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Private Sector Development in Africa and Korea-Africa Development Cooperation

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Why Private Sector Development (PSD)?

Although Africa has witnessed outstanding economic performance, poverty remains prevalent throughout the continent since growth has not been translated into job and income creation. Still trapped within the confines of a mono-cultural economy, Africa's dependency on a limited inventory of primary goods, consequently leading to a shortage of added value and retreat into de-industrialization, hinders it from escaping the poverty trap. Unemployment is a deep-seated issue as industries lack the capacity to assimilate the 15 million young people joining the job market every year. Youth unemployment in South Africa, one of the

most developed countries on the continent, exceeds 50 percent.¹ The sustained high level of youth unemployment triggers security risks. History is evidence of its association to political violence and civil unrest, driving youth to join rebel groups in some countries. Projected population growth rates indicate the need to involve youth in innovative and creative activities. Social problems also still loom large, as access to affordable and reliable energy, sanitation and social welfare remains limited.

¹ Analyse Africa, <http://www.analyseafrika.com> (accessed January 11, 2016).

Neither have the Millennium Development Goals shown tangible outcomes on poverty reduction and economic growth in Africa. Accordingly, the development cooperation paradigm is shifting from government and institution-led development to private sector-led development. Focal areas of development cooperation with the aim of eradicating poverty are also changing from an emphasis on social development such as education and public health to economic development such as job creation and private sector development. Developing the private sector would be efficient in eradicating poverty on both the micro and macroeconomic levels. On a micro level, the increase of jobs would lead to an increase in income whereas on a macro level, an increase in tax revenue will support public investment in education, infrastructure and other areas that enhance the productivity and capacity of the poor. In order to achieve middle-income status by 2025, developing the private sector as a practical leading agent of economic transformation, increasing productivity and creating value is of paramount importance to Africa's economic and social development.

The current address of Africa's private sector

Africa's private sector is the "engine" of economic growth, as 80 percent of Africa's gross production, 67 percent of gross investment, 75 percent of gross credit and 90 percent of employment all stem from the private sector.² Although impressive in numbers, Africa's private sector has several distinctive challenges. First, the small size of most private firms hinders productivity and competitiveness. No less than 95 percent of firms in Africa are SMEs,

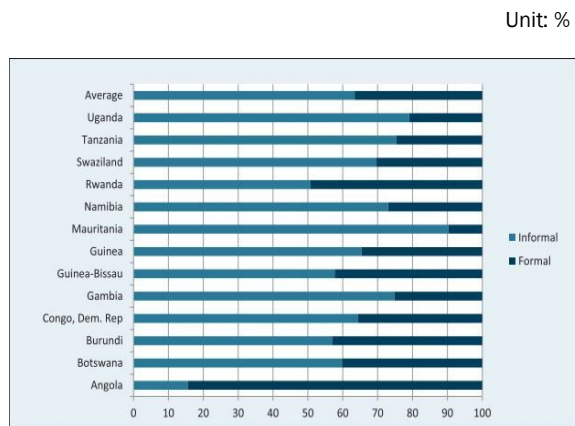
and of these, 90 percent are micro-enterprises.³ Micro-enterprises operate on a subsistence level with less than ten employees and are also often made up of family members or relatives. Unlike in advanced countries, SMEs in Africa receive little financial and administrative support in creating and expanding businesses. Consequently, they contribute little to technological innovation or regional development. However, while SMEs contribute only a small part to gross production, the sheer number of these enterprises means that they play the greatest part in job and income creation.

Moreover, these firms are largely based in the informal sector, making them difficult to identify and support. It is estimated that around 40 percent of total economic activities originate from the informal sector. The informal sector exists over a wide spectrum of industries including agriculture, manufacturing, distribution and services. Firms in the informal sector are unaccounted for and are outside the legal boundary, and therefore have limited access to basic infrastructure and financial services. Also, complex regulations, long registration processes, high administration costs, barriers to banking and other services discourage firms from registering legally, which increases the amount of dead capital.

² AfDB (2011), *Private Sector Development as an Engine of Africa's Economic Development*, p. 21, AfDB.

³ Fjose, Grunfeld and Green (2010), *SMEs and Growth in Sub-Saharan Africa: Identifying SME roles and Obstacles to SME Growth*, p.5, MENON Business Economics.

Figure 1. Distribution of micro-enterprises in the formal and informal sectors in selected African countries



Source: AfDB (2011), *Private Sector Development as an Engine of Africa's Economic Development*, p. 21, AfDB.

Other major structural factors that deter the growth of the private sector include financial exclusion, lack of infrastructure, deep-rooted corruption and excessive business regulations. In the case of financial services, commercial banks are reluctant to lend loans to SMEs due to the lack of pledged assets, larger risks and geographical inaccessibility. Micro-financing is another option for SMEs, but the size of capital is limited. SMEs are also reluctant to approach public financial institutions because they must submit numerous documents, pay high transaction costs and face high interest rates. As a result, SMEs are more accustomed to using rotating savings and credit-issuing mechanisms such as religious organizations, social clubs and credit cooperatives. In the case of infrastructure, transportation and energy networks are particularly lacking and underdeveloped, increasing production costs. For some landlocked countries, transportation costs account for 75 percent of total export prices. Africa also outruns other regions in terms of productivity loss. Power outages amount to 12 percent of total working hours in Africa compared to 7 percent in South Asia

and 1 percent in East Asia.⁴

The complexity of regulations and procedures in general in Africa is well illustrated in Djibouti, where it takes 37 days and 11 administrative procedures to register a business, costing 195 percent of per capita income. On the other hand, it takes 2 days, 2 procedures and 0.8 percent of per capita income in Australia.⁵

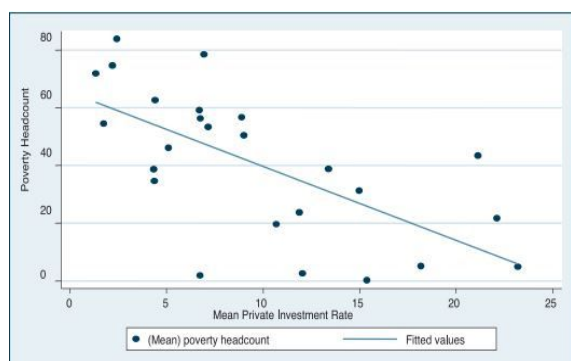
Identifying variables with high impact on Africa's PSD

Unlike other countries, because so many people are employed in SMEs, inclusive growth – inclusion of the poor in policy building and outcome sharing – is important for Africa's sustainable development. The relationship between investment in the private sector and the poverty headcount is clearly illustrated in Figure 2. An increase in private sector investment expands business opportunities that create jobs and increase income. Investment in SMEs in particular would mean more opportunities for the poor. However, expanding investment alone will not decrease poverty.

⁴ Iarossi, Giuseppe (2009), *Benchmarking Africa's Costs and Competitiveness*, Africa Competitiveness Report 2009, p.91, World Economic Forum, World Bank and AfDB.

⁵ AfDB(2011), *Private Sector Development as an Engine of Africa's Economic Development*, p. 41, AfDB.

Figure 2. Private sector investment and poverty headcount, 1996-2008



Source: AfDB (2011), *Private Sector Development as an Engine of Africa's Economic Development*, p. 1, AfDB.

To identify variables that increase the effects of PSD and their degree of efficacy in Africa, a wide spectrum, as listed in Table 1, was examined through a cross-sectional analysis. The analysis employed a linear structural equation model using the three-stage least squares method to account for the endogeneity of GDP per capita and unemployment rate. An unstructured covariance matrix was assumed to reflect complicated relationships among selected variables.

Table 1. List of selected variables

Category	Variable
Inclusive growth	Small business ownership
	Home and financial asset ownership
	Financial system inclusion
	Intermediation of business investment
Market efficiency	Higher education training
	Labor market efficiency
	Goods market efficiency
	Technological readiness
	Market size
Social development	Informal sector
	Primary education
	Health
	Infrastructure
	Business and political ethics
	Concentration of rents
	Tax code
Macro-economic indicators	Social protection
	GDP per capita
	Unemployment rate

Note: Indicators for each variable are from different sources:

- 1) Inclusive growth: The Inclusive Growth and Development Report 2015 and World Economic Forum, 2) Market efficiency: Global Competitiveness Index 2014-2015 and World Economic Forum, 3) Informal sector: La Porta and Schleifer (2014), *Informality and Development*, Vol. 28, No.3, Journal of Economic Perspectives 4) Social development: The Inclusive Growth and Development Report 2015, World Economic Forum and Global Competitiveness Index 2014-2015, 5) Macro-economic indicators: World Bank Database.

The results of analysis indicate that in Africa, small business ownership is the only significant factor of inclusive growth that affects both income and employment. With each increase of value for small business ownership, GDP per capita also increases by 127.5 per cent, while unemployment decreases by 20 percent. Therefore, small business ownership should be encouraged and considered a priority in setting private sector development policy goals.

Table 2. Results of the linear structural equation model using the three-stage least squares method (Africa)

Dependent variable	GDP per capita ^a	Unemployment rate
Explanatory variable	(1)	(2)
GDP per capita ^a	-	-1.286 (1.804)
Unemployment rate	-0.015 (0.011)	-
Small business ownership	0.822*** (0.200)	-19.973*** (6.174)
Home and financial asset ownership	-0.533** (0.195)	7.058* (3.783)
Financial system inclusion	0.347 (0.323)	23.613*** (6.378)
Intermediation of business investment	-0.400*** (0.076)	3.361* (1.952)
Higher education and training	-	-9.733** (4.416)
Labor market efficiency	-	-34.968*** (5.346)
Goods market efficiency	-1.889*** (0.326)	-
Technological readiness	1.165 (0.326)	-

Market size	0.753 ^{***} (0.105)	-
Informal sector	0.034 (0.015)	0.238 (0.427)
Primary education	-0.212 ^{***} (0.072)	-10.229 ^{***} (1.621)
Health	-0.214 ^{***} (0.074)	5.767 ^{***} (2.013)
Infrastructure	-0.453 ^{***} (0.267)	-32.856 ^{***} (6.666)
Business and political ethics	1.519 ^{***} (0.412)	27.923 ^{***} (6.505)
Concentration of rents	0.160 (0.112)	21.321 ^{***} (4.135)
Tax code	-0.057 (0.102)	5.178 (2.223)
Social protection	0.432 ^{***} (0.184)	13.691 ^{***} (3.150)
Number of observed countries	19	
R²	0.977	0.3883

Note: †Log transformed value. Respective significance levels ***1%, **5%, *less than 10%. Numbers in brackets indicate standard error.

Although previous theoretical and empirical research provides evidence that income levels and employment are positively related, this was not the case for Africa, which suggests the need to consider them separately when setting policy goals. When looking at income in isolation from unemployment, variables including technological readiness, market size, the informal sector, business and political ethics, concentration of rent and social protection turned out to be significant. The impact of technological readiness, in particular, turned out to be of great significance as GDP per capita increased by 220.6 percent with per value increase. In the case of unemployment rate, improvements in higher education and training, labor market efficiency, primary education and infrastructure turned out to be significant. Higher education and training, which turned out to be most significant, decreased the unemployment rate by 9.7 percent with per value increase.

There are some limitations to the employed

model. First, the number of observations is small and standard deviations are fairly high. Second, due to the limited number of inclusive growth indicators the mid and long-term effects were not analyzed. Third, selected independent variables were obtained from numerous sources, making correlations among variables hard to determine. Fourth, due to the high complexity of indicators the assumed unstructured covariance matrix may weaken the validity of the inference of the chosen model.

PSD strategies employed by other countries and its implications for Korea

The UK, Germany and the US have been long-term players in the development field. They have specified private sector development as priority support areas, set aside exclusive sections and budgets of development institutions for PSD and have clear principles and directions on its implementation. The UK in particular has worked on private sector development for a long time since the 1990s as a means to eradicate poverty. The Department for International Development (DFID) has increased its budget for PSD and has dedicated a larger sum to the field. It has also dispatched PSD specialists in priority partner countries to provide direct assistance. In particular, since the UK has a mature financial market, it has expanded financial inclusion programs in Africa since 2002. M-Pesa is one of its examples of success, where thanks to its implementation financial accessibility in Kenya has increased from 58.7 percent in 2006 to 67.3 percent in 2009.⁶

⁶ KPMG (2012), *Financing Deepening and M4P: Lessons from Kenya and Rwanda*, no.9, p.3, Development in Practice International Development Assistance Services Impact Paper.

Germany, on the other hand, has a comparative advantage in vocational training and thus is effectively linking job creation to PSD. Germany has provided demand-based vocational training in Rwanda, where members from the chamber of commerce, cooperatives, and small shop owners met periodically for group counseling to discuss common problems and seek solutions. As a result, the private sector was able to utilize demand-based training sessions while training institutions were able to develop courses that fit the needs of the job market. As such, Germany is keen on involving the private sector with the government in collecting ideas and implementing strategies. The Public Private Dialogue system currently operates in 30 districts in Rwanda. In addition, both the UK and Germany emphasize the need to consider country-specific conditions and demands. The UK takes an evidence-based approach through the Country Poverty Reduction Diagnostic report written by field offices, while Germany categorizes target countries based on its development stage.

The US' emphasis lies on utilizing the market. Through its 'Trade Africa' partnership program it is trying to invigorate intra-trade within the African region and also expand economic cooperation with the US. The US has operated programs targeting small enterprises since the 1980s through the Office of Microenterprise and Private Sector Promotion at USAID and through field offices. The US is a leading country in using Public Private Partnership (PPP) as a support measure. In 2013 alone, the US raised 20 trillion dollars worth of private funding by partnering with 3,000 companies through 1,600 PPP arrangements.

In comparison to the three countries, Korea's PSD strategy is fragmented among different agencies and ministries. Therefore a govern-

ment-wide PSD strategy with an independent budget that is sharply monitored and evaluated is necessary. Also, Korea needs to diversify its PSD strategy according to the development status and fragility level of partner countries as Korea's priority partner countries in Africa – Ghana, Ethiopia, Mozambique, Rwanda, Uganda, Tanzania and Senegal – each face different economic challenges and opportunities. The first step towards doing so would be to incorporate the diversification outcomes into the upcoming Mid-term ODA policy for 2016-2020. Furthermore, the three countries have a common ground in that they utilize their strengths and past experiences. For instance, the UK has an advanced financial industry focus with support for financial inclusiveness whereas Germany, with a strong technical and vocational education system, emphasizes linking job creation and private sector development. The US, with its competitive market mechanism, has a strong public and private partnership scheme. In this context, Korea should also examine its development experience and areas of strength related to PSD support.

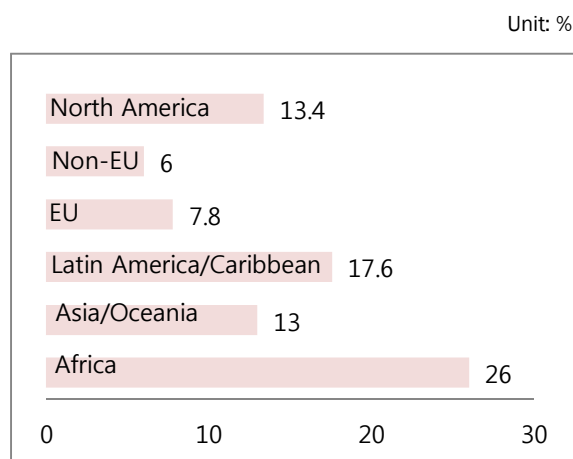
Priority areas to consider for PSD cooperation between Korea and Africa

Increasing the dynamics and impact of PSD is crucial to maximizing its effects. Unfortunately, Africa's PSD needs - financial inclusion, human resource, ease of regulations, poor infrastructure – outweigh the supply capacity of Korea. Moreover, not only is Korea a late-comer to the development cooperation field, but also has a relatively small amount of funding capital compared to other bilateral donor countries. In consideration of such handicaps, the following areas are selected for PSD cooperation with Africa based on the experience

and success of Korea's economic development.

First, as Africa is currently undergoing an active entrepreneurship boom, perhaps to a greater degree than in any other place, entrepreneurial support is in demand. Interest in startups and entrepreneurship has grown rapidly, mainly due to the political and social stability that is just beginning to take root after years of civil war across the continent. However, the success rate of new businesses is low mainly due to inadequate support measures.

Figure 3. Early stage entrepreneurial activity by region, 2014



Note: Survey population aged between 18-64

Source: Singer, Amoros and Moska (2014), *Global Entrepreneurship Monitor: 2014 Global Report*, pp.35~36, GEM.

Tailored start-up support for Africa would mean that local residents have easy access to the service and is also sustainable in terms of maintenance and improvement. Taking into account the lack of infrastructure, communication channels, and limited vocational training opportunities the application of 'appropriate technology' could foster successful businesses. As illustrated in Table 2, Korea has developed numerous appropriate technologies in the agriculture and energy sector, areas that could have a direct impact on the income and welfare of Africans.

Table 3. Examples of appropriate technology developed in Korea

Sector	Technology
Agriculture	Post-harvest management and processing
	Controlled horticulture
	Distribution-related technology (ex. barcodes)
	Organic fertilizer production
	Mango drying
	Eco-friendly growth promotion
Energy	Bio-energy
	Solar ray technology
	Sugarcane charcoal development technology
	Electricity/gas generating heat pump
	Organic solar batteries
	High efficiency fuel cells

Source: Park, Kim, Jang and Kwon (2014), *Utilizing Appropriate Technology for Development Cooperation with Africa*, pp. 95-130, KIEP.

Second, Korea can provide assistance in the construction of industrial complexes. Special Economic Zones (SEZs) and industrial parks are considered to be an important game changer for industrialization and export promotion. Korea's adoption of industrial parks contributed to its successful transition from a war-driven country to a global exporter and member of the OECD. Industrial complexes in Africa can be useful tools in expanding trade because African countries have Preferential Trade Agreements with the EU and the US. Several countries in Africa such as Ethiopia and Kenya have become favored destinations for investment in light industry. Korean companies have also been eyeing their development with interest. If supply and demand conditions from both sides match, the construction of light industrial complexes through a Public Private Partnership (PPP) could be an option. The construction of industrial complexes has already been attempted in Africa, but lengthy customs processes, lack of management skills, frequent blackouts among other challenges have barred their efficiency. Moreover, too much focus has been put on building factories rather than creating value chains through skills

training, research and development or forward/backward linkages. Therefore, it is important that a solid and broad feasibility study is conducted with a view on the growth strategy, target market, ease of accessibility and demand-met skills training programs. Although Korea has much experience in building industrial complexes, it has a limited understanding of the African market. Therefore, it should begin with mid and small-sized urban industrial complexes that are more accessible.

Third, human resource development is desperately needed to achieve inclusive growth. The young population is rapidly expanding in Africa; yet university enrollment remains at 7 percent in sub-Saharan Africa (compared to the world average of 30 percent) while only 1 percent of the adult population has graduated university (compared to the world average of 3.9 percent).⁷ The quality of education is also poor, leading to the dissatisfaction of companies that employ graduates. One of the reasons for this job mismatch is the lack of higher educational institutions and vocational training centers. The brain drain of professional workforce such as scientists, engineers, doctors and professors is another serious issue. In order to vitalize the private sector, a skilled workforce that meets the needs of companies is essential, but much of the educational focus has so far been on primary education alone in line with the MDGs. Korea also has previously placed too much weight on the hardware aspect, such as building training centers or providing educational equipment. Korea needs to adjust its policy direction towards meeting industrial needs. For this, it needs to understand what kind of real skills are needed on the field, and also be sensitive to the economic transfor-

mation from a mining and agriculture-based economy to a manufacturing and service-based economy. The quality of educators is another reason for the poor quality of education. Teachers in Africa have limited experience and often leave the educational field due to an insufficient income. Korea has already started a training program for educators in Rwanda. The quality of this program could be enhanced by cooperating with Germany or Japan, countries that have advanced experience in education and training. Other options for alleviating the job mismatch can include partnering with universities, tailoring education programs to industrial development stages, and implementing national licensing systems.

Fourth, although the agricultural sector has witnessed much failure in the past, it remains the backbone of many African economies and thus should be a priority area for PSD. More than 70 percent of the population is still engaged in the agricultural sector, and 25 percent of the continent's GDP comes from agriculture. Africa's agricultural sector currently faces various problems such as low productivity, climate change and absence of a trading market, which have triggered higher food security risks. On the other hand, Africa has hope in that 202 million hectares of arable land remains uncultivated. This equals around 50 percent of globally uncultivated land. Increased investment in agricultural infrastructure such as water, roads and storage facilities could greatly increase output. Most importantly, agriculture in Africa is small-scale and self-sufficient. The creation of an agricultural value chain would lead to job creation and increased income. Agro-industrial complexes could be applied to Africa as in the case of Korea, which was able to raise the income of the rural population through this development. The ultimate aim of an agro-industrial complex is to realize economies of scale, form a value chain (increase in productivity → stor-

⁷ British Council (2014), *Can higher education solve Africa's job crisis?*, p. 4, British Council; AfDB (2011), *Private sector development as an engine of Africa's economic development*, p. 118, AfDB.

age/processing → selling), and through it create added value. Since agricultural villages are small in size, located in difficult-to-access areas and lack infrastructure, it is important to identify areas with easy access to markets as enclaves. Once the hardware is in place, the transfer of technology, improvement of storage and processing mechanisms and capacity development, in which Korea has experience, can be provided. The Saemaeul Undong is a good example of capacity development, as it trains rural leaders and encourages rural unification.

Africa is witnessing a rapid influx of foreign private capital, mostly in the form of FDI, surpassing ODA amounts. Investment earnings from FDI between 2006 and 2009 are higher than that of Latin America and Asia. Thus, the question being asked now is ‘how’ to invest in Africa rather than ‘should’ we invest in Africa. However, the private sector still faces challenges in financing, capacity building and technology development. Since Korea’s financing capacity is relatively limited, it should focus on capacity building and technology development in its cooperation with Africa regarding private sector development. 