus advocates minimal regulatory government intervention and a very limited role for supporting particular economic actors. Especially important for sub-Saharan Africa, it presupposes a significant growth potential even for informal micro enterprises if unfair regulations are abolished. This is in marked contrast to neo-structuralist positions that emphasize market failure and the need for corrective policies, especially to enhance competitive advantages and to support disadvantaged groups.

Looked at from this perspective, it is important to identify the most important constraints for private sector development in sub-Saharan Africa. This provides criteria to assess the effectiveness of alternative policy approaches. Although considerable variation exists across countries in sub-Saharan Africa, the study makes out five distinctive structural deficits of the region’s enterprise structure that command the attention of policymakers: (a) widespread and rising informality; (b) a “missing middle” and lacking upward mobility of enterprises; (c) weak inter-firm linkages; (d) low levels of export competitiveness; and (e) lack of innovation capabilities.

From a policymakers’ or donors’ perspective it is thus imperative to learn which policies make African economies more productive and socially inclusive, in particular which ones

help to overcome the above deficits. The study examines the relevance and impact of three regulatory business reform areas that are emphasized in the Doing Business Reports, namely easing business registration, providing property rights, and simplifying labour regulations. Preliminary findings show that reforms to ease business registration and the acquisition of licences seem to have the most favourable impact, saving businesses substantial amounts of money and time. However, there is no evidence that these reforms improve enterprise performance. Property titling programmes have not improved access to credit significantly. In some cases they have even resulted in anti-poor concentration processes. Simplification of labour regulations is partly necessary to spur labour mobility and increase wage flexibility. Again, however, there is little evidence to suggest that labour regulations are a significant growth constraint. Shortage of a skilled workforce seems to be a much greater limitation than inappropriate regulations. In sum, there is no evidence that the recommended reform packages are sufficient to unleash private sector dynamism. Most importantly, there is no evidence that policies aimed at establishing a “level playing field” are pro-poor and appropriate to lift the workforce in the informal economy out of poverty.

Instead, practical experience suggests a combined approach that builds on market forces wherever possible and offers targeted public support schemes where necessary. The study identifies measures to improve state-business relations, support innovative entrepreneurship, strengthen intra-firm specialization and linkages, promote exports and improve financial services as especially important to address the deficits of Africa’s private sector. Examples of successful, or at least promising, policy interventions from GTZ’s and UNIDO’s portfolios are provided. At the same time, the study stresses a number of principles of public service delivery that should be applied to avoid common errors of the past, e.g. the neglect of outreach and the distortion of existing service markets.

1. Introduction

Sub-Saharan Africa (SSA) is not on track to achieve the Millennium Development Goals (MDGs). This is the recent message of the United Nations MDGs Report 2007 (UN 2007). Even though most indicators have improved slightly in the region, this progress is marginal compared to other developing regions and too slow to reach the MDGs by 2015. For instance, SSA has seen a decline of the proportion of people living on one dollar a day or less from 45.9% in 1999 to 41.1% in 2004. But compared with all other developing regions, this is still the highest incidence of poverty and the slowest decline encountered.

This is to a large extent due to insufficient economic growth. The African long-term growth record is described as U-shaped, since the higher growth rates posted in the 1960s were followed by a contraction from the 1970s to the middle of the 1990s. Growth rates picked up to 5% in the most recent period from 1995-2005 (Ndulu et al. 2007). But even at this rate it is unlikely that poverty will be reduced significantly in many countries because:

- (a) Sustainable average growth rates of at least 7% are needed throughout the coming years to make faster progress towards MDG 1 (namely, to reduce by half the proportion of people living on less than a dollar a day) by 2015. This growth performance was recorded only for four countries in SSA during 1998-2006, suggesting that it will be very difficult for most countries to meet this goal in the coming years (UNECA 2007 and Ndulu et al. 2007).
- (b) High growth rates are not productivity-driven but mainly due to an increase in commodity prices. In fact, productivity growth in the region has been much slower than the world average. Fortunately for Africa, world primary commodity prices excluding crude petroleum recorded a 45 per cent increase during 2002-2005, benefiting the mostly primary commodity exporting countries in SSA. Oil-exporting countries had by far the highest growth rates, and in 2006 this group contributed 57.5% of the continent's 5.7% growth rate (UNECA 2007). This growth pattern is usually not socially inclusive, benefiting mostly the owners of a small number of large enterprises and not resulting in a significant increase of formal employment.

Commodity-based growth also exposes the region to terms-of-trade fluctuations and exchange rate volatility, and it may have undesired Dutch disease and rent-seeking effects.

The challenge is thus to create economic dynamism and productivity growth beyond oil and the few other commodity sectors. This dynamism must spring from the private sector.

What, then, are appropriate strategies for private sector development (PSD) in SSA? Previous economic strategies to unleash private sector development have fallen far behind expectations.

- Several decades of project-based aid for local economic development, entrepreneurship development, vocational training and the like have yielded disappointing overall results. Although laudable project successes do exist, these often remain isolated events with no country-wide outreach and no measurable effect on aggregate economic growth.
- On the macro level, structural adjustment programmes prescribed an orthodox mix of trade and price liberalization, reduction of the size of the state, and privatization, but these likewise failed to spur economic growth.

Against this background, donor agencies are now testing a new magic bullet. Much hope is now placed in reforms of the regulatory environment for businesses. The simplification of business registration procedures as well as reforms of labour regulations and property titling are highlighted as key elements of a conducive business environment. The effectiveness of special enterprise support schemes, in contrast, is questioned and regarded as “a throwback to the old resource-driven and state-led development paradigm, in which wise planners detect a need, throw resources at it, and attempt to microengineer outcomes instead of accepting the decentralization of decisionmaking that markets represent.” (Klein/Hadjimichael 2003: 65).

Unlike special enterprise support schemes, these generic business climate reforms tackle the regulatory environment that affects every single enterprise in the respective country, and they are thus claimed to induce improvements with broad social outreach. And in contrast to previous structural adjustment programmes, they deal with practical constraints that hamper day-to-day business operations (rather than macro variables) and therefore promise to have an immediately stimulating effect on PSD. What is more, these reforms claim specifically to remove some burdens that affect the poor disproportionately, and they would thus have a direct pro-poor effect.

What can we expect from these reforms? Do they tackle the most binding constraints on PSD in SSA? And which measures have the strongest effects and should be adopted with priority? And what about the “old” project-based aid that aims to improve the performance of specific groups of firms or supporting organizations, such as export boards, business associations and industrial standards organizations? Do we still need it, and if so, how does it relate to the regulatory reforms? These questions are addressed in this paper.

This paper consists of seven chapters. The second chapter presents different notions of the “enabling environment” for private sector development. It proposes a terminology that helps to keep some commonly used approaches apart and discusses the underlying assumptions of each of the approaches. It also highlights the fact that the phenomenon of the informal economy is interpreted quite differently in different schools of thought, with important implications for the policies derived from each approach. Chapter 3 then elaborates on some characteristics of the private sector that distinguish SSA from other regions. It shows that informality is especially widespread, that there is little upward mobility of enterprises and a lack of medium-sized enterprises. This is reflected in weak inter-firm specialization and linkages, lack of export competitiveness, and low innovative capabilities.

Chapters 4 to 6 then go on to discuss the relevance of different elements of business environment reform for tackling the competitiveness problems of the region’s private sector. Chapter 4 reviews what we know about the relevance of regulatory business environment reforms. The focus is on three elements that are treated prominently in the World Bank’s Doing Business Reports, namely easing business registration, providing property titles, and simplifying labour regulations. We test whether tackling these issues in the recommended way triggers enterprise upgrading and economic growth. Preliminary findings show that easing business registration saves costs and encourages formalization, but it is not clear whether this in fact makes African societies more enterprising and wealthy. Property titling and labour market reforms seem to have even less effect on competitiveness. Chapter 5 then briefly discusses some elements of the broader investment climate, such as better infrastructure and good governance, whose importance is generally acknowledged. In chapter 6 we extend our scope to other private sector development strategies that go beyond the basic set of neoclassical investment climate issues and discuss the relevance of selective and targeted policy interventions that support private sector groups more directly, such as entrepreneurship development, linkage, and export promotion programmes. In this section we provide some examples of successful, or at least promising, policy interventions from the GTZ and UNIDO portfolios. Furthermore we summarize good principles of service delivery that need to be followed in order to make public support programmes more responsive to market demand and increase their outreach. The concluding seventh chapter sums up our lessons learnt about PSD in SSA and identifies some gaps for future research.

2. The enabling environment for private sector development: different concepts and their underlying assumptions

There is growing consensus among development researchers and practitioners that:

- (a) A thriving private sector is crucial for poverty reduction, and that
- (b) Certain business-friendly conditions must be in place to unleash private sector dynamism.

We know much less, however, about what exactly a good business-enabling environment is. Most people would agree that low levels of bureaucracy, an independent judiciary, good roads and a functioning education system, for example, are parts of a good business-enabling environment. However, there is a lack of clarity about the relative importance of each of these elements. Some analysts and policymakers place their emphasis on de-bureaucratization, whereas others focus on public sector support programmes of different kinds. Indeed, some elements of the business-enabling environment are a matter of controversy. Opinions diverge for example with regard to the appropriate level of labour market regulation, the need for industrial and innovation policies, and the appropriate level of trade openness.

This section makes a distinction between different concepts of the “business-enabling environment” and proposes a terminology. It makes fundamental underlying assumptions of neoclassical and neo-structuralist approaches explicit and in particular highlights their differences with regard to explaining the phenomenon of informality.

2.1 Introducing a terminology

First of all, it is necessary to open up the “black box” and define the business-enabling environment. In the following we distinguish two approaches that are based on quite different assumptions about the “ingredients” of successful private sector development: the neoclassical and the neo-structuralist approach. Within the neoclassical approach we further

propose a distinction between a narrower concept—which we call the “regulatory business environment”—that highlights those regulations that immediately affect businesses through the costs of compliance, and a broader concept—the “investment climate”—which encompasses wider framework conditions such as infrastructure, health and education. We believe that this proposed terminology helps to make underlying assumptions explicit and to test these assumptions empirically.

Figure 1 depicts these different approaches. It shows that the neo-structuralist approach addresses the widest spectrum of elements, with the regulatory business environment approach focusing on the narrowest spectrum. Most of the elements of the inner circles are generally recognized as important elements of the business-enabling environment, but, as we will argue in this chapter, opinions diverge with regard to:

- (a) The need for government engagement in the outer circle, and
- (b) The design of some policies within the inner circle, especially the most appropriate regulation of land markets, labour laws, and tax systems.

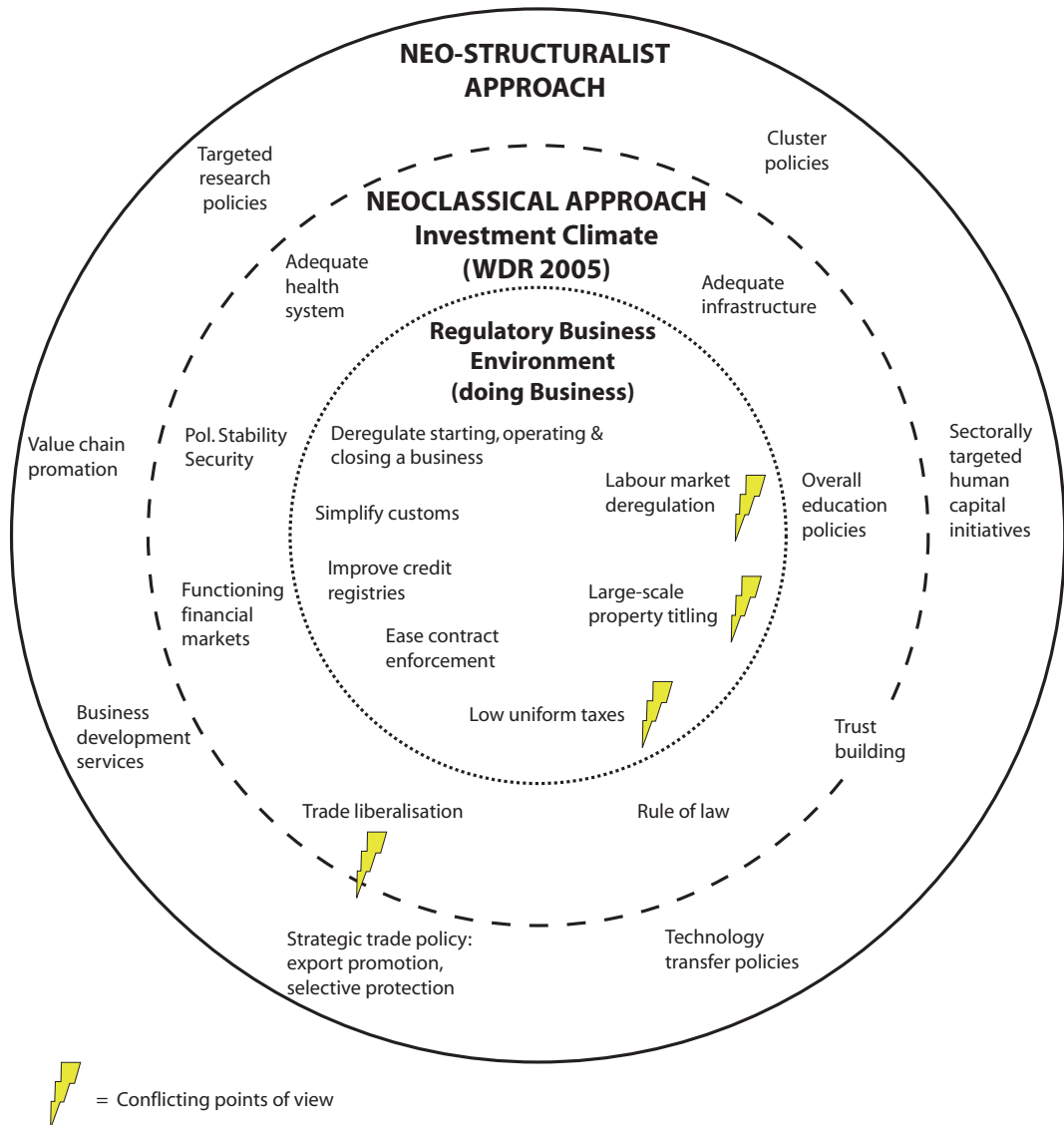
2.2 The neoclassical approach

Proponents of the neoclassical approach to the business-enabling environment assume that most factor markets work reasonably well without government intervention if property rights and competition are guaranteed. Such interventions are in most cases considered less efficient than market-based solutions, and it is stressed that many government interventions in fact hamper private sector development. Measures to improve the business-enabling environment consequently focus on deregulation and the good functioning of markets, with only a limited role assigned to the public sector in a few areas where market failure is most obvious.

Within this concept, we may further distinguish the narrow concept of the regulatory business environment and the broader concept of the investment climate. None of these concepts is clearly defined and used consistently in the pertinent literature. For analytic purposes, however, we propose using the following definitions:

- (a) The “regulatory business environment” covers regulations that immediately affect businesses through the costs of compliance. These are composed of direct costs, such as license fees, and indirect costs resulting from—often unnecessary—transactions. The latter include transaction costs arising from the time that has to be spent in obtaining a licence as well as increasing costs stemming from inappropriate government regulations that make contract enforcement or the hiring and firing of workers unnecessarily complicated and costly. The costs of the regulatory business environment are most prominently analysed in the Doing Business series published by World Bank/IFC on an annual basis since 2004. The latest edition (World Bank/IFC 2007) measures the costs and time associated with complying with 10 types of regulations: starting a business, employing workers, getting credit, enforcing contracts, closing a business, registering property, dealing with licences, protecting investors, paying

Figure 1.
The business-enabling environment: neoclassical and neo-structuralist approaches



taxes, and trading across borders. The emphasis on easing regulations and providing property rights was inspired by the work of Hernando de Soto (1989, 2000) as well as by reform experiences in Eastern Europe. Some of the most influential proponents of the regulatory business environment claim that such reforms are not only appropriate to unleash private sector development and growth but that they immediately benefit the poor more than proportionally because “heavy regulation and weak property rights exclude the poor from doing business” (World Bank/IFC 2005: 3; see also: Klein/Hadjimichael 2003, Klein 2006, Klapper 2006).

- (b) The term “investment climate” comprises all the elements of the regulatory business environment, but in addition it includes the quality of infrastructure, the health system, the overall level of education, rule of law, political stability and security, functioning financial markets, trade liberalization and international rules and standards as factors which constitute the “location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand” (World Bank 2004: 1). The World Development Report 2005 “A Better Investment Climate For Everyone” (World Bank 2004) conceptualizes this understanding of the investment climate and elaborates on its elements.

The term “investment climate,” as used in the World Development Reports and Investment Climate Surveys, thus refers to a set of enabling factors broader than the “regulatory business environment.” The difference is only one of analytical focus, i.e. authors who emphasize the relevance of the Doing Business indicators would probably not question the significance of the additional elements of the wider investment climate.

Both the World Bank’s “regulatory business environment” and “investment climate” documents are highly sceptical about deliberate government action aimed at improving the performance of enterprises and developing competitive advantages. The World Development Report 2005, for example, warns that “experience suggests that such strategies are far from straight forward and can go spectacularly wrong ...[as] ... picking “winners” can be an expensive gamble” with public funds (World Bank 2004: 160). The Doing Business Reports likewise argue that creating a level playing field through deregulation and guaranteed property rights is the most important condition for boosting economic growth and making it more equitable. The Reports emphasize that extensive government regulations hamper the formation, registration and growth of private enterprises and create numerous opportunities for rent-seeking bureaucrats to extract bribes, thereby increasing corruption significantly. Throughout the Reports, government interventions are largely perceived as “distortions” and “burdens” for private investors.

2.3 The neo-structuralist approach

Analysts from a neo-structuralist or evolutionary background stress the role of additional determinants in explaining private sector dynamism, and especially the ability to upgrade and build knowledge-based competitive advantages. Aside from a few exceptions (that will be discussed later on), they do not deny the relevance of any of the elements highlighted in the World Bank’s Investment Climate Surveys and the Doing Business Reports. The key difference lies in their assumption that market failure is pervasive and governments have a more active role to play in correcting such market failure. The risks of government failure, e.g. political capture of rents by bureaucrats and politically well connected actors in the private sector is acknowledged, but the consequence is to establish checks and balances rather than not addressing market failures at all.

Market failure is especially relevant in two areas:

- (a) The creation of competitive advantages in increasingly globalized and knowledge-intensive markets;
- (b) The pursuit of pro-poor outcomes in highly asymmetric markets.

There is an extensive body of literature dealing with the emergence of competitive advantages in particular technologies or industries. This literature comes from business studies (e.g. Porter 1990) and evolutionary economics (Nelson/Winter 1982) as well as from innovation research (Lundvall 1992; Malerba 2002). The concept of systemic competitiveness (Esser et al. 1994) provides a heuristic framework for the analysis of determinants of competitiveness that draws on these and other strands of the academic debate. All this literature coincides in showing that the competitive advantages of firms, regions and nations is more and more dependent on deliberate action (“man-made advantages”), the interaction of multiple private and public actors, and the existence of highly specialized and diversified institutions. Using Porter’s terminology, it is advanced factors such as specialized sector institutions and highly skilled workforce in areas of competitive advantage—rather than basic factors like natural resources, location and pools of unskilled labour—that increasingly determine competitive success.

As the process of building competitive advantages becomes more complex and involves more actors and growing information flows, more coordination and facilitation is required. While a considerable part of this will usually be supplied by private service providers, the role of the public sector in this process necessarily also increases. Four reasons stand out:

- (a) More complex and knowledge-intensive industries are likely to generate greater knowledge spillovers for other industries. Since a private investor in an industry A is rarely able to appropriate all the benefits of spillovers into industries B and C, the result may be underinvestment. The same applies for investments that entail dynamic scale economies, or to put it simply, that are likely to create the basis for competitive advantages in the future. Evolutionary theory and empirical work clearly demonstrate the cumulative character of technological development. Underinvesting in technological learning because it does not yield immediate returns to investment may seriously constrain future competitive advantages.
- (b) Industries increasingly depend on complementary manufacturing and service facilities. As long as these are not in place, investment will be discouraged. Efforts to simultaneously encourage complementary firms and foster linkages between them may help to overcome such coordination failure.
- (c) Information becomes more important. Collecting and processing information, however, is costly and may not pay off for individual investors. Consequently, it may be fully rational to set up information systems or subsidize the search costs of private firms if the expected social benefits (e.g. in terms of export market development) are high. This is especially relevant if firms are small, if markets are distant and not well-known, and if the economic activities developed are non-traditional ones.

- (d) Values and visions of society are important determinants of competitiveness (Esser *et al* 1994). There is clear evidence that societies have vastly different preferences with regard to education and technological learning. In some societies both governments and individuals display short-term and rent-seeking behaviour, and people tend to value technological progress, hard work, or entrepreneurial risk-taking much less than others. Governments can influence such values and visions. Some measures are fully in line with neoclassical thinking, e.g. to ensure macro-economic stability in order to provide better conditions for long-term investments, or to reduce opportunities for rent-seeking. But governments may go beyond this; they may, for example, assume an active role in fostering social consensus about the need to build a learning and industrializing society, and they may formulate and implement strategies to achieve this.

The second difference relates to pro-poor outcomes. Neoclassical theorists assume that competition is generally healthy for private sector development. Competition induces firms to challenge old ways of doing business. New firms enter the market, whereas some established companies, no longer able to compete, will exit the market, allowing more productive firms to occupy their positions. This process of entry and exit creates a healthy turbulence that drives technological progress and creates ever more productive jobs (see Klein/Hadjimichael 2003; Carree/Thurik 1999). While there is little doubt about the benefits of such processes, critics highlight that there are many asymmetric markets where firms operate with extremely different productivity levels. Under such conditions unfettered competition, especially by foreign market entrants, may “wipe out entire populations” of enterprises (Cimoli *et al.* 2006) and leave their workforces without a realistic chance to adapt. As entry and exit do not occur on a “level playing field,” the social effects may be negative.

Extremely asymmetric competition is an important feature of SSA, where:

- (a) National enterprises and even subsidiaries of multinational corporations are on average much less productive than their international competitors, and where
- (b) Huge productivity gaps exist within economies between micro and small enterprises on the one hand and large modern (often foreign) firms on the other.

Looked at from this perspective, it is doubtful whether creating the basic market institutions and providing infrastructure alone will suffice. The neo-structuralist and evolutionary schools of thought assume that neither competitiveness nor pro-poor outcomes can be achieved without correcting market failures. To create a business-enabling environment that is conducive is thus a far more complex undertaking than just providing the basic market institutions. This has been proven by the failure of orthodox structural adjustment programmes. It is therefore doubtful whether the regulatory business reform agenda, with a similar market optimism, can solve the structural problems of Africa's private sector development.¹

¹In an earlier article we discuss the Doing Business report's “new minimalist approach” in detail: Altenburg/von Drachenfels (2006).

Even from a neo-structuralist perspective, however, the role of private investors is paramount, and markets are the most important institution for testing and selecting innovations. Intervening in markets always involves substantial risks of inefficiency and political capture. But—as Rodrik (2007) rightly stresses—this applies not only to private sector promotion but to interventions in any policy area. The challenge is thus to find the right balance between measures designed to unleash market forces and to correct market failures.

2.4 Different interpretations of the informal economy

The neoclassical and neo-structuralist approaches also provide different interpretations of the informal economy which in turn have quite dissimilar policy implications (see table 1).²

Proponents of the neo-structuralist interpretation³ of the informal economy (e.g. Tokman 1990) argue that the informal economy is comprised of marginal activities that provide income for the poor and a safety net when no formal employment opportunities are available. Viewed from this perspective, multiple deficiencies—beyond insecure property rights and red tape—hamper the development of informal enterprises. Among these deficiencies are lack of education and technical and management training and limited access to capital and markets. Most owners of informal micro enterprises are necessity entrepreneurs who run their business as an activity of last resort in the absence of employment alternatives. The informal economy absorbs a segment of the labour force that is not easily employable in the modern economy, e.g. people with low levels of education, handicapped, ill and elderly people, single mothers who need to care for their children during the day as well as persons who are temporarily unemployed. Opportunities for self-employment or the formation of micro enterprises are largely restricted to activities with low entry barriers in terms of skills and capital (e.g. street trading, garment manufacture). Labour supply in these activities tends to be high, creating cut-throat competition with low returns and often decreasing productivity. The observation that the informal economy often grows during recessions (e.g. Mezzera 1993) suggests that it comprises a workforce with limited employability rather than being a seedbed for thriving future entrepreneurs.

Proponents of the neoclassical approach in contrast do not take characteristics and motives of the entrepreneur into account. Instead, the distinguishing attribute of informal firms is non-registration. It is assumed that the informal economy is comprised of enterprises that operate informally because the costs, time and effort of formal registration are too high (de Soto 1989; Palmade/Anayiotos 2005). World Bank Enterprise Surveys⁴ use percentage of sales not reported for tax purposes as a measure of informality. Accordingly, even large and modern enterprises may be part of the informal economy if they do not report significant shares of their sales.

²See Chen (2004) and Rakowski (1994) for a detailed discussion of different concepts of the informal sector.

³Chen (2004) distinguishes a “structuralist” and a “dualist” school of thought. In the dualist version formal and informal modes of production are largely unconnected, whereas in the structuralist version the informal economy is subordinated to large capitalist firms.

⁴www.enterprisesurveys.org.

In contrast to the neo-structuralists, this approach assumes that the informal economy hosts a significant number of vibrant opportunity entrepreneurs with viable business ideas and the means to exploit them in terms of technical skills, market access etc. However, staying informal comes at a cost. Informal entrepreneurs live under the permanent threat that their assets may be seized by others, and they therefore avoid long-term investments; even if they manage to trade their assets informally, their market value will be lower than that of identical assets with an enforceable property title; furthermore, informal tenants cannot use their assets as collateral; they may not even have access to public utilities; and they may be forced to pay bribes to avoid harassment by public officials. Providing property rights and easing enterprise registration will thus increase security of ownership, ease access to credit and public utilities like electricity, and thereby stimulate investment and growth. It should be noted that this builds on the implicit assumption that access to credit is constrained mainly by lack of registration, i.e. factors such as small scale, geographic distance, and others that increase transaction costs for banks are not taken into account. We will come back to this in chapter 4.

Obviously both approaches have very different policy implications. Following the neo-structuralist interpretation of the root causes of informality, what is needed to tackle the multiple deficiencies of entrepreneurs in the informal economy is a comprehensive policy mix, whereas the neoclassical approach calls for policies that reduce administrative entry barriers and create incentives to legalize businesses.

Table 1. Different approaches to informality based on different underlying concepts

	Neoclassic approach	Neo-structuralist approach
Concept of informal economy	Defined by lack of formal registration.	Defined by multiple deficiencies (skills, capital, time constraints) and lack of absorptive capacity of modern economy.
	Many vibrant opportunity entrepreneurs with viable business ideas.	Mostly necessity entrepreneurs with no long-term business plans, confined to simple activities with low entry barriers, oversupply and low returns. Run business to survive in absence of employment opportunities.
Main policy implications	Provide property rights, reduce bureaucratic entry cost and provide incentives for legalization.	Adopt targeted policies for upgrading, e.g. providing management and technical training, support producer cooperatives, build linkages with formal enterprises, direct public purchases to informal sector organizations. Legalization may be helpful, but is not decisive.

3. Characteristics of the private sector in sub-Saharan Africa

In the previous chapter we have shown different perspectives on the drivers and constraints of private sector development. Assumptions about the efficiency and failures of markets as well as the ability of governments and donors to correct potential failures diverge strongly. This chapter summarizes some of the characteristics that distinguish SSA's private sector from that found in other parts in the world and serves to explain a good part of its competitive weaknesses. This analysis is necessary to get a better understanding of why the region fails to increase its competitiveness and thus helps to specify the policy challenges ahead.

Of course, the region's economic structure and performance are quite diverse. Growth experiences vary from "a few countries experiencing consistent long-term growth, a few experiencing long-term stagnation and decline, and the majority experiencing growth between 1960 and 1973, decline between 1974 and 1994, and renewed growth since 1995" (Ndulu et al. 2007: xi-xii). Likewise, there are obvious and fundamental differences, even between neighbouring countries, with regard to the sectoral composition of the economy, technological capabilities, export performance, etc. These differences partly result from country-specific factor endowment, but also from differences in governance performance, political stability, levels of exchange with regional and global markets, and other framework conditions.

Compared to other developing regions, however, there are also many conspicuous commonalities that justify our intent to make some generalizations for the whole region. Obvious commonalities are that the overall region displays comparatively low per capita incomes, low rankings on the Human Development Index, high poverty incidence and productivity growth slower than in other developing regions. Given this report's focus on framework conditions for enterprise development, this chapter specifically highlights five distinctive structural deficits of the region's enterprise structure that command the attention of policymakers:

- (a) Widespread and rising informality;
- (b) A “missing middle” and lacking upward mobility;
- (c) Weak inter-firm linkages;
- (d) Lack of export competitiveness;
- (e) Lack of innovation capabilities.

The policy implications discussed in this study of course need to be adapted to specific country situations.

3.1 Widespread and rising informality

High levels of informality persist throughout SSA. Although estimations of the size of the informal economy show remarkable differences among countries, informality in general seems to be highest in SSA when it is compared with other world regions. Since most new jobs are created in the informal economy, the relative size of the informal economy is increasing.

Measuring the exact size of the informal economy⁵ is not an easy task. Different definitions of informality lead to strongly divergent estimates of the size of the informal economy. Furthermore, any estimation is especially difficult for SSA due to the limited availability and low quality of data. Thus survey results and econometric estimates should be interpreted carefully.

Many studies cite Schneider’s (2005) estimates of the “shadow economy,” as he calls the informal economy. Schneider’s econometric approach provides estimates (see annex) of the shadow economy (in % of official GDP) in 2002/03 for 27 sub-Saharan African countries. These estimates range from 33% in Namibia to 63% in Zimbabwe.

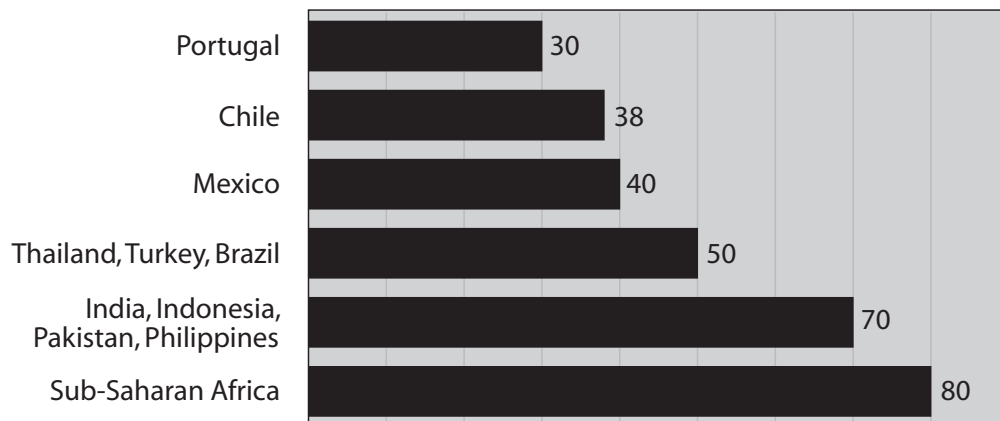
Comparing these data with the World Bank’s Enterprise Surveys, we see substantial divergence (see annex). This is probably to a large extent due to different measurement methods. The World Bank surveys use the difference between actual sales and sales reported to tax authorities as a proxy of informality. The surveys reveal huge differences across countries. However, there are serious doubts about the reliability of the data, e.g. with regard to the validity of voluntary responses about tax payments. In Botswana, for example, only about 53% of sales are reported to tax authorities by the average surveyed firm, whereas the percentage is 88% in Zambia. But can we really conclude from these figures that informality is more common in Botswana than in Zambia? In view of Botswana’s lower level of corruption and more successful socio-economic development, this is rather implausible.

⁵Throughout this document our use of the term “informal economy” follows Flodman Becker (2004: 8): “The informal sector is increasingly being referred to as the informal economy to get away from the idea that informality is confined to a specific sector of economic activity but rather cuts across many sectors. ‘Informal economy’ also emphasises the existence of a continuum from the informal to the formal ends of the economy and thus the inter-dependence between the two sides.”

It is necessary to distinguish between informality in rural and urban areas. According to the FAOSTAT database of the Food and Agriculture Organization (FAO), in 2000 nearly 180 million people (about a quarter of the population) were economically active in agriculture. A large part of this workforce consists of subsistence producers who only occasionally sell their surplus production, and many rural micro economic activities are non-formalized.

Regarding the levels of informal employment in the non-agricultural workforce in SSA, we find the following estimates in the literature. UNDP's Commission on the Private Sector and Development (2004) presents an estimation of the share of non-agricultural workforce that is informal. According to its figures, which it compiled from the World Bank and the International Labour Organization, 80% of the non-agricultural work force in sub-Saharan Africa are active in the informal economy. Figure 2 shows that this exceeds by far the estimates for more developed countries, but also for developing countries like India, Indonesia, Pakistan and the Philippines.

Figure 2. Estimated share of non-agricultural workforce that is informal



Source: UNDP's Commission on the Private Sector and Development (2004), p. 12.

Xaba et al. (2002) compile results from various studies showing that 61% of urban employment in SSA is in the informal economy and as much as 93% of new jobs are created in the informal economy. As a consequence, the size of the informal economy continues to expand relative to the formal economy. According to Orwa (2007), informal (self-)employment in Kenya increased from 4.2 million persons in 2000 to 5.1 million persons in 2002, and this accounted for 74.2% of total employment.

Flodman Becker (2004), citing various documents of the International Labour Organization (ILO), reports that the informal economy represents 92% of total non-agricultural job opportunities for women in SSA, with 95% of these jobs performed by self-employed persons and only 5% by people with paid-employee status. Chen (2004) provides some figures to confirm that informal employment is generally a larger source of employment for women than for men in SSA: 84% of non-agricultural women workers are informally employed, compared to 63% of men.

Mead (1994) differentiates the informal economy between poor people who are pushed into self-employment by a lack of employment alternatives (“supply push,” in his terminology, or “necessity entrepreneurship,” according to the Global Entrepreneurship Monitor) and those who have identified promising business opportunities and are thus pulled into self-employment by market opportunities (“demand pull” or “opportunity entrepreneurship”). Mead’s research in Southern and Eastern Africa suggests that supply push explains the major share of informality in the region.

More recently this has been confirmed for different countries in SSA by various authors who find rapidly increasing levels of informal self-employment and attribute this mainly to the limited employment opportunities in the formal economy. This is reported by Nelson and de Bruijn (2005) for the United Republic Tanzania and by Sandefur (2006) for Ghana and Uganda. For Kenya, Bigsten, Kimuyu and Lundvall (2004: 710, 703) also observe that the reason why necessity entrepreneurship is prevalent is that “compared to his formal competitor, the informal African entrepreneur is generally less experienced and less educated (...)” and the “(...) [informal] sector is generally a second-best choice for those unable to find or keep positions in the formal sector.”

However, some studies also find evidence of opportunity entrepreneurship. Nelson and de Bruijn (2005), for example, state that for some opportunity entrepreneurs the informal economy provides a low cost arena for experimentation as it offers greater flexibility to adjust business activities and—for instance—the labour inputs. All in all, however, studies from SSA largely confirm the neo-structuralist perspective that highlights not administrative burdens but lack of entrepreneurial skills and behaviour as well as other internal deficits of the firm as the most binding constraints for growth.

3.2 A “missing middle” and little upward mobility

Countries of sub-Saharan Africa typically display a firm size distribution characterized by a large number of micro and small enterprises on the one hand and a small number of large enterprises on the other hand. Hardly any micro and small enterprises grow sustainably and make the transition to medium-sized or even large enterprises.

Enterprise structures in SSA are mostly characterized by a large base of micro and small enterprises, a small number of—often either foreign- or state-owned—large enterprises, and a low number of medium-sized enterprises in between the two poles. This “missing middle” creates an important disadvantage for countries in SSA “(...) because medium-sized firms may combine the advantages of flexibility, quick decision-making, commitment, close contacts with customers etc. with certain scales of production. (...) Medium-sized firms, as well as some highly professional small enterprises, often occupy specific niche markets—often in the “interstices” left over by larger firms. By doing so, they expand the specialization spectrum of a given locality. Such firms are, therefore, crucial for articulating small and large firms and for bridging the technological gap between both poles of the enterprise structure” (Altenburg/Eckhardt 2006: 23).

Sandefur (2006) provides data on changes in employment by firm size in the Ghanaian manufacturing sector between 1987 and 2003 (table 2). The data show a strong increase of employment in micro and small firms (<20 employees), relative stagnation at a low level in medium-sized firms (20-99 employees), and a marked decrease of the employment share of large firms (>200 employees). The average firm size thus decreased significantly.

Table 2. Ghanaian census data on number of manufacturing firms and employment

Size	1987				2003			
	Firms	%	Emp.	%	Firms	%	Emp.	%
1-4	2,884	35	7,400	5	14,352	55	35,834	15
5-9	3,391	41	21,264	14	7,829	30	48,982	20
10-19	1,101	13	14,306	9	2,427	9	30,784	13
20-29	310	4	7,235	5	541	2	12,405	5
30-49	232	3	8,594	5	401	2	14,538	6
50-99	191	2	13,116	8	287	1	18,270	8
100-199	114	1	15,866	10	124	0	16,819	7
200-499	74	1	22,596	14	87	0	26,240	11
500+	52	1	46,707	30	40	0	39,644	16
Total	8,351	100	157,084	100	26,088	100	243,516	100
Ave. Size	19				9			

Source: Ghana Statistical Service, *National Industrial Census 1987, Phase I Report*, and *2005 National Industrial Census Bulletin No. 1*.

Note: Size categories and average size refer to employees per establishment.

Source: Sandefur (2006), p. 28.

This example points to the fact that few micro and small firms manage the transition to medium-sized or even large firms. In a study of nine countries⁶ in SSA, van Biesebroeck (2005: 577) describes this lacking upward mobility as follows:

“(...) transitions between size classes or movements in the productivity distribution are very slow, especially at the top of the size or productivity distribution. Large firms remain large, and more productive firms remain at the top of the distribution. Smaller and less productive firms have a very hard time advancing in the size of productivity distribution.”

He finds that for over eight years only a negligible share of micro and small firms has managed to grow into the “large” category.⁷ Also, it is rare for micro and small firms to cross the 25-employee threshold. Many existing large firms did not grow out of small firms: “Entering as a large or medium firm is equally common as transitioning to large or medium size from all smaller size classes combined.” (van Biesebroeck 2005: 569) In his detailed analysis of the Ghana manufacturing census, Sandefur also finds that a number of firms do graduate to higher size classes, but there are few cases of substantial expansion and in particular no movements of firms from the smallest category to the largest category.

⁶He analyses data from the World Bank’s Africa Regional Programme on Enterprise Development (RPED) surveys for Burundi, Cameroon, Côte d’Ivoire, Ethiopia, Ghana, Kenya, United Republic of Tanzania, Zambia and Zimbabwe.

⁷Van Biesebroeck mentions that the size categories in the data vary slightly but that in general micro firms have fewer than 5 employees, small firms between 5 and 25 to 50 employees (varying by country) and large firms more than 100 (in Zimbabwe more than 200) employees.

What are the reasons for the low growth dynamics of micro and small enterprises? UNECA (2005) identifies lacking knowledge of bookkeeping and market analysis as an important reason. This leads to weak business plans and severely constrains the growth potential of micro enterprises in SSA. Roy (2004) confirms a lack of planning among micro enterprises in Benin, Burkina Faso, Niger and Togo. Lack of market information is also typical for micro enterprises. Most owners simply opt for a certain business activity because of personal experience, and they rarely carry out market research and invest in detailed business plans. The planning cycle (production/purchasing of product X–selling to customer–production/purchasing of product Y) is typically very short as “many commerce microenterprises buy and sell whatever they can get their hands on at a good price” (Roy 2004: 23). This behaviour also limits long-term growth potential. These findings again support the perspective that internal weaknesses are the most binding constraints for micro and small firm development. Investing in human capital would thus be more important than cutting red tape.

3.3 Weak inter-firm linkages

Inter-firm linkages in SSA are weak. This applies to linkages between the informal and the formal economy. Many firms are barely integrated into value chains, and existing chains tend to be short. Inter-firm specialization in local clusters is limited. Existing networks of ethnic business communities exclude indigenous African firms.

Linkages among small and large, modern and traditional, or domestic and international enterprises in value chains or through clusters have a number of positive effects which ultimately contribute to company competitiveness. Cooperation allows firms to reap economies of scale and scope. Innovations, learning and skills development can evolve from interaction among firms. Geographic agglomeration of firms can increase the local availability of skilled labour, inputs and machinery. At the same time, concentration increases rivalry among firms, which is another important driver of innovation and competitiveness (Altenburg/Eckhardt 2006).

For SSA these positive effects of linkages and clustering have been confirmed by McCormick (1999) for clusters from the clothing (Kenya, South Africa), vehicle repair (Ghana, Kenya), metal products and fish sectors (both Kenya). In general terms, however, the hoped-for positive effects seem to be quite limited in SSA. Case studies in the United Republic of Tanzania and Kenya, for example, show that “linkages between the small-scale and large-scale sectors are weak, and backward linkages are particularly weak between small-scale manufacturing and agriculture” (Lawrence 2005: 1132). Foreign investors were reluctant to develop domestic linkages because they “found it simpler to provide a package of fixed and working capital inputs which matched the technology they supplied.” (Ibid: 1128)

Weak linkages between micro and small enterprises and larger firms are related to the “missing middle” phenomenon. Yumkella and Vinanchiarachi (2003) assert that sourcing from micro and small enterprises by large firms in SSA is difficult because of the huge gap regarding product standards and constant supplying. Specialization of micro and small

enterprises in niche markets and as suppliers to major mass customization firms is mostly missing. Kappel, Lay and Steiner (2004) conducted a survey of 265 micro and small enterprises from 10 different sectors, mostly in urban areas, in Uganda. They find that most enterprises are not engaged in any formal relationship with other enterprises. Their survey shows that 65% have never had any formal link with other enterprises and 80% have never had a subcontracting arrangement with medium or large enterprises. Ishengoma and Kappel (2006: 12) observe that:

“... the nature of the linkage relationships that seem to exist in developing countries is one whereby large, formal enterprises supply input to informal enterprises. (...) The forward linkages (i.e. informal enterprises supplying formal ones) while reported to have a positive effect on the performance of informal firms, are not very prominent in developing countries.”

The weakness of linkages between large and small firms is problematic for future private sector development in the region. Since small firms lack access to market information, finance and business services, regular interactions with other firms, especially with modern medium-sized and large firms, could be an important alternative channel for learning, technology adoption and trade credit, all leading to productivity growth. In addition, regular interaction with the formal economy creates an incentive for formalization.

Another specific feature of SSA is that where business networks do exist, these are often exclusive, with closely connected insiders but weak or almost no linkages to outsiders. In his analysis of characteristics of networks, communities and markets in SSA, Fafchamps (2001 and 2004) stresses the need, in the absence of formal institutions, for businesses to build trust as a means of ensuring contract enforcement. There is evidence that informal institutions among ethnic networks are better developed and increase efficiency as they provide privileged access to input factors and reduce the risks of opportunistic behaviour. Biggs and Shah (2006: 3061) present evidence from the World Bank's Africa Regional Programme on Enterprise Development (RPED) surveys to “show that the social capital in minority ethnic networks confer major benefits on member firms, facilitating larger size at entry, higher productivity, and faster growth.” Eifert, Gelb and Ramachandran (2005) come up with similar findings for SSA in their evaluation of the World Bank's Investment Climate Assessments.

3.4 Lack of export competitiveness

A low number of businesses export a relatively low number of products, mostly of scant technological content, to global and regional markets. Integration into global value chains is an exception. The region's share in global trade is decreasing. In this regard, comparison with the export-led development in Asian developing countries is telling.

Fafchamps, Teal and Toyé (2001: 53) have claimed that “exporting out of Africa is currently the only promising avenue for growth [as] the link between exports and growth seems indisputable [thus] a dramatic rise of exports out of Africa is essential for sustained

growth in the continent as a whole.” Bigsten et al. (2004) show for Cameroon, Ghana, Kenya and Zimbabwe that exporting impacts positively on productivity, ruling out a self-selection effect of efficiency-increasing firms that opt to enter the export market. Bigsten and Söderbom (2005) argue that compared to other world regions, the technological gap to developed countries is largest in SSA. Interaction with foreign firms and customers therefore creates extraordinary opportunities for rapid technological learning. Thus the challenge for the private sector in SSA is to increase the number of exporting firms and to combine integration into global value chains with efforts to enhance technology transfer. Given the existing technological gap, however, this is a huge challenge.

The most recent Economic Report on Africa (UNECA 2007) once again highlights the poor export performance of SSA. According to Ackah and Morrissey (2005), trade policy reform and liberalization since the 1980s have, for most countries, resulted in an increase in imports, though without any comparable increase of exports. Although some countries in the region have recently increased the value of their exports considerably, three limiting factors need to be considered:

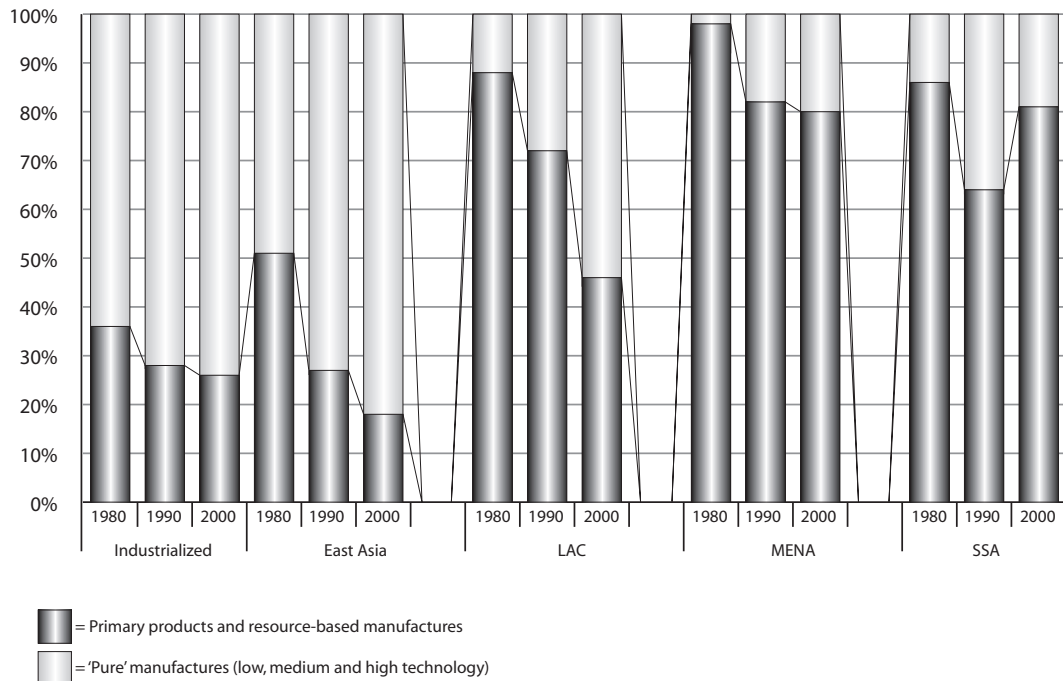
- (a) Most of this increase in trade value can be attributed to increasing exports of oil and raw materials, and it thus benefits a small number of countries and a few large enterprises, e.g. in the upstream oil sector.
- (b) The share of world merchandise exports remains below 3% and the export pattern shows little diversification, which makes the exporting private sector in SSA extremely vulnerable to global price shocks.

There are “alarming signs of de-industrialization” (UNIDO 2005: 13). Technologically, the export structure of countries in SSA was relatively more advanced in the 1990s than it is today. Although South-South trade is increasing, SSA’s manufacturing exports to the South amount only to US\$ 15 billion, and these are of scant technological content. Figure 3 shows that primary products and resource-based manufactures account for more than 80% of regional exports.

Clarke (2005) uses the World Bank’s Enterprise Survey data to compare the export performance of seven countries⁸ in SSA with that of China, India and the Philippines. Manufacturing exports were equivalent to 3% of GDP for the countries in SSA in 2002, compared to 18% in the three Asian countries. Exports as a share of total output amounted to 12% on average in the SSA countries, compared to 22% in the Asian countries. Given the huge availability of labour in SSA, Clarke highlights the potential advantages of exporting labour intensive goods to capital-rich industrialized economies. But he finds that especially small and medium enterprises (except from Ethiopia) mainly export to neighbouring countries.

Rankina, Söderbom and Teal (2006) find evidence that firm size, foreign ownership and skills are significant determinants for exporting in Kenya, Ghana, United Republic of Tanzania,

⁸Ethiopia, Kenya, Mali, Mozambique, Senegal, United Republic of Tanzania, Uganda and Zambia.

Figure 3. Technology structure of exports by main regions

Source: Lall/Kraemer-Mbula (2005), p. 15

South Africa and Nigeria. Typical indigenous African small enterprises that lack entrepreneurial and management skills thus contribute little or nothing to exports from the region.

3.5 Lack of innovation capabilities

The innovation capabilities of the private sector in SSA are very limited, and supporting innovation systems are weak. Even if innovation is understood as introduction of a known product, production technology or process that is only new to the local environment, the rate of innovation is low.

As Oyelaran-Oyeyinka (2007) points out, although innovation happens in every country, the nature of innovation and innovation processes varies according to a given economy's stage of development. All countries of SSA are at a development stage where existing innovative activities are focused on minor improvements in products or processes and largely confined to learning by using existing foreign technologies. Very few firms pursue systematic research and development activities (see also Gamba 2005). Innovation processes in SSA are thus largely related to diffusion and only rarely to inventions.

Although it is generally difficult to measure innovation and innovation capacity in the private sector (especially in developing countries, where there are very few companies applying for patents), the few reliable figures available concerning innovation show that SSA

lags clearly behind other developing regions. The Africa Competitiveness Report 2007, published by the World Economic Forum (WEF 2007), includes hard data as well as the results from the annual Executive Opinion Surveys, which covered 2,374 senior management respondents in 29 African countries in 2007.

Executive Opinion Survey data are available for the categories “technological readiness,” “business sophistication” and “innovation.” On a scale from one (worst) to seven (best) SSA⁹ scores 2.71 on “technological readiness,” lagging behind Latin America and the Caribbean (3.42) and Southeast Asia (3.30). “Business sophistication” in SSA scores 3.57 (Latin America and the Caribbean: 4.26, Southeast Asia: 4.33), and “innovation” reaches 3.05 (Latin America and the Caribbean: 3.25, Southeast Asia: 3.48).

Data on the certification of firms likewise reflect disconnection from international production standards. Quality management systems potentially increase productivity by optimizing the production process and institutionalizing its regular revision and improvement. Wolf (2007) reports data on ISO 9000 certification for 1997–2003 which show that within this period the number of certified firms increased only slightly, with the total number of certified firms remaining well below 100 in most countries.

Successful innovation in industrialized and more advanced developing countries results in most cases from intensive cooperation and feedback loops between firms and supporting institutions, including universities, research centres and vocational training institutions. In most SSA countries very little headway has been made in developing such linkages. Universities, for example, devote very few resources to research and are rarely in a position to provide innovative solutions for the private sector (Rippin 2007). According to Wolf (2007), figures for scientists in R&D per million people range from a couple of dozen to some hundred for the SSA countries reported on. Moreover, only very few research institutions in the region have gained international reputation.

⁹Including South Africa, which raises the average values for SSA in all pillars of the GCI as it is the highest ranking country in SSA.

4. Selected aspects of the regulatory business environment and their impact on private sector development in sub-Saharan Africa

Reforms of the regulatory business environment have received broad attention among national policy makers as well as within the donor community, and in many countries they figure as an important part of private sector development policies.

The following three areas of reform have been especially influential in contemporary private sector development programmes and will therefore be discussed in detail in this chapter:

- (a) **Reforms to ease business registration** and the acquisition of licences are seen as key to stimulate the formalization of businesses. The resulting increased entry of formal firms is expected to enhance competitive pressure and crowd out inefficient firms, thereby accelerating the diffusion of new business practices and raising productivity.
- (b) **Property titling** is supposed to enable even the poor to use land as collateral to obtain formal bank credit. It is also assumed that security of ownership provided by formal titles will stimulate land markets and increase incentives for long-term investments.
- (c) **Simplification of labour regulations** is presumed to be good for growth by enabling firms to flexibly adjust the workforce to demand peaks respectively downturns.

Following we will briefly summarize the rationale underlying each of these three areas of reform and review available evidence from sub-Saharan Africa in order to test whether they have had the alleged effects on enterprise growth, productivity, and social inclusion. More specifically, the question is whether these reforms contribute to resolving the structural deficits analyzed in the previous chapter.

4.1 Reforms to ease business registration and the acquisition of licences

Burdensome procedures and regulations consume time and financial resources. These transaction costs cut into the resources that can be used for core business activities. Moreover, higher entry barriers and levels of bureaucratic “red tape” are seen as a major cause of informality and corruption. Choosing informality or trying to circumvent procedures by bribing officials is a rational behaviour for business owners if the associated costs are lower than those associated with formal compliance. Doing Business 2007 (World Bank/IFC 2006: 12) states that “each procedure is a point of contact—an opportunity to extract a bribe.” And indeed, an econometric analysis by Djankov et al. (2002) finds that countries with heavier regulation of entry show higher corruption and more informal economic activity. Simplifying and even abandoning unnecessary regulations is therefore seen as an important step towards creating a better business environment and enhancing productivity growth.

However, two qualifications are necessary. Firstly, certain regulations are necessary, e.g. to protect consumers, and they often even benefit businesses. Arthur (2006) notes that in Ghana manufacturing product safety and other quality were long ignored because of a widespread assumption that consumers would purchase products anyway. However, as competition increased and Ghanaian firms tried to increase exports, the lack of a national quality assurance system became an obstacle. Compulsory standards can thus be beneficial for a country’s competitiveness. Te Velde (2006a: 1) rightly argues that:

“... few would object to improved and streamlined business regulation. (...) Yet this is not the end of the story. Is less regulation always better? The simple answer to this is no. A key dilemma facing business regulation is to ensure an optimal level of regulation, not just a minimum level of regulation.”

Secondly, different studies do not concur on how important administrative entry barriers like cumbersome registration procedures really are for PSD. Klapper et al. (2006: 1,2,32) note for European firms “that costly regulations hamper the creation of new firms, especially in industries that should naturally have high entry. These regulations also force new entrants to be larger and cause incumbent firms in naturally high-entry industries to grow more slowly,” thereby slowing down the productivity enhancing process of competition and selection. Van Stel, Storey and Thurik (2007) investigate the effects of business regulations on the formation of new enterprises for 35 countries (although few of these are developing countries and only South Africa is included from the African continent). They find that minimum capital requirements seem to lower business start-up rates across countries, but they find no evidence that number of procedures, time and cost to start a business have a significant impact on start-up rates. The authors:

“... do not subscribe to the view that heavily ‘regulated’ countries (in terms of entry regulations) need only to reduce such ‘burdens’ in order to become more enterprising and by implication more wealthy. What seems more likely is that entry regulation influences the distribution of business activity between the formal and the informal economy, rather than influencing the total volume of activity. (van Stel et al. 2007: 16)

Focusing on developing countries, Bennett and Estrin (2006) construct a model of entry of entrepreneurs in a new market to study the effects of bureaucratic delay and license fees. As assumed, they find that the two factors serve to reduce entry. But they also find that if the entry fee is zero, excessive entry takes place. If the entry fee is raised from zero, welfare first increases and then declines, thus suggesting that regulatory barriers of certain levels increase welfare.

Doing Business 2007 (World Bank/IFC 2006) provides examples of reforms that have successfully reduced unnecessary regulations: Madagascar reduced the minimum capital requirement to start a business by 80% and sped-up the registration process by relocating legal clerks to one-stop shops; in Burkina Faso it is now possible to obtain the professional licence as well as company, and tax and social security registrations at a one-stop shop; Ethiopia and Uganda have sped up business registration and Mozambique and United Republic of Tanzania have simplified their business licensing regimes. It is also reported that Benin, Burkina Faso, Cameroon, Gambia, Madagascar, Malawi, Mali, Mozambique, Niger, Nigeria and Zambia all began to simplify business regulation in 2006. The report predicts that while these first reform measures may seem small, they will give rise to growth opportunities and attract investors.

The—already well-documented—business licensing reform in Kenya is a case where business registration and license acquisition has been made easier. In 1998 the Government of Kenya established a new single business permit (SBP) to replace the former system where businesses had to obtain various licences for each business activity. In view of the fact that many businesses had been reporting the licensing process to be a serious barrier to their development, this reform has proven to be a sensible measure. The benefits of the reform are plainly evident in that it is now easier and less costly for businesses to register, and the costs for local authorities have declined as well. Decisions concerning the introduction of the SBP as well as on licence fee levels have been left to local authorities. An early study by Abuodha and Bowles (2000) revealed two effects of the reform. Firstly, license fees rose regardless of whether a business was located in an SBP-administrative area or a non-SBP-administrative area. The direct registration cost was thus not affected. Secondly, compliance costs, i.e. the indirect costs involved in dealing with public administration, in fact declined in the SBP areas. Another study by Gamsler (2003) provides us with some interesting figures on Kenya's change to the SBP. According to him, at the peak level of the deregulation project the government spent £400,000 per year, whereas the reform is estimated to save businesses £3.8 million. Gamsler claims that (2003:7) "few other means of promoting private sector development show this return on investment. Moreover, as smaller firms are the hardest hit by excessive and inappropriate regulations (...) Kenya's smallest firms will be the largest beneficiaries from this reform."

If burdensome entry procedures encourage businesses to stay informal, it is plausible to assume that easing entry barriers would serve to decrease informality. However, it remains to be seen whether reforms also increase the numbers of start-ups, induce formalization and, above all, bring about sustained enterprise growth and innovation. At present it is

difficult to present empirical evidence that easing business registration has the claimed huge impact on productivity, economic growth, and poverty. As Kenyon (2007: 9) argues,

“... measures to reduce the costs of entry are unlikely to be sufficient in the absence of positive incentives or “carrots.” Common sense suggests that linking these changes to access to other resources, such as training, finance and the provision of physical infrastructure may be even more effective.”

4.2 Property titling programmes

Peruvian economist de Soto (1989, 2000) argues that even the poorest in the informal economy own assets that should be formally registered in order to be eligible for use as collateral to obtain bank credits. As long as assets are not registered, they remain “dead capital.” The state should therefore provide title deeds and secure property rights effectively (e.g. World Bank/IFC 2004-2007 and Safavian/Fleisig/Steinbuks 2006).

Land as a key factor of production is as relevant in SSA as in any other world region. The conflicts arising from the (re-)distribution of land in many countries in SSA are well known. Land in rural areas is mostly administered in some form of customary land management, whereas in urban areas we find an amalgam of customary and statutory land rights. In general, the absence of formalized property titles in rural and urban areas is seen by many as a key constraint to PSD in SSA.

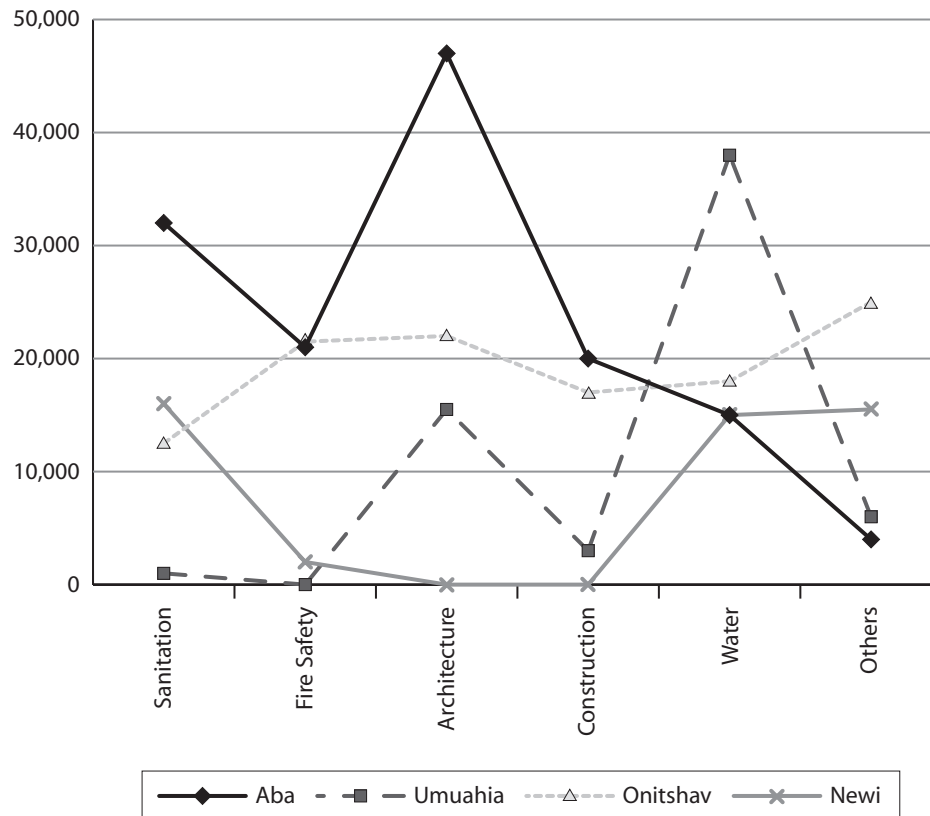
Toulmin (2005) states that in Western Africa only 2-3% of land is held on the basis of a written title, whereas figures for East and Southern Africa are significantly higher—a circumstance mainly due to registered land occupation by large commercial farmers and not to higher levels of registered property among smaller businesses in urban or rural areas. According to Klein (2006), however, property titling has gained momentum in SSA.

Box 1: How regulations vary on the subnational level

License fees are an important source of revenue for local authorities in SSA (Abuodha/Bowles 2000). According to Fjeldstad (2006), business licences generate between 5-30% of own local government revenues in urban councils.

Several studies highlight the high variance of levels of regulation and license fees even on the subnational level. Agboli and Ukaegbu (2006) for example show this for the costs for selected permits in four Nigerian towns.

Average official cost of obtaining selected permits in four Nigerian towns



Source: Agboli/Ukaegbu (2006), p. 18.

This may have different reasons. First, varying levels of regulation may reflect specific characteristics (and cost structures) of different localities. Local authorities may, for instance, offer services in different quantities and qualities. Second, different levels of regulation may result from rent-seeking by local bureaucracies. Third, different levels of capacity of public authorities may explain variations on the subnational level.

Differing costs of permits are therefore not per se an indicator of over-regulation. In the first case, they would be justified. In the second case, policy reforms should focus on deregulation, whereas in the third case it may be more important to raise the administrative capacities of the less efficient authorities.

Inconsistent application of regulations is frequently reported to be a greater burden for businesses than the number of regulations as such. A business climate survey (GTZ/KPMG 2006) conducted in the Mozambican provinces of Manica, Sofala and Inhambane showed that lack of transparency and consistency of interpretation of regulations in particular is perceived by businesses as a serious obstacle.

Box 2: Addressing sector-specific business environment issues on the basis of value chain analysis

The Engineering Capacity Building Programme (ECBP) is a key part of Ethiopia's industrialization strategy, and it is jointly implemented by the Ethiopian Government and German Development Cooperation. Priority sectors of the programme are: leather, textiles, pharmaceuticals, and agribusiness. The main goals consist in fostering competitiveness and employment. A strong focus is on increasing exports and (foreign direct) investment.

The ECBP addresses business environment issues as a key part of the programme and applies a specific methodology to address sector-specific constraints. The programme started with extensive stakeholder workshops to identify bottlenecks of any kind that constrain enterprises along the whole value chain of the respective sector. This yielded a number of interesting insights:

- (a) Constraints in the business environment differ considerably across sectors and locations. In the pharmaceutical sector, for example, guidelines for public tenders practically excluded domestic manufacturers because they required a minimum range of 100 different products. Together with the sector business association, GTZ successfully lobbied for changes in this regulation. As a result, Ethiopian manufacturers won public orders of over 6 million EUR within the first four months since the change was effected.
- (b) Stakeholder consultation revealed constraints related to the regulatory business environment as well as challenges in other fields such as lack of market knowledge, technical and management skills as well as outdated technology. Policy interventions therefore focus on a broader set of issues.
- (c) The Doing Business indicators seem to overstate some problems. The DBI ranked Ethiopia 149th in 2007 with regard to trading across borders. According to the report, it takes 45 days and US\$ 1.700 to export and 52 days and US\$ 2.455 to import a 20-foot, full container load of certain categories of textile products. GTZ's in-depth analysis shows lower figures. Export may take 7-22 days and is associated with direct costs of up to US\$ 900 plus 0.25% of the value of goods. Import can take 10-39 days, with direct costs of up to US\$ 1.800 plus 2.9-3.5% of the value of goods.
- (d) Delays in the trading process are reported to be caused by a lack of administrative capacity e.g. among customs officials and clearing agents rather than the number of procedures as such. This suggests that what is needed is capacity building rather than, or in addition to, administrative simplification.

Source: Personal interviews with Valerie Schuster and German Müller, GTZ Ethiopia.

Box 3: Ways of improving the regulatory business environment

The in part burdensome regulatory business environment for the private sector in Mozambique is described by FIAS/USAID (2001). Since 1999 UNIDO has been assisting the Government of Mozambique to establish one-stop shops—Balcão de Atendimento Único (BAU)—in three provinces (Cabo Delgado, Tete, Zambezia). Making existing laws public, the BAUs reduce bureaucracy by making enterprise registration and licensing more transparent. Through their work they also collect information on bottlenecks in the application of existing law, and these data then serve to provide the government with hard facts, paving the way for targeted regulatory reforms. In cooperation with the Provincial Directorate of Industry and Commerce (DPIC), UNIDO provided assistance to a BAU that already started operation in 2004 in Cabo Delgado. Since then the BAU has provided information and eased and encouraged registration for several hundred enterprises. Among them were established businesses that had been operating informally as well as start-ups. Information on bottlenecks in existing regulations stimulated reforms for the industrial and commercial sector as DPIC used this feedback to speed up decision-making through delegation of decision power to the BAU. UNIDO's support contributed significantly to a better business environment not by changing laws and regulations but by making them more transparent, at the BAU, for the public and private sector and by providing capacity building for the BAU's staff.

However, red tape is still widespread in the regulatory business environment in Mozambique, especially in sectors where decision-making power is delegated only in part from the national ministries to the provincial directorates (e.g. tourism and transport sector). Recently a business climate survey (GTZ/KPMG 2006) conducted in the provinces of Manica, Sofala and Inhambane showed that lack of transparency and consistency of interpretation of regulations in particular is perceived by businesses as a serious obstacle.

Two observations are worth highlighting: Firstly, reforming the regulatory business environment is a political process. It needs to be acknowledged that the bargaining process for decision power often does not allow quick wins. Secondly, inconsistent application of regulations is frequently reported to be a greater burden for businesses than the number of regulations as such. Improving service delivery, increasing transparency and building trust between the public and the private sector is thus of the utmost importance for successful reform.

In South Africa, GTZ's South African Local Economic Development project is implementing a low-cost and consensus-oriented local red tap reduction process (see Rucker/Wegmann 2006). The change process is supported by an external independent facilitator and aims at the identification of local reform champions. The process is demand oriented, as local stakeholders define the reform agenda. Public-private-dialogue leads to the identification of bottlenecks for the private and public sector alike. Screening of these problems for issues that are primarily within the responsibility of the local level

make it possible for public and private stakeholders to reach agreement on specific reform measures. The main focus of this approach is in the first place on kick-starting reform and result-oriented dialogue, achieved by initiating a series of quick reform measures. The process thereby builds the trust and capacity at the local level needed for constant monitoring and targeted reforms of the local business environment. The underlying philosophy is that “starting small and building local momentum before taking on larger challenges is important to sustainability” (Hindson/Meyer-Stamer 2007: 19).

Source: Personal interviews conducted with public and private sector stakeholders in Mozambique and with UNIDO and GTZ staff in Mozambique and South Africa in September 2007; UNIDO (2007).

With regard to PSD the following positive effects of land titling are put forward in theory and are highlighted by proponents of the neoclassical approach:

- (a) Increased access to capital, as newly titled owners can use their property as collateral to obtain formal credit;
- (b) Better access to public infrastructure services (electricity, water, ICT) for formally registered plots;
- (c) Increased security minimizes the risk of loss of investments in premises because of arbitrary expropriation;
- (d) Better allocation of land resources due to lower costs of property transfers. Transaction costs fall as it becomes easier to access information about property status. This stimulates land markets, which in turn leads to more efficient land use patterns;
- (e) Increased investment and growth as a result of the previous effects.

Following the ideas of de Soto, parts of the literature on the informal economy claim that property titling is especially pro-poor because current inefficiencies hit micro enterprises hardest.

Now what does empirical evidence from SSA tell us about the impacts of property titling? In general Toulmin (2005: 44,45) argues that “evidence from research in sub-Saharan Africa shows that many of the benefits assumed to stem from land titling are not automatic, and, in some circumstances, titling may have the opposite impacts from those expected.”

Based on our literature review we want to differentiate this statement by highlighting the following two points.

Firstly, evidence of increased access to credit and higher levels of investment as a consequence of obtaining a property title is patchy for SSA. A summary of six case studies (Ethiopia, Ghana, Mozambique, Namibia, Niger and Uganda) by Kanji et al. (2006) finds little evidence of poor groups that use land as collateral, even if they hold property titles. The main reasons seem to be that the risk of losing land is felt to be too great and that even for persons with registered land, regular employment and income are the more impor-

tant, if not the key, factors involved in obtaining a loan from a bank.

Deiningering et al. (2007), in a publication for the World Bank, also state that in the rural African context titling has little potential to increase credit access, thus challenging the main argument of the World Bank's titling programmes.¹⁰ Table 3 (taken from Biggs/Shah 2006) also fail to show any systematic relationship between a title to property and receiving supplier credit or a bank loan at start-up.

Furthermore, Brasselle, Gaspart and Platteau (2001) find for Burkina Faso that land borrowing and lending transactions take place within family relationships or other networks. In this constellation trust and security are reinforced because of the desire to keep such relationships going, and so borrowing arrangements are frequently renewed or not easily ended. This leads the authors to suggest that tenure security on lands that appear to be held under a rather doubtful arrangement may in fact be much higher than what this arrangement seems to suggest at first sight. As these traditional arrangements are sufficient to stimulate investment, and also enable land transactions, the authors see no immediate need for government interventions, e.g. designed to introduce centralized procedures aimed at formalizing land rights.

Table 3. Finance characteristics of small and medium enterprises

	Kenya	Tanzania	Zambia	Zimbabwe
Pct. receiving supplier credit	30.3	11.8	19.2	66.4
Avg. years of supplier relation	8.5	7.9	8.6	12.0
Pct with title to property	37.4	37.1	47.9	43.2
Pct. rec. any bank loan at startup	24.6	8.2	11.4	11.2

Source: Enterprise Surveys 1990s, Regional Program on Enterprise Development, World Bank.

Cited in: Biggs/Shah (2006: 3051).

Secondly, land titling is a sensitive issue that has often resulted in anti-poor concentration processes in SSA. Toulmin (2005) describes situations where land registration, in fact intended to achieve clarity over ownership, may cause disputes when elite groups assert claims to land, especially of smallholders who lack resources to defend themselves. Furthermore, holders of secondary land rights (e.g. women and herders) may be in a worse position after registration since their rights are usually not set down in the registry.

The World Bank recently acknowledged disappointing results from land titling programmes in SSA and questioned the approach that has been used so far:

“In fact, hardly any of the countries that introduced legal reforms with much fanfare have succeeded in developing, let alone rolling out, a low-cost system for land administration at a scale that is sufficiently large to provide an option for

¹⁰In 2003 the same author had still claimed that property titles have a strong effect on credit (Deiningering 2003).

the majority of the poor. This made it difficult for many of the expected benefits from such legislation to materialize, implying that the poor often continue to be excluded from formal systems and vulnerable to land loss. More generally, failure to implement land legislation has raised doubts regarding the technical, institutional, and political feasibility of such reform.” Deininger et al. (2007: 1)

Studies on the distributive impact of land markets in SSA show different results. Baland et al. (2007) show for Uganda that land market transactions mitigate initial inequality in land endowments rather than leading to a concentration process of land in the hands of a few. Kanyinga (2000), in contrast, shows increased inequality in land ownership as a result of land tenure reform in Kenya. He finds an increasing gap between a group of economically and politically powerful landowners and the group of the landless and powerless. Nissanke and Sindzingre (2005) claim that traditional land rights have a security and equity function as they ensure certain access to land even for the very poor and thereby protect against the risk of falling below the subsistence level. Individualization of these traditional land rights may undermine this function by leading to land concentration.

Finally, Stamm (2006) reports a failed land reform from Côte d’Ivoire. Starting at the beginning of the 1990s, the Ivorian government tried to design and enact a new land act; to date, though, this land reform has not proven successful. Originally it was planned to provide certificates to everyone who held any form of a land use right. But this was not done, and consequently, for instance, the rights of herders were not taken into consideration and pressure to speed up the overall process made it as good as impossible to resolve unclear ownership situations. According to the author, this caused disregard for the traditional mechanisms used to identify rights to land. Even though the proposed new land law has not been enacted to date, the tensions caused by the preparatory work for it have contributed considerably to destabilizing the country. Badly implemented reforms may thus be worse than no reforms at all.

This review of the literature leaves us with a sceptical view on land titling in SSA. Anti-poor results are reported in various studies. So far provision of property titles does not seem to have significantly increased access to credit. Furthermore, many Africans are sceptical about, or even reject, land market reforms in a way that is expressed in a provocative statement by Manji (2006: 141):

“A new language has to be learned: the language of private property, payoffs and productivity, and of efficiency, exchange and incentives. In this triumphalist vision of economic rationality, a ‘disembodied homo economicus’ will sweep aside solidaristic social relations and practices of subsistence.”

On the other hand it is plausible to assume that formally recognized land rights protect the vulnerable and that functioning land markets are important if the private sector is to reap economies of scale, expand businesses, and thus create new employment.

Given the unclear empirical evidence and the political opposition, it is essential to raise the credibility of reforms by making them both more inclusive and more home-grown.

Above all, it needs to be acknowledged that manifold informal institutions and customary land management systems exist in SSA. Some authors thus advocate building on existing local customary land rights. This would have several advantages. In particular, an approach of this kind would make it possible to adapt to local conditions and to strengthen decentralization, with local authorities and people developing ownership of the process. Furthermore, given the administrative capacities in many countries in SSA, it may be easier to start small rather than embarking straight off on ambitious nationwide reforms.

4.3 Simplification of labour regulations

The debate over the right balance between the protection of workers and the flexibility of labour laws needed to bring about efficient levels of employment for businesses has generated a huge body of literature. Rigid labour laws are often identified as a severe growth constraint for businesses, as the former may discourage firms from hiring new workers even if growth opportunities exist. In *Doing Business 2008* only 11 countries out of 45 from SSA rank in the top half of the indicator “employing workers”.¹¹

Botreo et al. (2004) find in their analysis of 85 countries, among them 13 countries from SSA (excluding South Africa), that heavier regulation of labour increases unemployment, especially among young people. The *Doing Business Report* likewise argues that “more flexible labor regulations boost job creation” (World Bank/IFC 2007: 19). Also not surprisingly, this indicator has been heavily criticised and blamed for stimulating a race to the bottom since the first edition of *Doing Business*. Recently a paper by the International Labour Organization (ILO) argues that *Doing Business* takes:

“(…) a simplistic ‘regulations are costs’ perspective that negates many of the beneficial externalities associated with labour laws” [that it] “(…) suffers from overly rigid assumptions—a worker with 20 years of tenure working in a firm with more than 200 employees—that is not representative of the world of work, particularly in developing countries.” [and that] “(…) [t]he index is based on a myopic view of the labour market that if adhered to cannot guarantee improved economic performance or employment. It thus sends misleading policy messages that, if implemented, risk hurting workers but also business and the economy in general.” (Berg/Cazes 2007: 18)

¹¹This term was introduced in the 2007 edition to replace “hiring and firing,” which had been used in the 2004-2006 editions. It should be noted that the re-labelling was at first not accompanied by any change in the scope of the indicator and thus did not reflect the heavy criticism which had been articulated by Bakvis (2006) and others. The latest edition of *Doing Business* has now changed the methodology: “For employing workers, improvements were made to align the *Doing Business* methodology with International Labour Organization (ILO) conventions. It is now possible for an economy to receive the highest score on the ease of employing workers—indicating the most flexible labour regulations—and comply with all 187 ILO conventions. Two main changes were made. First, the calculation of firing costs was modified so that 8 or fewer weeks of salary now receives a score of 0 for purposes of calculating the rankings on the ease of employing workers. Second, restrictions on night work such as higher overtime premiums or limitations on scheduling work hours are no longer coded as rigidities.” (World Bank/IFC 2007: 68) However, this was followed immediately by continued criticism of the indicator formulated by the International Trade Union Confederation (ITUC 2007) and presenting various country cases in which the “employing workers” indicator and World Bank policies are said neither to reflect on poor outcomes of past reforms nor to give due consideration to impacts on the poor.

With regard to countries in SSA, the critique of the underlying assumptions of the indicator indeed seems justified. Enterprise Surveys show that if we exclude South Africa, less than 15 per cent of firms have more than 100 employees, and the Ghanaian census—presented in chapter 3, above—also shows that very few firms employ more than 200 workers. Moreover, the critics point to the assumption that workers will be more productive if job security and working conditions (e.g. more paid vacation days or restricted working hours) improve. On the other hand, rigid labour laws that limit the benefits of formal employment to a small share of the working population can be seen as anti-poor. They widen and perpetuate the gap between the unemployed and the employed, thus preventing the emergence of a dynamic labour market that would reduce inequality by enabling more people to get access to formal employment. Moreover, rigid labour laws do not allow wages and employment to be adjusted in accordance with variations in productivity among firms.

So there are good reasons for flexible labour markets. This idea was also given prominent place in the structural reform programmes of the 1990s in SSA. But the impact of labour market deregulation was, according to Johanson and Adams (2004:50), rather disappointing in SSA:

“The failure of the formal sector to generate enough wage employment to absorb all labour market entrants has drawn attention to the need for labour market reforms. As a consequence, structural adjustment programs have given considerable attention in the past decade to the review and reform of labour codes that create costly barriers to labour mobility and impede wage flexibility, especially in francophone countries. Although such reforms may be important, little evidence has emerged to suggest that reduced labor regulation is a spur to employment growth and demand for skills.”

Furthermore, new research shows that wage flexibility seems to be much higher in SSA than was generally assumed. Kingdon, Sandefur and Teal (2005) analyse employment data for Ghana, United Republic of Tanzania, Uganda, Ethiopia and South Africa between the end of 1980s and 2000. They focus on three aspects of flexibility of wages and employment: (a) the ability of real wages to decline over time, (b) the tendency for wages to adjust in the face of unemployment, and (c) the extent of wage differentials between sectors and/or firms of various size. Interestingly, they find that the labour markets in the five countries have been quite flexible regarding the first two aspects. Wages and employment has seen erratic changes, indicating that economic dynamics are reflected by both, and this in turn suggests that labour laws are not distorting labour market dynamics. However, the authors also confirm the third aspect, noting the existence of substantial wage differentials between firms and sectors, especially a high income divide between those working in large firms and those who do not.

It is reported for countries all over the world that large firms pay higher wages than small ones. But this effect seems to be particularly marked in developing countries. In a study on Cameroon, Ghana, Kenya, Zambia and Zimbabwe this was confirmed by Strobl and Thornton (2002). The authors can only partly explain this wage premium in larger firms by identifying observable worker characteristics that explain a large share of it. This

suggests that larger firms employ persons with higher observable human capital. Söderbom, Teal and Wambugu (2005) also confirm this phenomenon for Ghana and Kenya, but they, too, are unable to explain it to the full extent. They suggest that labour markets may work differently in poor and rich economies because of structural differences between these countries. Based on our general analysis of PSD in SSA, we subscribe to the idea that much of the wage premium in larger firms can be explained as due to the very limited availability of skilled workers in SSA. Sender, Cramer and Oya (2005) who investigate disparities in the quantity and quality of labour supply in SSA, remind us that we should be careful with such over-generalised statements, but they also provide us with a comprehensive overview of labour supply in SSA that mostly supports the thesis of the limited availability of skilled workers. We therefore underline our assumption that reforming labour laws with a view to increasing flexibility will not solve the problem that firms are forced to compete for scarce skilled labour, and that this leads to increasing wages.

To conclude, even if there is a need to reform labour laws, this is unlikely to have a strong impact on private sector performance. The Africa Competitiveness Report 2007 (WEF 2007) provides us with two interesting findings that support this argument:

- (a) Only slightly more than 10% of firms in low-income countries in SSA perceive labour regulations to be a growth constraint. The report suggests that this constraint is relevant for firms in upper-middle income countries, but only three countries belonging to this group are included in the Enterprise Survey sample (Botswana, Mauritius and South Africa).
- (b) The availability of skilled workers has a bigger impact on employment creation than lowering labour regulations.

The fact that few firms in low-income countries report problems with labour regulation may be explained in part by non-compliance. Siekpe and Greene (2006: 244), for example, describe the characteristics and impact of Ghana's Minimum Wage Act (No. 1495 of 1990) and general labour regulations like this:

"[It] provides that the minimum wage shall not apply to persons working less than 27 hours per week, piece workers, share croppers, sea-going personnel or apprentices. Labour legislation in Ghana sets a minimum employment age of 15 and prohibits night work and certain types of hazardous labor for those under 18. However, observance of minimum age laws is eroded by local custom and economic circumstances that encourage people to become wage earners at an early age."

4.4 Summing up: What regulatory business reforms contribute to enterprise development

Overall, the results of regulatory business reforms are mixed. Reforms to ease business registration and the acquisition of licences seem to have the most favourable impact,

saving businesses substantial amounts of money and time. However, there is no evidence that these reforms contribute to improve enterprise performance, e.g. helping micro and small enterprises to increase productivity and to leap into higher size categories, or become competitive in new markets. Furthermore, some regulations are necessary, and what bothers entrepreneurs is often inconsistent application of regulations rather than the number of regulations as such.

Property titling programmes have not yielded the hoped-for results in SSA. Property titling has not improved access to credit significantly. Furthermore, it has sometimes resulted in anti-poor concentration processes in SSA. Unless complemented with additional enterprise support programmes, property titling is not an important driver of enterprise development in the region.

With regard to the simplification of labour regulations, there are cases of over-regulation that create costly barriers to labour mobility and reduce wage flexibility. Again, however, there is little, if any, evidence to suggest that reduced labour regulation triggers employment growth and demand for skills. Few African enterprises perceive labour regulations to be a growth constraint. Shortage of a skilled workforce seems to be a much greater limitation than inappropriate regulations.

On the whole, there is a lack of empirical evidence on the development impacts of the ongoing regulatory business environment reforms. Since most of the reforms in SSA have just started, it may, though, still be too early to ask for demonstrated impact. Evaluating the reforms will yield meaningful results only in a couple of years. However, the coming Doing Business Reports should be able to provide increasing evidence of development impact.

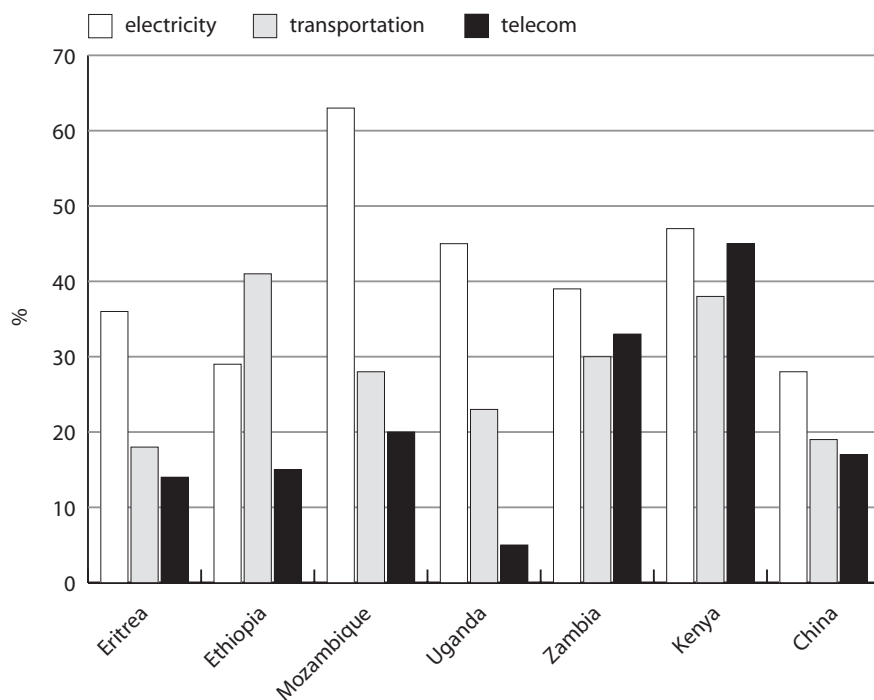
5. General investment climate issues

Beyond the regulatory business environment, i.e. the enterprise–bureaucracy interfaces that are the subject of the Doing Business Reports, a number of elements of the overall investment climate are of undoubted importance for PSD in SSA. These are well known and generally accepted and will therefore be summarized only briefly. Four elements stand out for their overall importance:

- (a) **Good governance** is an overarching issue for PSD in SSA. Having put the topic of good governance high on the agenda through the African Union and the New Partnership for Africa's Development (NEPAD), African governments have accepted their responsibility to improve the performance of the public sector. This is an important step, but it has to be acknowledged that severe problems persist in the region. Unstable political conditions, if not outright conflicts and crises, have been present in SSA during the last decades, and peacebuilding and political stability are still issues of the utmost importance for many SSA societies. According to Transparency International, levels of corruption are still very high in many sub-Saharan African countries. Likewise, the rule of law can still not be taken for granted in many countries there. All this creates uncertainty and investment risks and thus hampers economic development.
- (b) **Lack of adequate infrastructure** is arguably one of the major challenges for PSD (see figure 4). Along with an undersupply of telecommunication services (see Eifert/Ramachandran 2004), the World Bank's Enterprise Surveys identify unreliable electricity supply as the most severe problem for the private sector. Despite improvements, poor regional transport networks and intercontinental connections are still a major obstacle for doing business in many countries in SSA (see for instance OECD/AfDB 2006). The poor quality and limited availability of information and communication technologies (ICT) become apparent if we consider that World Development Indicators for 2003 show that only 8.5% of the population were fixed line or mobile phone subscribers and only 2% were registered internet users. Eifert and Ramachandran stress that these figures are a result of high costs for ICT in SSA. So even where ICT infrastructure is available, many people cannot afford to use it.

(c) **Low levels of education are still widespread in SSA.** Although the proportion of people receiving secondary education in SSA doubled from 10% in 1980 to over 20% in 2000, SSA lags far behind East Asia (almost 40%) and South America (about 30%) in this field (see World Bank 2004). According to the World Development Indicators, gross tertiary enrolment was on average lower than 6% in 2003. Basic education indicators are also disappointing, with a primary education completion rate of only 61% in 2004 and literacy rates below 60% (ages 15 and older), where data is available (see World Bank 2006).

Figure 4. Percentage of firms citing infrastructure as a major or severe constraint



Source: Eifert/Ramachandran 2004, p. 25.

(d) **The underfunded health sector** is not able to cope with HIV/AIDS and other diseases that are a serious challenge for PSD in SSA. HIV prevalence is 6.2 % on average among 15–49 year olds in the region, but it is even dramatically higher (20-40 %) in Southern African countries (see World Bank 2006). Absenteeism due to illness or in the worst-case permanent inability to work clearly affects the production and productivity of firms. Shrinking numbers of skilled and experienced workers in the labour pool due to low life expectancy because of AIDS and other diseases is a dire socio-economic development. World Development Indicators for 2003 show that life expectancy in SSA is only 46 years compared to South Asia, the next lowest region, which has a figure of 63 years.

In a nutshell, there is no good investment climate without comprehensive socio-economic development. Neglect not only of infrastructure but also of social development backfires on the economy.

6. Abandoning the assumption of a “level playing field”—the case for targeted and selective private sector promotion in sub-Saharan Africa

In the previous chapters we have argued that, given the wide range of cumbersome and unnecessary regulations for economic activities, it is important to adopt measures to simplify business registration and the acquisition of licenses, to advance property titling and reform labour regulations where necessary. We have also shown, however, that there is no evidence that such reforms are sufficient to enable firms to grow and upgrade technologically. While it is obvious that cumbersome regulations discourage the formalization of enterprises with growth potential, it is far from clear whether reforms of the regulatory business environment would make a significant change for the vast majority of informal enterprises.

The Doing Business Report has the merit of drawing attention to the multiplicity of unnecessary and cumbersome regulations that hamper private sector development as well as to the need to develop a benchmark that receives much public attention and creates pressure for reforms. But it tends to overstate the relevance of the regulatory business environment. In fact, there is no evidence that the structural weaknesses of the private sector in sub-Saharan Africa identified in chapter 3—widespread informality, a missing stratum of dynamic medium-sized firms, little upward mobility in the enterprise sector, low levels of inter-firm division of labour and specialization in the value chain, lack of export competitiveness and innovativeness—can be overcome by focussing on regulatory simplification. Other constraints, such as low technical and entrepreneurial skills as well as lacking access to investment capital and market information, may be much more binding. Empirical evidence suggests that entrepreneurial, technological and institutional learning are complex and slow incremental processes. They require learning at the firm level as well as trying out new practices in public institutions and new cooperation and network arrangements within and between the private and the public sector.

This chapter suggests some policies and specific support programmes that may accelerate and deepen such learning processes. We do not attempt to provide a comprehensive overview of private sector support policies. The focus here is on showing how targeted and selective policies can, in a manner complementary to regulatory business reforms, make valuable contributions to addressing some of the key problems for PSD in SSA.

6.1 The role of active government support for private sector development

Empirical evidence shows that where countries have managed to build lasting competitive advantages, this was in almost any case achieved on the basis of concerted public-private efforts. Governments have always had an important role in creating incentives to invest in new technical and entrepreneurial skills, facilitating collective action, developing and ensuring all kinds of quality standards, motivating investors to surmount technological lags, or avoiding too strong trade shocks that might have wiped out entire industries. And even today they continue doing so in all major industrialized countries (see Cimoli et al. 2006; Fagerberg/Godinho 2005).

We are fully aware of the fact that active and targeted private sector support has often not yielded satisfactory results in the past. Governments and donors too often stimulate the supply-side and neglect market opportunities; budget allocations are made without having the capacity to monitor outcomes; lobbyists often exert influence on spending patterns and sometimes manage to capture part of the budget; some programmes may distort incentives and crowd out private service providers; and few programmes achieve broad outreach (see DCED 2000). As Rodrik (2007: 2) argues, however, the same shortcomings apply to almost any policy area, including, for example, health and education policies; but no one would seriously argue in favour of doing away with public health and education policies. The question is thus not whether governments should be involved but how.

Any effort to strengthen the entrepreneurial culture in countries where governance is weak and cultural practices often discourage business success, and any effort to increase the quality of public support systems where bureaucracies lack customer orientation and efficiency, requires time. Government and donor interventions in entrepreneurial skills and public sector efficiency must therefore be viewed as long-term investments. They are probably indispensable for building up those modern institutions that form the basis of competitive advantages in more advanced industrial economies, even if they do not yield path-breaking results within the lifespan of a particular development programme. Seen from this modest perspective, some government and donor interventions can in fact demonstrate important achievements with regard to creating nuclei of change in the private sector and the public sector of sub-Saharan Africa. Such interventions are presented in chapter 6.3. Before we turn to these examples, however, some good practices of service delivery are presented that should always guide government and donor interventions.

6.2 Good practices of service delivery

Many donor activities in support of the private sector lack a clear business orientation, provide inappropriate services that have not been tested in the marketplace, and lack financial sustainability because they do not charge cost-covering fees. Since subsidies per beneficiary tend to be high, such programmes necessarily fail to reach out to a significant part of the potential target group. Moreover, programmes may benefit the politically well-

connected rather than those that really need them. And finally, subsidized business development services (BDS) may even crowd out private service providers and thus hamper the development of service markets. This well-founded critique has been voiced with regard to industrial policy in general (see Pack/Saggi 2006), and donor programmes in particular (see DCED 2000).

This critique led to a new paradigm among donors. Efforts are now increasingly being focused on private service providers and market-based incentives. The “market development paradigm is driven by the belief that the objectives of outreach and sustainability can only be achieved in well-developed markets for BDS, and not by direct provision by donors and governments.” (DCED 2000: 5) Hence it is crucial to separate BDS funding and facilitation (e.g. quality assurance and upgrading of providers, programme evaluation) from service provision, which should be left to (mainly private) providers and delivered on a commercial basis (see Hitchens/Elliott/Gibson 2004; World Bank 2003).

Expecting micro and small entrepreneurs to purchase at cost-covering prices the whole range of BDS that would be optimal from a public welfare perspective, is however quite unrealistic, especially in poor SSA countries with limited entrepreneurial development—firstly because many services are fully or partly public goods, and the respective services are not fully privatized even in the richest countries; and secondly because many micro and small entrepreneurs may be too poor, too uneducated and risk-averse, and may have short-term preferences that hinder them from investing optimally in enterprise services. In addition, public BDS providers, already established, are likely to stay, and it may therefore be more effective to improve their performance than to pin hopes on the development of private markets (see Altenburg/Stamm 2004).

Practical experience therefore suggests a combined approach that builds on markets wherever possible and applies the principles of New Public Management to public providers. Furthermore, a stronger focus on outreach is needed. Especially where public programmes deliver services directly to the firm level, outreach is in most cases insufficient, markets may be distorted and rent-seeking behaviour encouraged. Substantial outreach may be achieved quite easily where customers are ready to purchase services at cost-covering prices—either because the benefits of a service are immediate and clearly visible (e.g. transportation) or because compliance with certain standards is made compulsory and enforced in practice (e.g. pollution control).

In most BDS, however, achieving outreach is a challenge. Better service quality at lower prices will obviously help. In addition, some creative solutions have already been implemented successfully to upscale different types of services. These include:

- Providing BDS through the Internet and providing village level web access;
- Making use of other mass media;
- Encouraging large enterprises, especially lead firms in value chains, to include more and poorer suppliers and distributors in their networks and provide services for them. Partnerships with NGOs, governments and donors often help to reduce transaction costs;

- Encouraging firms to engage in BDS provision for their local business community as part of Corporate Social Responsibility programmes;
- Building practical support for micro and small enterprises into the curricula of vocational schools.

At the end of the day, however, it needs to be acknowledged that certain development goals, including human capital formation and empowerment of poor micro entrepreneurs and employees, do require carefully targeted temporary public support.

The following set of principles should be applied to any government and/or donor engagement aimed at reforming the business environment (based on DCED 2000; Altenburg/Stamm 2004; Hausmann/Rodrik/Velasco 2005):

- Carry out market assessments prior to any intervention in order to identify where markets actually fail and public intervention is required, and to avoid distorting prices and crowding out private service providers;
- Improve the accountability of government agencies and service providers by giving them clear mandates and obligating them to report on their achievements and make the reports widely available;
- Monitor and evaluate performance so that funding and delivery of BDS can be evaluated and compared with private providers;
- Separate funding from service delivery and establish a direct link between performance and the next round of resource allocation;
- Make co-financing by the recipient business compulsory. This makes it possible to weed out companies that are only interested in subsidies and unwilling to risk their own capital;
- Create competition among service providers, e.g. through open and transparent competition for public funding. Competition for public funds not only helps to identify the most appropriate service providers but also increases financial discipline and encourages bidders to come up with innovative solutions. Encouraging competition with private providers is an efficient means to create discipline for public providers;
- Involve the private sector, especially representatives of the target group, in the design and supervision of public support programmes.

6.3 Selected policy interventions for private sector development

This section provides examples of selected policy interventions that address especially important growth constraints for private enterprises and require some corrective measures to address market failures.

6.3.1 Improving state-business relations

Improved state-business relations can be assumed to contribute to a better understanding of private sector needs by the government and thus to a more efficient allocation of resources in the economy. A government that is informed through regular meetings with the private sector about investment climate problems will usually have stronger ownership for reforms. Being in constant dialogue with private investors is also necessary to enable public officials to assess where markets can be expected to work and where they are likely to fail and to offer or withdraw public support accordingly. This can create trust between the public and the private sector, make policies more predictable, and thus minimize risks for the private sector. It can also lead to jointly planned, financed and implemented public-private initiatives to deal with coordination failures and public goods.

Based on these considerations, te Velde (2006b) undertakes an interesting attempt to measure state-business relations for 20 countries in SSA between 1970-2005. He finds that better relationships are associated with faster growth and correlate positively with other governance indicators and, for example, the Doing Business Indicator “trading across borders.”

Of course there is a risk that state-business dialogue and cooperation may be used by politically well-connected groups to lobby for their own particular interests. Rent-seeking and even corruption may be undesired consequences. State-business relations should therefore be transparent and open to as many stakeholders as possible.

Regarding the informal economy, Nelson and de Bruijn (2005) argue that voluntary formalization must be based on an exchange transaction between informal enterprises and the government. The latter offers a legal status with associated rights, and in exchange the enterprises are expected to comply with government regulations. To activate this process, however, it is necessary to negotiate the terms of formalization, rights and regulations in a bargaining mechanism between the state and small scale sector associations. Such a process has recently been documented by Orwa (2007) for Kenya. In August 2005 local *jua kali* (informal economy) associations formed an umbrella body (the National Informal Sector Coalition NISCO) which gave the numerous small associations a more powerful voice and led to first results, including a large hawkers market in Nairobi, allocation of titled land to NISCO members, and allocation of 2 billion shillings for a revolving loan fund administered jointly by NISCO, microfinance institutions and the government.

6.3.2 Supporting innovative entrepreneurship

Chapter 3 of this report identified a lack of innovative and internationally competitive enterprises, especially indigenous African enterprises. Entry of micro and small firms is obviously not the problem. Across all countries of the region, new firms are constantly being created while others disappear. However, the Schumpeterian dynamism of “creative destruction” and constant search for more productive recombinations of production factors that drives innovation and productivity growth is obviously not working here, or is at least very slow. Despite high entry and exit rates, productivity growth is a good deal lower in SSA than in other regions (Ndulu et al. 2007).

We assume that the most likely explanation for this is the combination of a huge surplus of unskilled labour and low absorptive capacity of the formal labour market that leads to “supply push” or “necessity” entrepreneurship: persons with low skill levels and little working capital account for the vast majority of new entries of firms in SSA. Furthermore, these skills have usually been acquired through apprenticeships in other local micro-enterprises and therefore do not add innovative perspectives to the local skills pool. Few of them have been exposed to market environments with different consumption patterns (e.g. foreign countries or urban areas, where wealthy customers demand a differentiated range of products), and this makes it difficult for them to perceive product innovations. This in turn creates a situation where new firms again and again replicate old business models in the very limited number of activities that are easy to access without new skills and significant upfront investments. The result is fierce competition and low and stagnating productivity.

In addition, several disincentives exist in SSA that discourage entrepreneurial behaviour and the pursuit of capital accumulation. For example, contracts are difficult to enforce, it is not easy to protect properties, and entrepreneurial success may encourage relatives to claim their share and public officials to extract bribes. On top of this, entrepreneurial success is not always well regarded in African societies.

Secure property titling and other regulatory business environment reforms can be expected to encourage entrepreneurship. However, given the multiple problems obstructing entrepreneurship—lack of access to finance; low levels of schooling, entrepreneurial and technical skills; lack of exposure to non-traditional markets; cultural preferences; etc.—it is less likely that this will be sufficient to unleash entrepreneurship, especially in poor communities. Modern entrepreneurship programmes across the world increasingly adopt an integrated approach that combines measures designed to increase the social acceptance and appreciation of entrepreneurship with business plan competitions, training programmes, financial support for start-ups, provision of shared infrastructure in business incubators and coaching by “business angels” from successful private companies. Most programmes are implemented in close cooperation with networks of business people, chambers of commerce and public institutions (Altenburg/Eckardt 2006).

Given the low percentage of indigenous African firms among modern large and medium-sized firms, Biggs and Shah (2006) propose targeting education and training support to these firms. Within this group, students of universities and technical colleges as well as repatriates with international business experiences and market exposure may be especially encouraged because of their potential to develop new business models and explore non-traditional markets. Box 4 shows how UNIDO supports an Entrepreneurship Curriculum Programme that integrates sensitizing, training and business plan development with the introduction of a one-stop shop and business service provision.

6.3.3 Strengthening inter-firm specialization and linkages

Chapter 3 highlighted the lack of inter-firm specialization in SSA and pointed to the problems this creates with regard to foregone learning opportunities and productivity growth. Creating supplier relations and fostering knowledge flows between modern enterprises

Box 4: An integrated programme for entrepreneurship development in Mozambique

The Mozambican government wants to increase the practical relevance of the education system. In cooperation with the Ministry of Education and Culture, UNIDO has, since 2004, provided technical assistance to implement an Entrepreneurship Curriculum Programme (ECP) for secondary and technical and vocational schools. UNIDO supports capacity-building of teachers and has assisted with curriculum development. The ECP consists of three components that build on each other to stimulate and strengthen entrepreneurship:

Attitude: Simple methods within the local economic environment (e.g. work for the community, contact with established entrepreneurs through visits to enterprises) are used to promote a sense of dignity of work and thereby to change the attitudes of students towards work and self-employment.

Opportunities: Students are encouraged to creatively identify business opportunities, especially with regard to their local environment. As a result, students are also encouraged to create initial capital.

Management: Students are provided with training in simple business management techniques (e.g. drafting a business plan, accounting and record keeping) and are familiarized with aspects of the regulatory business environment by visits of staff of the regional one-stop shop to empower them to start their own formal businesses.

The ECP is part of the larger UNIDO-supported programme “Micro and Small-Scale Industry Development in Cabo Delgado Province,” which also comprises other services (introduction of a one-stop shop, establishment of a private business service provider, HIV/AIDS prevention in the workplace), all of which make it possible to exploit synergies.

Since 2004 ECP has been implemented together with the DPEC as a pilot in Cabo Delgado. First experiences in the pilot schools are reported to have shown good results, e.g. a change of attitude on the part of students, an empowerment of young women and various new business projects and/or the upgrading of existing businesses (UNIDO 2007; Mate 2006).

The Government of Mozambique has now decided to extend the provincial pilot of the ECP on a large scale to all provinces. UNIDO will be providing technical assistance during this scaling up from 2007-2011. In 2007 already 42 schools, 220 teachers and 11.300 students are involved in the ECP. The government is planning to upscale the ECP by 2010 to several hundred schools in order to achieve significant outreach.

Source: Own field visit and interviews with programme officers.

and indigenous small scale enterprises is important to bridge the deep productivity gap between both poles of the African enterprise structure. It is well established that large buyers are important drivers of technological learning in value chains. There are several reasons for this (e.g. Kula/Downing/Field 2006; Schmitz/Knorrninga 2000):

- In modern value chains emphasis is placed on compliance with increasingly higher standards;
- Large buyers often target especially demanding export or high-end domestic markets;
- Suppliers are under the constant threat of being replaced by new sources;
- Some buyers actively support their suppliers.

Supplier relations thus provide SMEs with market access, new products and process technologies, and often even trade credit. Strengthening linkages can also be an adequate policy for opening exclusive business networks and for embedding the informal economy. As mentioned earlier, exclusive networks are quite common in SSA. Biggs and Shah (2006: 3063) argue that:

“Linkage programs’ and ‘cluster development initiatives’ could be important in underwriting some of the costs of building trust between networked firms and ‘outsiders’. (...) Subsidizing some of the costs of bringing firms together in various types of relationships or clusters may be beneficial in expanding the boundaries of networks and reducing the adverse effects of lock-in. Beyond this, broader efforts to help link-up SMEs, particularly indigenous-African firms, with foreign investors and larger indigenous enterprises, as potential suppliers, could help to compensate for some of the exclusionary effects and monopoly power of existing networks. ”

In an overview of donor approaches to supporting pro-poor value chains, Altenburg (2006) describes how governments can help to strengthen linkages. The report reviews international experiences with regard to linkage promotion and identifies five promising types of intervention:

- Awareness raising and matching events that help to make markets more transparent and set up first contacts between customers and suppliers;
- Incentives to support spillovers from lead firms to their suppliers, including co-financed grant schemes, tax incentives and “soft” Corporate Social Responsibility programmes;
- Provision of value chain finance, e.g. providing soft credit lines and credit guarantees to development banks in order to stimulate linkages and developing new financial instruments for supplier finance, especially factoring and warehouse receipts;
- Promotion of socially inclusive standards. Policymakers can inform and sensitize poor producers about standard issues, help to set up non-exclusive low-cost certification systems, and promote fair label and other standards that directly benefit the poor;

- Promotion of franchising as a way of providing local entrepreneurs with access to modern and viable business models.

As a general message, linkage programmes should always cooperate closely with the private sector, especially lead firms in those value chains that are crucial for a given country's pattern of international specialization. Investment promotion and linkage development should be closely coordinated to generate positive spillovers and prevent foreign investments from undermining national value chains.

An interesting approach to business environment reform through the value chain approach is presented in box 2 in chapter 4. It shows how value chain approaches can be used to identify sector-specific investment climate issues and tackle them through dialogue and joint action.

Zeng (2006) summarizes experiences of eleven studies on enterprise clusters in SSA. He identifies two origins of the clusters. One type constitutes a spontaneous agglomeration and the other type is government-driven, especially through the establishment of special business parks. Box 5 provides an example where GTZ is supporting the establishment of business parks in an effort to combine the provision of appropriate infrastructure and to encourage cluster synergies.

Linkage programmes have been successful in many African countries, especially in agricultural value chains. In Uganda, for example, 10,000 out-growers are integrated in a value chain project involved in the manufacture of textiles and garments as well as the export of semi-processed organic cotton. In another linkage project, 2000 smallholder barley farmers benefit from contracts and technology transfer from a transnational brewery. In both cases, donor agencies and local non-profit organizations are engaged as intermediaries who provide training and absorb part of the transaction costs involved in dealing with many smallholders. The examples thus demonstrate that (a) TNC linkages with local smallholder farmers in a poor and land-locked sub-Saharan country can be commercially viable and (b) that limited external support was necessary to start the projects (see Altenburg 2005).

Box 5: Combining appropriate investment conditions and cluster synergies in industrial zones in Ghana

The GTZ-supported Programme for Sustainable Economic Development in Ghana has been supporting the establishment of industrial zones with access to modern energy services and BDS in Brong Ahafo Region since 2006. Three factors make these industrial zones attractive for businesses:

Access to affordable land, as it is difficult for businesses to expand their premises in overcrowded urban areas due to high costs and land tenure problems. Furthermore, recently graduated apprentices are often unable to find land to open their own enterprises.

Reliable access to electricity, which was identified as a major constraint for private sector development in Ghana in the GTZ-supported AGI Business Climate Survey by the Association of Ghana Industries (AGI/GTZ 2006). Currently enterprises are scattered around residential areas, causing electricity network overloads, ecological hazards and nuisances for their neighbours.

Provision of business services. Apart from improved access to electricity, other business services are being offered to the enterprises in the clustered environment by business associations and other service providers.

One industrial zone has been established, in another four the procurement process has started, and four more are planned in different district capitals in the Brong Ahafo Region. Access to these zones is granted to formal and informal enterprises of different sizes, ranging from start-ups to medium companies with high growth potential. Currently, most applicants for land in the industrial zones are MSME engaged in car-repair, woodwork, metalwork and agro-processing. The management model for the industrial zones is adapted to local conditions and consists of a Public-Private-Partnership between business associations and District Assemblies.

Sources: Telephone interviews conducted in May/June 2007 and Daily Graphic 19/01/2007.

6.3.4 Promoting exports

The number of exporting firms has to be increased, as linking them to global trade will not only open up new markets but also lead to increased productivity because of learning effects. Bigsten and Söderbom (2005: 35) claim that:

“[...] to create incentives for African firms to strive to participate and be competitive in international markets (...) is the most likely route to better economic performance.”

Fafchamps (2001: 53,54) had differentiated earlier:

“Manufacturing exports from the continent to the rest of the world are likely to be part of successful growth in Africa as a whole. This is because manufacturing is capable of creating the rapid transformation required for catching-up with the West. This does not imply, however, that all African countries should seek growth through manufacturing exports. In the immediate term, such strategy is likely to be successful only in a handful of countries. (...) For the bulk of African countries, however, manufacturing exports are not yet in the cards. Their best options are elsewhere: agriculture, mining, and tourism.”

Subramanian and Matthijs (2007) identify the following factors for effective participation in global network trade:

- Competitive prices;
- Speed to market and flexibility, e.g. transport connections to different markets [as well as the ability to respond flexibly to customer demands regarding product variations—authors' note];
- Labour productivity, which includes, in addition to shop-floor productivity, improvement of education, skills training and health policies;
- Product quality, for instance guaranteed by implementation of standards and certification.

The system of metrology, standards, testing and quality assurance (MSTQ) institutions has lately become much more important for successful exports. MSTQ institutions are needed to ensure that product standards are in line with requirements of export markets, and they are a precondition for many innovations. As it is impossible to set up and sustain complex MSTQ systems in each country of the region, regional cooperation is required in this field. However, each country needs to undertake efforts to assist indigenous enterprises in their efforts to comply with standards (see Oyelaran-Oyeyinka 2007). The case of Nile perch, where the EU banned imports from some East African countries until they were able to set up reliable sanitary and phytosanitary standards, is an interesting case in point (Henson and Mitullah 2004).

An interesting approach that has seen some success stories in SSA may be seen in export processing zones (EPZs). Eifert, Gelb and Ramachandran (2005) highlight the positive role EPZs can play. EPZs are enclaves with high business density, and thus, thanks to the clustering effect, they are in a position to encourage technology diffusion and knowledge spillovers. For governments it is cheaper to connect EPZs to the infrastructure network than isolated businesses. Furthermore, creating good infrastructure conditions in EPZs can showcase the benefits of good infrastructure and one-stop service points for businesses outside the EPZs, thus strengthening pressure for reform. The authors refer to the cases of Kenya's agribusiness sector and the EPZs of Mauritius and Madagascar.

Box 6: Integrated support for enhanced export competitiveness: the case of Ethiopia's leather industry

In 2003 the Ethiopian government launched its Industrial Development Strategy and identified the following priority sectors: textiles and garments, meat, leather and leather products, construction industries, micro and small-scale industries. Leather and leather products have a substantial export potential for the country. Leather exports amount to more than US\$75 million, representing 7% of Ethiopia's exports. The government expects especially shoe production to increase from 6.4 million pairs in 2005/06 to 20 million pairs by 2010. Corresponding exports are expected to reach US\$300 million in 2010.

UNIDO has been supporting the Ethiopian leather sector since 1990. The organization assisted the Ministry of Trade and Industry of Ethiopia to prepare a Master Plan for the Ethiopian Leather and Leather Products Industry. The plan identifies as main problems of the tanning and footwear industry a shortage of high quality raw leather input (mainly due to parasites and bad slaughtering infrastructure) and a difficulty faced by firms in acquiring up-to-date technology and designs. Moreover, the Master Plan points to the problem of inadequately skilled workers along the value chain, with corresponding low productivity.

UNIDO now supports the competitiveness—especially with a view to export markets—and environmental sustainability of the industry along the overall value chain. Support comprises:

- Help to establish the Leather and Leather Products Technology Institute, which now provides 1-3 year training for students in the areas of tanning, shoemaking and technology and also offers short-term training for the leather industry;
- Establishment of effluent treatment plants for tanneries;
- Export promotion for leather products;
- Assistance to the micro and small footwear product units located in clusters in different parts of Addis Ababa, where there is a concentration of shops that sell locally manufactured footwear;
- Promotion of subcontracting (e.g. to Italian and German companies) to enable the Ethiopian leather sector to access the global value chain, which is regarded as crucial to increasing production and upgrading technology. The footwear value chain is a buyer-driven value chain where large buyers with core competences in branding and marketing are the driving actors in setting up the value chain;
- Help to create a better image for Ethiopian products through a “Made in Ethiopia” marketing concept. For example, the Ethiopian brand “Taytu” was quite successful at a Paris fashion show.

Sources: Own field visit and interviews with programme officers and MoFED (2006); MoTI / UNIDO (2005).

6.3.5 Developing financial services for SMEs

Access to, and cost of finance are reported throughout the Investment Climate Assessment surveys to be a severe problem for businesses in Africa. Better financial services are needed to address the problem of missing competitive and growth-oriented SMEs in SSA.

The success stories of microfinance are well known and the body of literature on this topic is large. However, the limitations of microfinance are also obvious, especially with regard to investment finance for growing enterprises. Put in a nutshell, there is a lack of affordable “meso-finance” solutions for SMEs:

- Interests rates of microfinance institutions are too high for medium and long-term investments;
- There tends to be a huge gap between the maximum loans provided by microfinance institutions and the minimum loans available from commercial banks; and
- More sophisticated and diversified financial products, like leasing, factoring and risk capital, are largely unavailable.

Honohan and Beck (2007) show that financing patterns of firms in Africa show some similarities, but also some striking differences, to those of firms in other regions. Especially remarkable is the very low percentage of external finance. Firms in Africa finance about 68 per cent of their investment needs with internal funds, a small share of investment with bank credit, a low number of investments with equity finance, a few investments with trade finance.

This points to weaknesses in the financial system. Furthermore, the fact that trade finance is hardly ever available reflects a lack of stable value chain relationships, contract enforcement problems as well as low levels of trust among indigenous African enterprises. Trade credit plays a role in networks within ethnic communities, but it is rarely provided for the large majority of indigenous African enterprises. Biggs and Shah (2006) note that negative stereotypes tend to prevail regarding the capability and trustworthiness of these businesses, and that these stereotypes lead to exclusion from ethnic networks. To enable better credit access for indigenous African enterprises, they suggest preferential public loans or programmes to tilt the allocation of government contracts for some length of time to these businesses with a view to re-establishing their trustworthiness.

Honohan and Beck (2007) also report that many observers of firm finance in Africa have found a missing middle in credit provision. Larger firms have access to the typically highly concentrated banking and finance sector in SSA, but banks are reluctant to provide loans for SMEs, since transaction costs for small loans are proportionally high, and investments are not always well managed, resulting in low repayment rates. Hammond and Kramer (2006: 51) illustrate the size of this finance gap:

“While microfinance is increasingly well provided for (although there is still huge unmet demand), loans top out at around a few thousand dollars. Above that is a vast gap—between a few thousand and \$500,000—where financing options are almost nonexistent. And it is precisely in this range—mesofinance—that successful small and medium-sized businesses in developing countries, seeking to expand, need investment capital, equipment financing, or loans. The gap is important because it is these businesses that provide most of the jobs and generate most of the new employment in every economy.”

This being the situation in Namibia, GTZ, the Development Bank of Namibia and Bank Windhoek joined forces for the “Post-loan Mentorship Programme” (see box 7).

Box 7: Post-loan Mentorship Programme in Namibia

In recent years, two of the four major commercial banks in Namibia have established SME desks. Since last year a public-private partnership between GTZ, the Development Bank of Namibia and Bank Windhoek has provided credit access in combination with business development services for SMEs. The partners pool resources so that a Namibian company specialised in business and consulting services can provide a mentorship programme to SMEs. The programme is made available to loan beneficiaries at a 98% discounted rate. Arguably this is a very high discount rate; however, the programme has just started and it is envisaged to raise the contribution paid by SMEs.

The owners of SMEs are given mentorship, which improves their business management skills, and consequently their credit repayment rate. This “credit-plus approach” supports SMEs in developing effective and efficient financial and operational systems. Moreover, it facilitates the development of networks and linkages and helps to achieve compliance with statutory requirements.

All this lowers the risk of non-repayment for the bank, thus increasing both the funds available and the willingness of the bank to make credit available to more businesses. The programme makes available to SMEs a credit segment that can be described as meso-finance and is designed to ensure that resources are better used.

Sources: Development Bank of Namibia (DBN) Newsletter Issue 17 April 2007.

7. Conclusions for private sector development in sub-Saharan Africa

The challenges for private sector development in SSA are manifold. The list can be derived from the unfavourable characteristics of the private sector in SSA, such as widespread informality, a “missing middle” of dynamic small and medium-sized enterprises, lacking upward mobility of micro firms and SMEs, low levels of inter-firm specialization, low quality standards and technological content as well as lack of export competitiveness and innovation capabilities.

“The difficulty most African countries will encounter in getting started on a high growth path partly relates to the wide range of constraints they face, given their limited fiscal space and institutional capacity.” (Ndulu 2006: 10)

Investment climate reforms in general, and a conducive “regulatory business environment” (in terms of lower costs of dealing with government regulations) in particular, are important preconditions for private sector development. However, there is no evidence that the recommended reform packages are sufficient to unleash private sector dynamism. Most importantly, there is no evidence that policies aimed at establishing a “level playing field” are pro-poor and appropriate to lift the workforce in the informal economy out of poverty. Some studies even point to partly negative poverty impacts. Thus a number of targeted support measures are required to address the above-mentioned challenges.

In keeping with UNECA’s report “Unleashing the Private Sector in Africa” (UNECA 2005), we advocate an integrated approach to PSD in SSA. Such an integrated approach would combine measures that improve the regulatory business environment and the investment climate, using selective and targeted policy interventions to improve the private sector’s access to finance (especially small and medium enterprises), to provide management and technical training, to provide a range of business development services, and to support inter-firm specialization and innovation capabilities. Especially with regard to widespread informality, we endorse Bigsten, Kimuyu and Lundvall (2004: 713), who conclude that

“[...] since a large part of the population will continue to depend on the informal firms for their sustenance for a long time to come, it is important that these firms are helped to become more productive, quite apart from helping them to graduate to the formal sector.”

Special public support schemes have not always been very effective in the past. There is no doubt that modes of delivery need to be improved. This report has identified some principles of good service delivery that need to be applied more stringently in the future, providing examples of programmes that can claim to have improved the business-enabling environment and promoted learning processes, at least locally.

Private sector development programmes for the countries of sub-Saharan Africa thus always require a combination of measures designed to reduce bureaucratic burdens and to boost public support. The appropriate mix depends on a number of country and location-specific factors: Market opportunities for example vary across regions as do entrepreneurial capabilities, the quantity and quality of available private services and the ability and service orientation of public providers.

On the whole, this study has shown that we have far too few data to determine the most binding constraints for private sector development. The Doing Business indicators make a valuable contribution in this regard, but they only measure a subset of relevant factors. Hence we can only speculate how important other factors—skills, distance to markets, market information, access to credit—are relative to the measured indicators. As this report shows, available evidence is patchy but indicates that the Doing Business indicators may not be the most appropriate ones to explain the performance of enterprises in SSA. In particular, neither time series nor cross-country comparisons exist to establish causal relationships between regulatory reforms and the performance of different segments of firms (e.g. by size or gender). Furthermore, the indicators assume a standard enterprise that is not typical for sub-Saharan Africa, and the indicators therefore tell us little about the growth constraints of the vast majority of micro and small enterprises in SSA.

The same, of course, applies for the special public support schemes discussed in chapter 5. We have drawn lessons from case study evidence but cannot support these observations with quantitative evidence. Hence there is an urgent need for research, particularly to identify the most binding constraints of the private sector in SSA, differentiating by firm size, informality, location, gender, etc., and correlating policy changes with changes in performance.

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Annex:

Informality in selected sub-Saharan-African countries

Compiled from Schneider (2005) and World Bank Enterprise Surveys
(www.enterprisesurveys.org)

Country	Schneider's estimates	World Bank Enterprise Surveys
	<i>Shadow economy (in % of official GDP) 2002/03</i>	<i>Sales amount reported by a typical firm for tax purposes (%)</i>
Angola	45.2	47.64
Benin	49.1	88.17
Botswana	34.6	52.78
Burkina Faso	43.3	79.28
Burundi	..	86.66
Cameroon	34.9	88.94
Cape Verde	..	92.90
Chad	48.0	..
Congo, DR	49.7	62.86
Congo, Rep.	50.1	..
Côte d'Ivoire	45.2	..
Eritrea	..	84.20
Ethiopia	42.1	..
Ghana	43.6	..
Guinea	41.3	..
Guinea-Bissau	..	67.06
Kenya	36.0	88.46
Lesotho	..	82.92
Madagascar	41.6	95.47
Malawi	42.1	69.72
Mali	44.7	74.47
Mauritania	..	52.38
Mauritius	..	91.88
Mozambique	42.4	..
Namibia	33.4	68.18
Niger	43.8	88.83
Nigeria	59.4	..
Rwanda	42.2	..
Senegal	47.5	19.52
South Africa	29.5	97.57
Swaziland	..	41.46
Tanzania	60.2	69.17
Togo	40.4	..
Uganda	45.4	76.71
Zambia	50.8	88.05
Zimbabwe	63.2	..



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