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Financing sustainable development in Africa: Taking stock, and looking forward

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A G D I Working Paper

WP/20/071

Financing Sustainable Development in Africa: Taking Stock, and Looking Forward

Forthcoming: Handbook of Research on Institution Development for Sustainable and Inclusive Economic Growth in Africa (Chapter 9)

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Financing Sustainable Development in Africa: Taking Stock, and Looking Forward

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Abstract

Financing sustainable development in Africa requires financing options that is best for development in the region without further escalating other societal problems. This chapter takes stock of financing options previously advocated for financing development in the African region such as development assistance and foreign investment. By considering its implication on development outcomes like poverty, inequality, and aggregate human development, some drawbacks still exist. Therefore, the chapter identifies, reconfigures and reinvents other financial flows such as mutual support networks, agricultural cooperatives, crowd funding, fiscal responsibility, other forms of informal banking, and remittances, among others to African countries for efficient provision of structures that can aid in the sustenance of development. We conclude that these alternative means of financing development could be a viable policy option to bridge income and development gaps; thereby mainstreaming the process for financial inclusion and sustainability.

Keywords: Finance; Sustainable Development

JEL Classification: G20; I00; O10

1. Introduction

Sustainable development in Africa, which includes the ability to meet present economic, social and environmental needs without compromising the capacity of future generations to meet their own prevailing needs, will require enormous economic resources to fund it. This implies that there must be a clear balance of prioritization of financing options on what works best for development in this region without further escalating other societal problems. The vast majority of the literature has focused on traditional financing means such as development aid (Alesina and Dollar, 2000), Foreign Direct Investment (Velde, 2006), even remittances from migrants (Maphosa, 2007), and to a large extent, foreign debt from bilateral and multilateral institutions (Chipumbu, 1993; Omotola and Saliu, 2009).

The puzzle in this chapter is not that the current means have not favored African development – because it has, but that a significant fraction of these funds has not been channeled for development structures that will facilitate sustainability. For instance, Kharas (2007) notes that despite the magnanimous flow of foreign aid to developing countries, a significant number of them channel these funds to debt forgiveness and other unprecedented natural occurrences, leaving out issues like infrastructural development and even education and health care development. Also, Safiq, Mansoon & Rafique (2013) observed that apart from national debts and inflation that continuously threaten the gross domestic product (GDP) of developing economies, foreign direct investment negatively affects economic performance. The limiting prospects of foreign funds for financing sustainable development is largely hampered by government instability, internal and external conflict, corruption and ethnic tensions, bureaucracies, unresponsiveness and unaccountability of government (Busse & Hefeker, 2007)

This chapter, therefore, sets out findings from an examination of the traditional funding options that African countries have relied on overtime, and then discusses new funding options by taking cases on how they have worked in specific African countries. For instance, issues like empowering cooperative societies and mutual support networks, agricultural cooperatives, crowdfunding, fiscal responsibility, other forms of informal banking alternatives, were considered for sustainability in Africa. These issues are essential considering that the set-up of African countries is unique and the specific structures are different from countries in other regions (Asiedu, 2002; Nkume, 2018), and policies that work

in other regions may not be adaptable for this region because the circumstances and informal institutions (i.e. the foundations on which policies thrive) differ so much.

The remainder of the chapter is distributed as follows: the next section discusses the trends in traditional means of financing development in Africa, which is followed by the linkage between these means of financing development and key indicators of human development. The fourth section discusses some relevant case studies of other financing options that can fit the development trajectories of African countries, while the fifth section concludes the paper with policy recommendations.

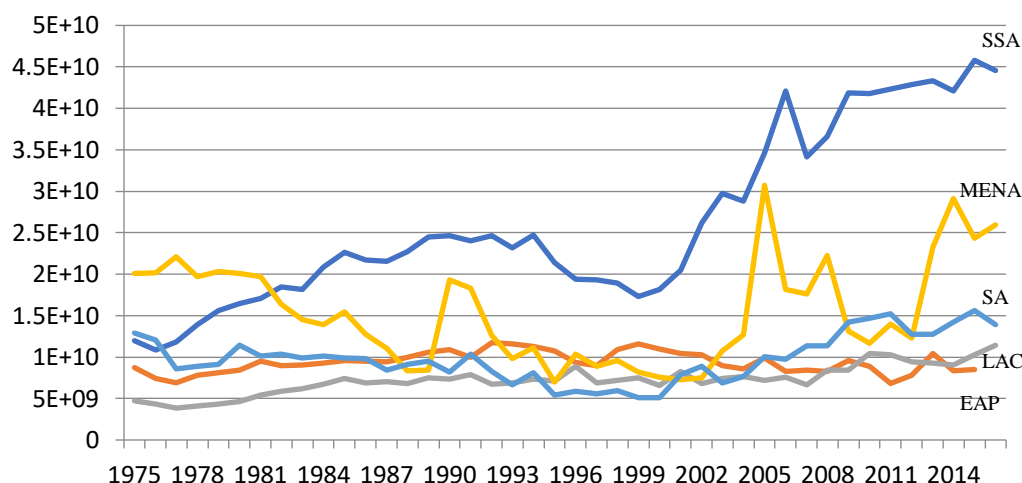
2. Trends in Traditional Financing Option for African Countries

The level and composition of this alternative financing means has changed markedly over time, which implies development, which will be discussed subsequently. Despite the increasing flow of finances to the African region, there is still the need for alternative financing means considering the issues surrounding these traditional means of financing, which will be discussed later. This section, therefore, presents the traditional finance means based on a historical perspective, and compares the trend with other regions of the world. Considering the inflow of official development assistance¹ at constant 2015 US\$ to countries in the African region (and compared to other regions) as seen in Figure 1, there has been a reasonably stable increase in the volume of this financial flow compared to other regions. In absolute terms, there has been about a fourfold increase in the value of this development assistance since 1975, from 11.9 billion to 45.8 billion in 2015.

Countries in other regions do not experience such a stable increase in foreign aid flow as compared to countries in the SSA region, as seen in Figure 1. Seeing the trend of foreign aid flow for MENA for instance, there is a sharp decline from about 30.1 billion in 2005 to approximately 12.7 billion in 2012, after which there was an improvement in the volume. The countries in the other regions like South Asia, Latin America and the Caribbean, and the East Asia and the Pacific all had a steady, but marginal, rise in aid flows. When compared to the value that flows to the SSA region, there is about fivefold difference in the value of aid flows to SSA countries compared to the value in East Asia and the Pacific countries.

¹Which are those monetary transfers from wealthy nations and rich countries to poorer countries that are broadly corresponding to low and middle income countries for development related issues like education, infrastructural development, and health care growth in the recipient countries? However, it is important to also note that foreign aid covers a multitude of different types of transfers - not all of which go directly to poor countries (Kharas, 2007). For instance, other administrative overhead costs of development agencies, and their domestic efforts to advocate in favor of more assistance, are also regarded as “aid.”

Figure 1: Aid Flow to SSA and some other Regions of the World



Notes: ODA is defined as Net official development assistance and official aid received (constant 2015 US\$). **SSA**- Sub Sahara Africa; **MENA** – Middle East and North Africa; **SA** – South Asia; **LAC** – Latin America and Caribbean; **EAP** – East Asia and Pacific

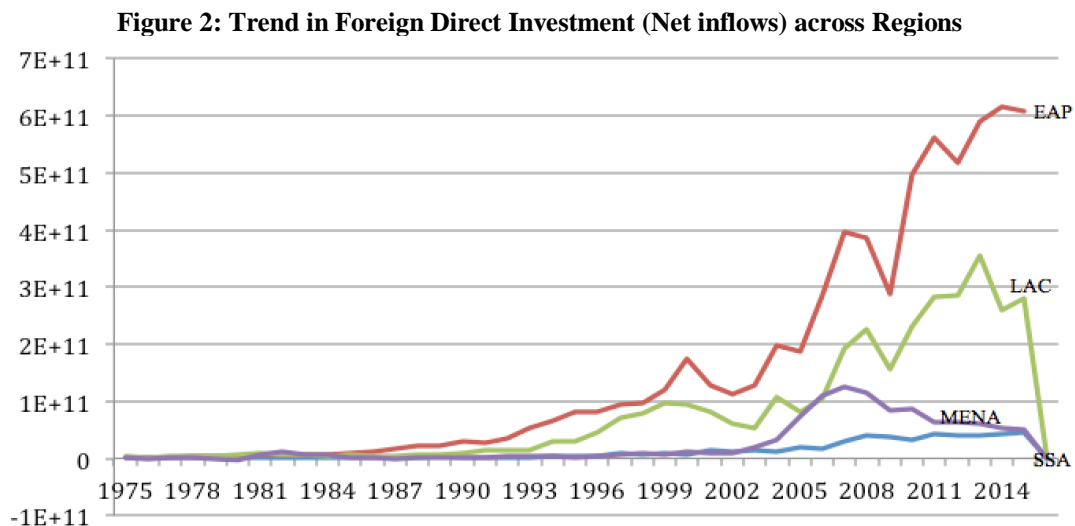
Meanwhile, the ODA flow to African countries in 2014 was highest in Ethiopia and Egypt, comprising about 7 percent of the total ODA flow to the region from Table 1. The remaining countries like Kenya, Tanzania, and Nigeria all received about 5 percent of the total foreign aid flows to the region, and Congo, Morocco, Mozambique, and South Sudan received 4 percent inflow. In comparison, the rest countries in the region received less than 3 percent of the total aid flow. The United States of America was the highest aid donor to the region, with the European Union countries giving about 12 percent of the total aid flow. The aid direction to the SSA region is unevenly dispersed with the top 10 recipients receiving about 47 percent of the entire aid flow to the region. The implication of this skewed aid flows could indicate that some countries are not only more privileged or positioned for such opportunities, but could also have an edge in funding requirements compared to other countries that have not received. Therefore, in addition to considering alternative funding paths for sustainable development, it is worthwhile for donors to consider the direction, spread and even nature of their donations.

Table 1: Aid flow and Aid Donors to African Countries

Top 10 ODA receipts by recipient			Top 10 ODA donors		
USD million, net disbursements in 2014			USD million, net disbursements in 2014		
Ethiopia	3585	7%	United States	9338	17%
Egypt	3532	7%	EU Institutions	6737	12%
Kenya	2665	5%	IDA	6386	12%
Tanzania	2648	5%	United Kingdom	4346	8%
Nigeria	2476	5%	United Arab Emirates	3787	7%
Democratic Republic of Congo	2398	4%	Germany	3018	6%
Morocco	2247	4%	France	2929	5%
Mozambique	2103	4%	African Dev. Bank	2042	4%
South Sudan	1964	4%	Global Fund	1957	4%
Uganda	1633	3%	Japan	1558	3%

Other recipients	28941	53%	Other Donors	12098	22%
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Unlike foreign aid, the inflow of foreign direct investment (FDI) to the African region has been a low trend in the past two decades compared to other regions; and more recently, the region has witnessed even more decreases. Generally, compared to other regions of the World, countries in SSA (for instance) see less foreign investment flow, which is about 13 times lower than those flows to EAP in 2015 alone.



Notes: SSA- Sub Sahara Africa; MENA – Middle East and North Africa; LAC – Latin America and Caribbean; EAP – East Asia and Pacific

Countries in Africa are still expected to receive less foreign investment compared to those in other regions when considering the projection of foreign investment flow across regions in Table 2. From Table 2, the foreign investment flows to Africa are estimated to increase by about 19 per cent in 2018 to \$50 billion from 42 billion in 2017. Despite this increase, African countries are seriously lagging when compared to countries in other regions. The projection for Africa is bolstered by the expectation of a continued fair recovery in the prices of commodities in the international market (despite that commodity-dependence will cause FDI to remain cyclical), and by favorable macroeconomic fundamentals (UNCTAD, 2018). Importantly, the recent signing of the African Continental Free Trade Area (AfCFTA) by 44 African countries could encourage a more improved FDI flows.

Despite the benefits embedded in FDI inflows for developing economies, the observed pattern of FDI inflows into the African continent courts urgent concerns as a dependable and sustainable source of financing. Apart from FDI being an outward and unpredictable form of finance for developing economies, governments within host economies have no control

whatsoever on the capitalist choices of when and where to invest. Thus, owing to the volatility of this form of financing, the onus lies on developing economies to stir real endogenous economic growth. Studies have further proven other funds such as remittances as more predictable than FDI (Vaknin, 2008; Büthe & Milne, 2008). Therefore, rather than depending on external funding sources, it is imperative that developing economies are more inward looking via indigenous and frugal approaches to financing, production and economic outputs. Vaknin (2008) also noted that FDI does not necessarily metamorphose to net foreign exchange inflows given that some Multinational Corporations (MNCs) borrow from local funds at appreciable interest rates to finance their investment; thereby, constituting further threats to local firms and crowds-out domestic firms from credit opportunities. Meanwhile, Büthe & Milner (2008) add that variations in FDI inflows are largely attributed to international trade agreements than local/host agreements or policies such as General Agreement on Tariff and Trade, World Trade Organisation (WTO) and African Continental Free Trade Area (AfCTA). This is because international commitments are passed as more worthwhile than local policies; thus, leaving host economies largely at the dictates of foreign investors especially where their activities are not so consistent with local objectives.

Table 2: FDI Inflows, Projections (2015–2018) in Billions of Dollars and Percent

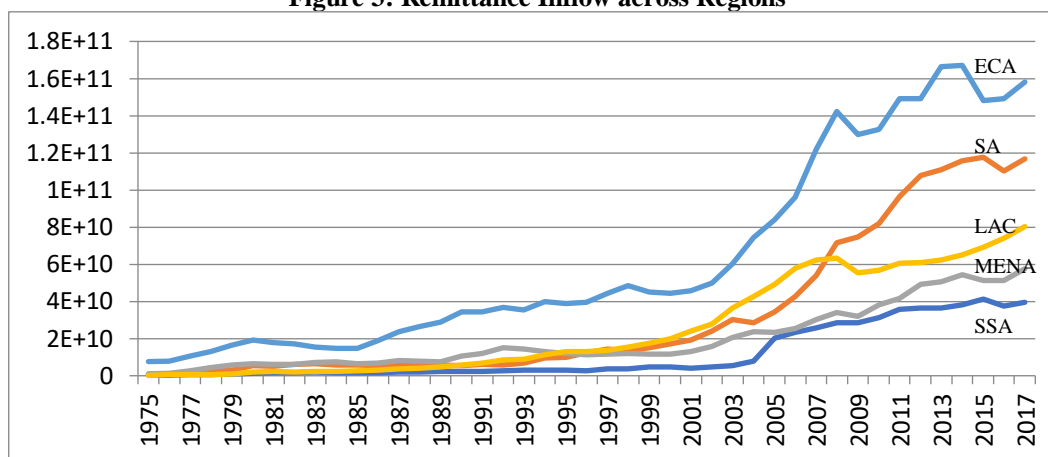
	2015	2016	2017	2018*
World	1921	1868	1430	1450 to 1570
Developed Economies	1141	1133	712	740 to 800
Europe	595	565	334	380
North America	511	494	300	320
Developing Countries	744	670	671	640 to 690
Africa	57	53	42	50
Asia	516	475	476	470
Latin America and the Caribbean	169	140	151	140

Note: * is the 2018 projected value.

Source: UNCTAD (2018)

Another source of foreign revenue inflow to Africa is remittance inflow, which is one of the most stable forms of foreign capital to African countries. For instance, unlike foreign aid and foreign investment that depend on the economic condition of the originating countries, remittance inflow remains stable, in terms of its volume, considering that it includes those monetary flows sent to the home countries by nationals for different purposes, including altruistic motives, investments, and other human capital development funding. Despite, remittance inflow to African countries still considerably lower than those of other regions of the world (see Figure 3), over the years, there has been a consistent increase in the trend of global remittance inflow, which makes this form of foreign capital flow to be an important source of countries developing funding option.

Figure 3: Remittance Inflow across Regions

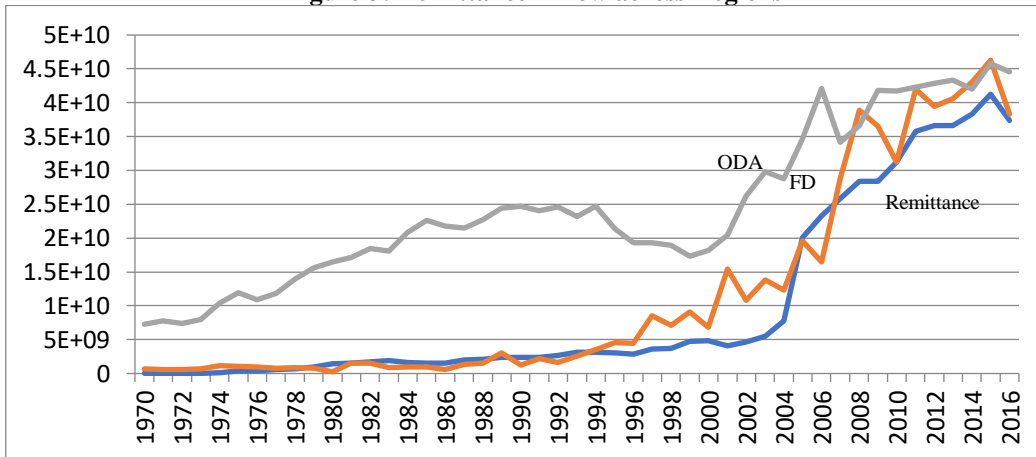


Notes: SSA- Sub Sahara Africa; MENA – Middle East and North Africa; SA – South Asia; LAC – Latin America and Caribbean; EAP – East Asia and Pacific

Considering the combined distribution of the three most important sources of foreign financial inflow to African countries as presented in Figure 4, we see from the trend that, as earlier noted, official development assistance is still the most important foreign capital flow to the region. As at 2016 alone, the volume of official development flow to African countries was about 19 percent more than remittance inflow and about 16 percent more than the total foreign direct investment. In terms of stability of the flows, Figure 4 shows that the trend of remittance inflow is smoother than the other funds, which confirms the earlier assertion that remittance inflow is more stable than the other funds.

As laudable as remittances appear, the flow to SSA has been adjudged as low when compared to the flows in other regions of the world like LAC and EAP. In addition, the sustainability of this capital source is a puzzling phenomenon given that remittances are largely dependent on a number of factors such as family reunification, immigration policies, (Docquier, Rapoport & Salomone, 2012) continual viability of the remitter or remitting organization and the host economy. Meanwhile, the *remittance decay hypothesis* which captures the remitting behaviour of migrants argues that the amount of remittances sent by migrants to their countries of origin declines through time. While some studies have validated the remittance decay hypothesis (Chami, Fullenkamp & Jahjah, 2005; Arun & Ulku, 2011; Makina & Masenge, 2015); others have argued otherwise in favour of the *remittance theory* (Docquier, Rapoport & Salomone, 2012, Hunte, 2004). Irrespective the direction of argument, the budding issue of interest within this chapter is the reliability and sustainability of this source of finance; hence, the subsequent section delves more into funds that emanate locally and are somewhat reliable and sustainable in developing economies.

Figure 3: Remittance Inflow across Regions



3. Linkage: Traditional Finance Means and Key Indicators of Human Development

When observing the relationship between the different indicators of financial flow and development, it is important to consider the type and volume of these financial flows because the impacts they have on the recipient countries depend on these characteristics. However, this study is not a rigorous examination of the importance of these financial flows, hence our inquiry is to observe the pairwise association between the different financial flows (especially the most popular ones in Africa) and the indicators of human development as suggested by the UNCTAD (2016) while taking into consideration health care and per capita income in the respective countries.

Figure 4: Scatter Plot – ODA, FDI, and Infant Mortality (2015)



In Panel A of Figure 4:

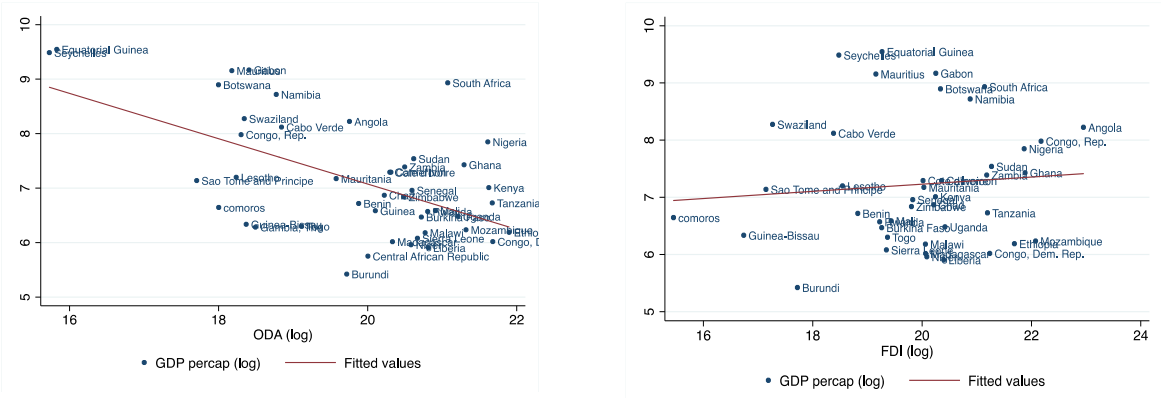
- upward association between ODA and infant mortality in the sampled countries- suggesting impaired financial sustainability for development.

Swanson (2015) argued that aid directed at helping poor countries might be hurting and slowing their growth

- FDI to African countries, reduces under-five mortality rate; suggesting that FDI can assist and not necessarily hurt the recipient countries.
- African countries receive less of this form of foreign capital flow compared to other regions of the world

The findings from this plot support the consensus in the literature that advocates for foreign investment as a complementary financial flow to assist African development (OECD, 2002; Torabi, 2015).

Figure 5: Scatter Plot – ODA, FDI, and Per Capita GDP (2015)



Another important development outcome that we consider in this section is the per capita income of African countries, which is a measure of the average income level of the population. Using a similar sample as presented in Figure 4, the scatter plots for the per capita GDP and the different financial flow indicators are in Figure 5. Foreign aid flow still maintains a significant negative relationship with per capita GDP of the respective countries in the African region, implying that this form of financial flow does not have a positive effect on the income level of the recipient countries in the region. In sharp contrast, we find a positive relationship between the volume of foreign direct investment and the income level of the respective African countries. This suggests that the average income of the population of the sampled countries increases at a consistent rate with the level of foreign direct investment inflow.

The negative relationship seen between foreign aid and the measures of development, and in contrast, seeing a positive relationship between foreign investment and the measures of development further reiterates the need to consider financing sustainable development in Africa effectively. The traditional mechanisms of finance do not consistently show an improvement in the measures of development, which reinforces the need to consider alternative means of financing sustainable development in Africa – which will be broadly discussed in the subsequent session. Finally, it is fair to say that there is an immense body of literature that criticizes the ability of foreign aid to deliver its development outcomes in the recipient countries. For instance, these studies point to the fact that international politics, governance and heightened public sector corruption is a major factor to be considered in ensuring the effectiveness of foreign aid in recipient African countries (see Kaufmann, 2009; Bauhr, 2016; Kenny, 2017).

4. Alternative Path for Sustainable Development in Africa

There are different alternatives, and more stable funding means that can help the sustainability of African countries. These alternative funding means have been used by some non-African countries and has worked in so many instances with accrued benefit and cost. However, when considering the cost, in relation to the cyclical nature of the traditional means of finance, which was earlier elaborated in the document. The first funding option for African countries to consider is the sovereign wealth fund (SWF) as finely elaborated in Nkume (2018). SWF, which are those investment funds in real and financial assets like stocks, bonds, real estate, precious metals, or in alternative investments like private equity funds or hedge funds that are managed by the State. These SWF are expected to be funded by excess revenue from commodity exports or foreign reserves that are held by the central bank to be used for future development projects.

African countries are beginning to think in this direction, especially with the increasing number that subscribes to this important funding option. According to Nkume (2018), countries like Algeria, Botswana, Libya, Ghana, Angola, Senegal, Tanzania, Kenya, and Mozambique, with countries like South Africa still in the process of assessing how the SWF would be structured in their economies. Taking Nigeria, for instance, there is a Nigeria Sovereign Investment Authority (NSIA) set up to manage this fund through the excess earnings from crude oil. The mechanism of operating this account is such that the NSIA receive monthly funding of a significant portion of the excess oil and gas revenue above the

budgeted revenue (NSIA, 2018), with the three sovereign funds under the NSIA being future generation funds, Nigerian infrastructure fund, and stabilization fund. Apart from Nigeria, the SWFs contribute about 40 percent of Botswana's and 100 percent of Libyan gross national income and even makes-up a quarter of Algerian national income (Fourie, 2016). To ensure these funds are effectively managed and to reduce the incidence of rent-seeking and corruption practices that plague other traditional means of funding development, there is the need for such funds to be administered by an independent financial body.

Another important concept to consider in funding sustainable development is the awakening of responsible state capacity in driving the development process in African countries. Unfortunately, most political leaders in African countries are short-term thinking, and many lack strategic ideas in propelling the development process of their respective countries (Jo-Ansie, 2007; Efobi, 2015). This has to change for there to be sustainable development in the continent. Reinventing responsible state capacity is all about the state being involved in deciding strategic competencies, and then enabling the private sector to get involved in such competencies. A vivid example of a country where this has worked is Brazil: in the 1970s, the government pursued an aggressive export-oriented industrialisation strategy by identifying sectors that they wanted to build competencies in (i.e. non-ferrous metals, chemicals and petrochemicals, paper, and machinery and equipment) and then mobilised Brazil's national bank to offer medium- and long- term financing to projects initiated by the private sector in these competencies. This initiative was successful in establishing a thriving steel industry in Brazil, which has boosted their export performance, and there has been an efficient development of other industries as a result of this initiative such as the automobile industry and even the aero industry. Brazil greatly contributes to the global supply chain of aircraft, which is a significant industrial revolution that places them among the fast-emerging economies of the world (UNCTAD, 2016).

India also have a similar success story like Brazil, where the State got involved in the development of specialised financial institutions which were tasked with the responsibility of providing long-term finance to specific industries that were identified as strategic for national development (Chandrasekhar, 2015). In some other instances, the Indian government engaged in state-owned enterprises to develop such competencies, which then spilled over to an industrial revolution. For instance, Amsden (2001) records that there were technological and human capital investments undertaken by the state had a great impact on local firms through

the supply of trained workforce in the specific industry that the government got involved – in this case, the pharmaceutical industry. A similar spillover was also recorded for Ethiopia, where certain technologies that were first initiated in the state-owned enterprises were later adopted and advanced by the private sector (UNCTAD, 2016).

The miracle of cooperative societies and informal mutual support network is another important alternative source of funding development in African countries. Unlike the formal financial institutions, the informal support networks are a form of pool funds by members to provide a type of insurance for its members in cases of cyclicity, and in cases where huge funds are needed for investment needs (see Mangasini, 2018).

5. Conclusion

Sustainable development in Africa includes the ability to meet present economic, social and environmental needs without compromising the capacity of future generations to meet their own prevailing needs. However, achieving these development goals will require enormous economic resources. Hence, the need to balance the prioritization of financing options based on what works best for development in this region. Indeed, there have been beneficial outcomes from some of the finance means: for instance, while we find negative relationship between foreign aid and some development outcomes, foreign direct investment was found to have positive association with similar development outcomes. We therefore argue for the consideration of other finance means like improving the effectiveness of mutual support networks, sovereign wealth funds, improving state capacity to chart the development course. We conclude that despite the importance of traditional means of financing development in the African region, their wide spread impact on non-mainstream groups (like those involved in the informal sector, rural populace, and even the disadvantaged group) is not effectively felt; hence, the rising rate of inequality and exclusive development. However, these alternative means of financing development could be a viable policy option to bridge these gaps; thereby mainstreaming the process for financial inclusion and sustainability.

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