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The Nexus between Governance Infrastructure and the Ease of Doing Business in Africa

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Abstract

This paper examines how each elements of “good governance infrastructure” may influence the “ease of doing business” for a sample of 41 African countries from 2005 to 2012. The empirical results from GMM and other estimation methods reveal government effectiveness, political stability, rule of law, regulatory quality, and absence of corruption are robust determinants for creating conducive business atmosphere, taking into account other factors such as human capital, physical infrastructure and the level of development of a country. Nevertheless, no evidence has been found for voice & accountability to significantly affect the ease of doing business. This implies a government that may enhance political stability, rule of law. Government effectiveness and low level of corruption is likely to create a more favorable business atmosphere despite offsetting deficiencies in voice and accountability.

Key Words: Governance Infrastructure; Institutions, Ease of Doing Business, Africa.

Introduction

After a long period of stagnation in the 1970s and 1980s, Africa has re-emerged in the 21st century as a continent alive with opportunity, driven by such factors as improved governance, better macroeconomic policies, management and business environments, abundant human and natural resources, urbanization and the rise of the middle class, and good economic performance and market potential. According to Mckinsey Global Institute (2010), Africa is one of the most rapidly growing economic regions in the world in which consumer spending in Africa that was $860 billion in 2008 is projected to grow to at least $1.4 trillion by 2020. More than 40% of Africans now live in the major urban areas, which has created a growing labor force and a rising middle class. The McKinsey report estimates that by 2030, the continent's top 18 cities will have a combined spending power of $1.3 trillion. The business climate is also a lot brighter due to government actions to end political conflicts, and to improve macroeconomic conditions throughout the continent. Moreover, trade between Africa and the rest of the world has increased by 200% since 2000. Similarly, private investments in Sub-Saharan Africa now exceed direct aid, thereby fostering long-term stability in both large and small countries. The World Bank report states that "Africa could be on the brink of an economic take-off, much like China was 30 years ago and India 20 years ago," though its officials think major poverty reduction will require higher growth than today's—a long-term average of 7% or more (The Economist, 2011).

Likewise, many African countries have made a significant progress is reducing the cost and burdens of doing business through a number of reforms such as setting up one-stop institutions for investors, streamlining licensing procedures, reducing the cost, duration and procedures for creating or expanding an existing business and reducing the tax burden on businesses (World Bank, 2013). Accordingly, of the 50 economies making the most improvement in business regulation for domestic firms since 2005, 17 are in Sub-Saharan Africa. Rwanda particularly stands out as having consistently improved since 2005. According to Economic Commission for Africa (2009), constitutional provisions and legislation have been adopted in many African countries to enforce business contracts and protect individual property rights, including intellectual property rights and shareholders' rights, and also simplified court procedures to increase the efficiency and reduce the cost of enforcing business contracts.

Despite those achievements, much more can be done to enable African economies to better enhance a business-friendly atmosphere. In Africa, it still takes longer and is costly to start a business and to obtain licenses, the labor market tends to be more rigid, taxes on businesses tend to be higher as a proportion of profits and it is relatively costly to export and import goods. Institutions for protecting property rights, enforcing business contracts, setting standards for accounting and auditing procedures and requiring compliance with codes and standards of corporate governance remain weak (Economic Commission for Africa, 2009). For instance, Table
1 shows that doing business index for many African countries as measured in distance from the frontier (DTF) is lagging behind many East Asian economies and OECD countries.

Table 1: The average doing business index in African countries compared to other regions (2005-2012)

Africa		South Asia		ASIAN+3		OECD	
Countries	**DTF**	**Countries**	**DTF**	**Countries**	**DTF**	**Countries**	**DTF**
South Africa	71.9	Pakistan	58.9	Singapore	90.9	New Zealand	89.9
Mauritius	68.6	Nepal	56.5	Hong Kong	87.6	USA	84.7
Botswana	64.1	Sri Lanka	56.1	Korea Rep.	78.3	UK	84.3
Namibia	62.4	Bangladesh	53.4	Japan	77.7	Ireland	84.2
Seychelles	62.1	Bhutan	50.1	Malaysia	74.6	Canada	83.6
Ghana	61.3	India	47.1	Thailand	71.6	Denmark	82.9
Kenya	58.6			Vietnam	59.2	Norway	82.1
Morocco	57.8			China	55.8	Sweden	80.4
Zambia	56.7			Brunei	54.9	Finland	80.4
Tanzania	53.9			Indonesia	52.6	Australia	79.7
Cape Verde	53.3			Philippines	50.9	Korea Republic	78.3
Egypt	52.1			Cambodia	46.6	Iceland	78.3
Ethiopia	52.0			LAO PDR	42.1	Germany	77.7
Rwanda	52.0					Japan	77.7
Uganda	51.9					Austria	76.0
Lesotho	50.9					Netherlands	75.4
Mozambique	50.3					Estonia	74.0
Nigeria	50.8					Belgium	73.9
Algeria	50.2					Switzerland	72.4
Madagascar	49.6					Israel	70.8
Gambia	49.1					Spain	70.5
Gabon	48.5					Portugal	70.5
Malawi	48.1					France	68.9
Senegal	44.0					Slovak Republic	68.4
Mali	43.1					Luxembourg	65.9
Cameroon	42.2					Hungary	65.0
Liberia	41.7					Italy	64.6
Burkina Faso	41.3					Slovenia	63.9
Benin	41.0					Czech Republic	62.3
Mauritania	40.4					Poland	61.7
Angola	40.3					Greece	58.7
Niger	37.4						
Burundi	37.4						
Guinea	36.9						
Congo DR	31.9						
CAR	31.2						
Chad	28.0						

Of course, there is a wide variation within Africa itself and countries such as Ghana, Mauritius, South Africa, Namibia, Botswana, Seychelles, Uganda, Tanzania, Rwanda have recorded a relatively high doing business index in the continent (Figure 1-7).

The *Ease of Doing Business Index* (EDBI) is published by the World Bank to compare the business environment of about 180 different countries. It is best measured by the distance to frontier (DTF) which is normalized to range between 0 and 100, with 100 representing the best performance..

Objective of the Study

The *overall objective* of this study is to thoroughly examine the explicit effects of the six elements of "governance Infrastructure" to the ease of doing business in African countries.

Significance of the Study

By studying past experiences and contemporary outcomes from this empirical studies, it is possible to draw lessons for the future such that "good governance infrastructure" is indispensable to facilitate the ease of doing business, entrepreneurship, and economic growth at large to a host country. To my knowledge, there is no study in this area so far that investigated the explicit effects of each elements of governance infrastructures on the ease of doing business in African countries, and thus this study would fill the gaps and may contribute to add knowledge in the field.

The Link between Quality of Institutions and the Ease of Doing Business

Good governance institutions that guarantee economic freedom plausibly have the capacity to provide the growth-enhancing kind of incentives, for several reasons: they promote a high return on productive efforts through low taxation, an independent legal system, and the protection of private property; they foster a dynamic, experimentally organized economy in which a large amount of business trial and error can take place (Johansson 2001). By the same token, Globerman and Shapiro (2003) argue that the governance infrastructure of a country would help to define its investment environment, and thus creates favorable conditions for economic growth. Recent empirical evidence tends to confirm the hypothesis that cross country differences in growth and productivity are related to differences in governance infrastructure (Kaufmann, Kraay, & Zoido-Lobaton, 1999b). Generally, there is an emerging consensus amongst economists, political scientists and international business scholars that FDI inflows to developing nations are conditioned by the host country's governing institutions, and that countries possessing strong institutions (i.e. competent regulatory agencies, efficient legislatures, transparent judiciaries, etc.).

In line with the above arguments, Kaufmann et al (1999) devised six aggregate governance indicators or clusters: *voice and accountability*, *political stability and absence of violence*. *government effectiveness*, *rule of law*, *regulatory quality,* and *control of corruption*. According to Kaufmann et. al. (1999), "good governance" may be defined as the process and institutions by which authority in a country is exercised: (1) the process by which governments are selected, held accountable, monitored, and replaced; (2) the capacity of government to manage resources and provide services efficiently and to formulate and implement sound policies and regulations; and, (3) the respect for the institutions that govern economic and social interactions among them.

Hence, the theoretical link between the above-mentioned elements of governance infrastructure and the ‘ease of doing business’ has been discussed below.

Voice and Accountability

Voice and accountability captures the extent to which citizens of a country are able to participate in the selection of governments. For instance, a study by Stasavage (2002) found a strong relationship between the presence (absence) of political ‘checks and balances’ and the FDI flows. Accordingly, Figure 8 shows Botswana, Ghana, Mauritius, Namibia, Senegal, Seychelles, and South Africa have a relatively better performance in voice and accountability index. Apart from those countries, the ‘voice and accountability index are still at infant stage in the remaining African countries. Particularly, the situation in Angola, Cameroon, CAR, Congo DR, Djibouti, Ethiopia, and Rwanda are alarming (Figure 8).

Political Stability and Absence of Violence

Political stability is essential if markets are to work effectively in guiding resource allocation and fostering confidence of economic agents in the economy especially to attract multinationals in investing their capital in the host country. As clearly noted from figure 9, many African countries apart from Botswana, Mauritius, Seychelles and Zambia have experienced a low level of political stability index from 2005-2012. On the other hand, the following countries are with deep political instability include: CAR, Cong DR, Cote Devoir, Egypt, Ethiopia, Kenya, Nigeria and Uganda.

Government Effectiveness

This refers the quality of public service provision, the quality of bureaucracy, and the credibility of the government's commitment to policies. In other words, government effectiveness captures the capacity of the state to implement sound policies (Rammal and Zurbruegg, 2006). As shown in Figure 10, countries such as Botswana, Ethiopia, Egypt, Ghana, Lesotho, Mauritius, Morocco, Namibia, Rwanda, Seychelles, Senegal, and South Africa have a relatively better performance in terms of government effectiveness mainly in implementing policies in to action. On the contrary, government effectiveness index is quite low in Angola, CAR, Congo DR, Cot Devoir, Liberia, Nigeria, Sierra Lione and Togo.

Rule of Law

It measures the extent to which agents have confidence in and abide by the rules of the society, including the effectiveness and predictability of the judiciary, and the enforceability of contracts. These conditions encourage FDI and presumably private domestic investment as well, by protecting privately held assets from arbitrary direct or indirect appropriation. Furthermore, it is rational to argue that inventions and innovations can be promoted only when they are well protected through protection of intellectual properties. Accordingly, Figure 11 demonstrates again those countries like Botswana, Mauritious, Nambia, and South Africa have better performance in enhancing rule of law. On the other hand, countries such as Angola, Cameroon, CAR, Congo DR, Cotedevoiur, Djibouti, Kenya, Liberia, Nigeria, Sierra Lione and Togo are very far behind in enhancing rule of law in their respecve countries.

Regulatory Quality

Regulatory quality measures the market-friendly policies such as lifting price controls or in adequate bank supervision as well as other efforts to lessen excessive regulations in areas of foreign trade and business development. Figure 12 clearly shows Botswana, Ghana, Mauritius, Morocco, Namibia, Rwanda, Senegal, Seychelles, South Africa and Uganda are relatively in a better position to create market-friendly regulatory policies. On the other hand, least performers in terms of regulatory quality index include: Angola, Cameroon, CAR, Congo DR, Cot Devour, Ethiopia, Liberia, Nigeria, Sierra Lione and Togo.

Absence of Corruption

Corruption has a very strong negative effect on doing business. For instance, according to Vittal (2001), if China manages to reduce red tape and corruption and enhance better rule of law and property protection, it can even double its FDI. Similarly, if corruption levels in India come down to those of Scandinavian countries, the GDP growth would increase by 1.5% and FDI will grow by 12 %. Figure 13 demonstrates Botswana, Ghana, Lesotho, Mauritius, Namibia, Rwanda, Senegal, Seychelles and South Africa are at least in a better position in terms of control of corruption. On the other hand, the gravity of corruption is worrisome in some African countries such as Angola, Cameroon, CAR, CDR, Cot Devour, Kenya, Nigeria, and Sierra Leone.

Of course, governance infrastructure is not the only factor that can contribute to economic well-being and create a favorable climate for FDI. Investments in human capital, physical infrastructure and other policy measures may also be important as discussed below.

Other Factors Influencing Doing Business in Africa

Human Capital

According to Habiyaremye and Ziesemer (2006), when educational attainment is used as a proxy for human capital, there are three main views that attempt to explain how education affects the production process and contributes to economic performance. The *first* view considers education as having the effect of increasing the labor ”efficiency units’’ making an educated worker more efficient. The *second* view is that educated workers are able to perform complex tasks and are therefore not substitutable by unskilled workers. The *third* view associates education and skills of workers with learning and creation of new technologies that generate more output keeping constant the level of inputs.

Infrastructure

Infrastructure development leads to a reduction in production and transaction costs, which, in turn, improves the competitiveness of businesses and makes a country more attractive to foreign investors. Cross-country studies by Canning and Bennathan (2000) indicates infrastructure; particularly *telecommunications infrastructure* significantly increases economic growth.

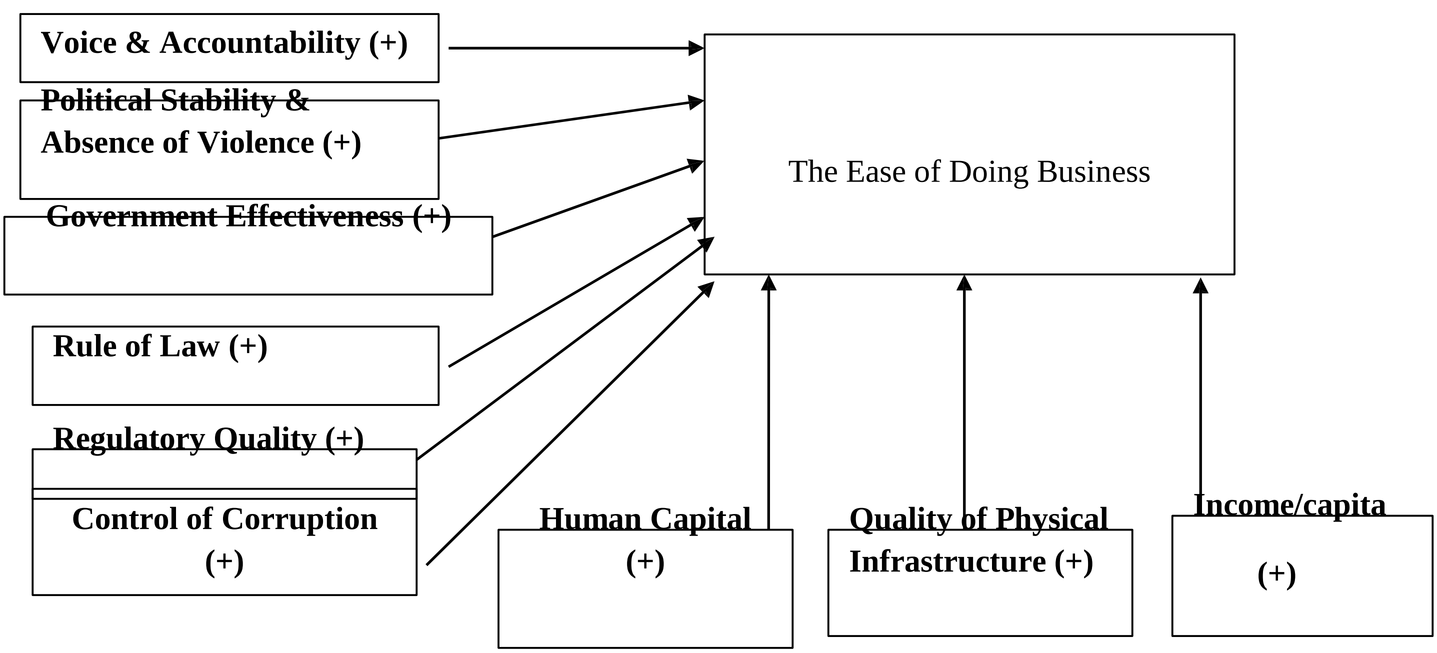
Income per capita

Income per capita which is captured by GDP/c (PPP), measures the level of development of that country and it is believed that it has a strong influence for the wide variation in doing business index among African countries.

Inflation

Macroeconomic stability such as a moderate and stable inflation provides the private sector with a stable environment in which entrepreneurs and consumers are able to plan and invest. Furthermore, a high inflation rate generally raises the cost of borrowing and also it makes it difficult and costly to forecast accurately costs and profits, and hence investors and entrepreneurs may be reluctant to undertake new projects.

Theoretical Model for the Nexus between Governance Infrastructure and Doing Business



Research Methodology and Model Specification

Based on the theoretical explanations discussed above, factors influencing the ease of doing business (EDB) measured in terms of in a given country can be specified as follows:

$$EDB = f\,(\text{voice, politic, effective, regulatory, rule of law, corrupt, } Z_{it}) \qquad (1)$$

Where; *voice, politic, effective, regulatory, rule, corrupt* represent *voice & accountability, political stability, government effectiveness, regulatory quality,* rule of law, and absence of corruption, respectively. Z_{it} represents the set of control variables including human capital, infrastructure, income per capita and inflation. Thus, our model becomes as follows:

$$EDB_{it} = \beta_0+\beta_1 Voice_{it}+\beta_2 Politic_{it}+\beta_3\ Effectv_{it}+\beta_4\ Regul_{it}+\beta_5\ Rule_{it} + \beta_6\ Corrup_{it} + Z_{it} + \varepsilon_{it} \qquad (2)$$

Where i indexes the countries under study, t denotes the year, and ε_{it} is the idiosyncratic errors. Thus, the model takes both the cross-section dimension and the time-series dimensions into consideration. Apparently, this study primarily applied a dynamic GMM model to address the dynamics nature of doing business in a given country. The System-GMM estimator developed for dynamic panel data estimation (Blundell and Bond, 1998; Arellano and Bover, 1995) is the most appropriate estimation method to control for the country-specific effects as well as the bias caused by the inclusion of the lagged dependent variable.

In order to prove whether the lagged values of the explanatory variables are valid instruments, 'Hansen test for over identifying restrictions' was conducted and the result suggests the instruments used are valid. In line with this, a 'Levin-Lin-Chu panel unit root test was conducted and the result confirms the data is stable with a constant mean, variance and standard error. Likewise, a test for heteroskedasticity was conducted using the Breusch-Pagan test, and hence the null-hypothesis of homoskedasticity was rejected, and eventually corrected using heteroskedasticity-robust standard errors. In addition to GMM estimator, this study also used feasible general least Square (FGLS) and Prais-Winstein panel-estimation methods with corrected heteroscedasticity standard errors so as to check the consistency of the results.

The data for the six-elements of governance infrastructure was found at the "Daniel Kaufman Good Governance Data Base" whereas the data for human capital, infrastructure, GDP/c and inflation was found at the World Development Indicators (WDI) data base.

Empirical Analysis and Results

Correlation Analysis

Though correlation tells us only the degree of association not necessarily causation, it suggests the direction and the strength of association between the dependent variable and the independent variables. Accordingly, apart from voice and accountability, all other good governance variables including political stability, rule of law, government effectiveness, regulatory quality, and control of corruption are significantly correlated with the ease of doing business in Africa. Of the control variables, human capital, infrastructure and income per capita have been found to be highly correlated with the ease of doing business even at 1% significance level (Table 2).

Table 2: Partial Correlation of Doing Business Index with the Independent Variables

Variable	**Correlation**	**Level of Significance**
Voice and Accountability	0.0221	0.694
Political Stability	0.1149	0.040**
Government Effectiveness	0.1491	0.008***
Regulatory Quality	0.2605	0.000***
Rule of Law	0.0892	0.1012*
Control of Corruption	0.037	0.047**
Human Capital	0.4213	0.000***
Infrastructure	0.3603	0.000***
GDP/C	0.3255	0.000***
Inflation	-0.0402	0.474

Regression Results and Main Findings

The empirical results using GMM, FGLS and Prais-Winstein panel estimation methods with heteroscedasticity corrected standard errors are presented in table 3 below.

Table 3: Regression for the Dependent Variable: Doing Business Index (DTF)

Explanatory Variable	GMM	FGLS	Prais-Wnstein Regression with panels corrected SE
$(DTE)_{it-1}$	.902*** (.521)		
Voice and Accountability	.020 (.037)	.068 (.045)	.012 (.015)
Political Stability and Absence of Violence	.045*** (.023)	.048*** (.015)	.051*** (.019)
Government Effectiveness	.083** (.041)	.166*** (.033)	.127** (.052)
Regulatory Quality	.075* (.045)	.165*** (.024)	.187*** (.042)
Rule of Law	.080* (.044)	.079*** (.027)	.079*** (.028)
Absence of Corruption	.039** (.015)	.032** (.016)	.048* (.028)
Human Capital	.072*** (.024)	.146*** (.014)	.161*** (.021)
Infrastructure	.033*** (.011)	.487*** (.056)	.479*** (.046)
GDP/c	.1528* (.0896)	.001 (.0006)	.058*** (.001)
Inflation	-.025 (.003)	-.006 (.007)	-.005 (.007)
Constant	2.860 (1.965)	29.104 (.600)	29.911 (1.067)
Number of observations	287	338	328
Number of groups	41	41	41
Observations per group	7	8	8
Wald Chi2 (11)	1051.54	2872.64	2872.64
Prob>chi2	0.000	0.000	0.000

Accordingly, the empirical results revealed that *political stability & absence of violence*, *government effectiveness*, *rule of law*, *regulatory quality* and *absence of corruption* are crucially important for increasing the ease of doing business in African countries. For instance, the GMM result from Table 3 shows a one percent increases each for *political stability* and *government effectiveness* may increase the *ease of doing business index* by 4.5 percentage points and 8.3 percentage points, respectively. Similarly, a one percent increases each for *regulatory quality* and *rule of law i*ndex may increase the *ease of doing business index* by 7.5 percentage points and 8 percentage points, respectively. By the same token, a one percent increase in the effort of *controlling corruption* may increase the *ease of doing business* index by 8 percentage points. The study, however, found no evidence for *voice and accountability* to influence the *ease of doing business* in African countries. This is perhaps if a government enhances the other elements of good governance infrastructure, it is likely to attract foreign investors as well as domestic entrepreneurs despite offsetting deficiencies in voice & accountability.

Other important control variables that influence the ease of doing business in Africa include: human capital (trained manpower), infrastructure, and income per capita. Indeed, the result is in line with previous arguments that the key for success in creating conducive business atmosphere is highly related with the ability of a given country to invest in education and physical infrastructure. Accordingly, the study found human capital and physical infrastructure is statistically significant at 1 % level, implying the high importance of those variables. On the other hand, the study found no evidence for inflation to significantly affect the ease of doing business in African countries. This is perhaps due to the fact that unless a country is experiencing hyperinflation like the one noted in Zimbabwe, a moderate and stable inflation may not significantly affect the business atmosphere. Interestingly, the empirical results from FGLS and the Prais-Winstein Regression with panel corrected standard errors also confirmed that except *voice and accountability*, all other governance infrastructure variables as well as human capital, income per capita and physical infrastructure are quite important to speed-up the "ease of doing business" in African countries.

Conclusion and Policy Suggestions

It is widely argued that a country's economic performance over time is determined to a great extent by its political, institutional and legal environment (OECD, 2001). This study, therefore, analyzed the impact of governance infrastructure on cross-country differences in the ease of doing business in African countries. Accordingly, the empirical results from this study have confirmed that government *effectiveness*, *political stability*, *regulatory quality*, *rule of law*, and *absence of corruption* are found to be robust determinants to accelerate the ease of doing business in African countries. Thus, it can be argued that states that have higher quality governance may create conducive business atmosphere and this in turn will facilitate capital flows from abroad as well as to stimulate domestic entrepreneurs in doing business in their own country in a better way. However, the study found no evidence for *voice and accountability* to significantly influence the *ease of doing business* in African countries. Other economic fundamentals which may contribute for the ease of doing business in Africa include human capital, physical infrastructure and income per capita. Thus, the main lessons from this study is policy makers in Africa should have to give due attention for enhancing good governance' infrastructure such as an effective, impartial and transparent legal system that protects property and individual rights in addition to investing in human and physical infrastructure so as to create a more stable business environment.

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Appendix A: Figures

Figure 1: Doing Business in Africa (DTF)

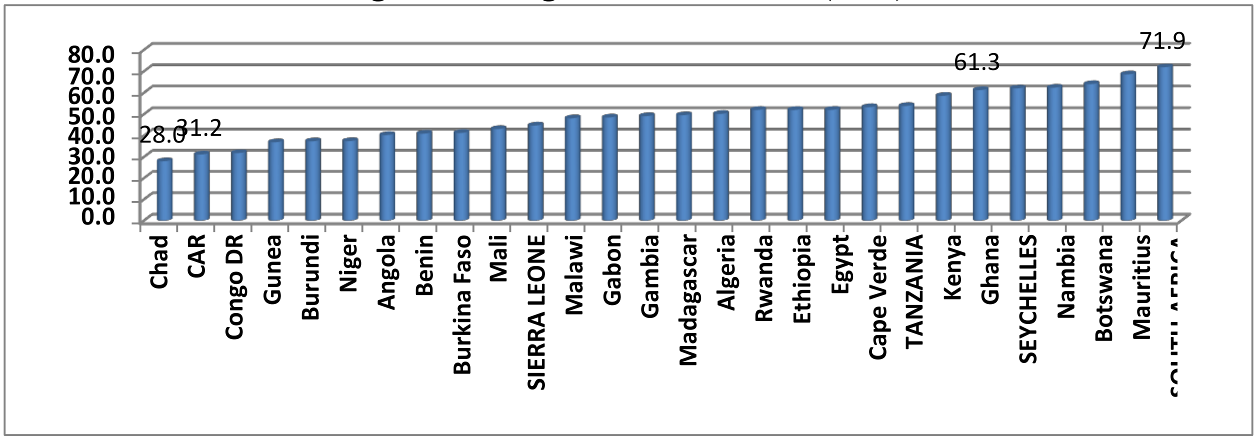

Figure 2: Improvement in Doing Business Index /DTF/ of Botswana (2005-2012)

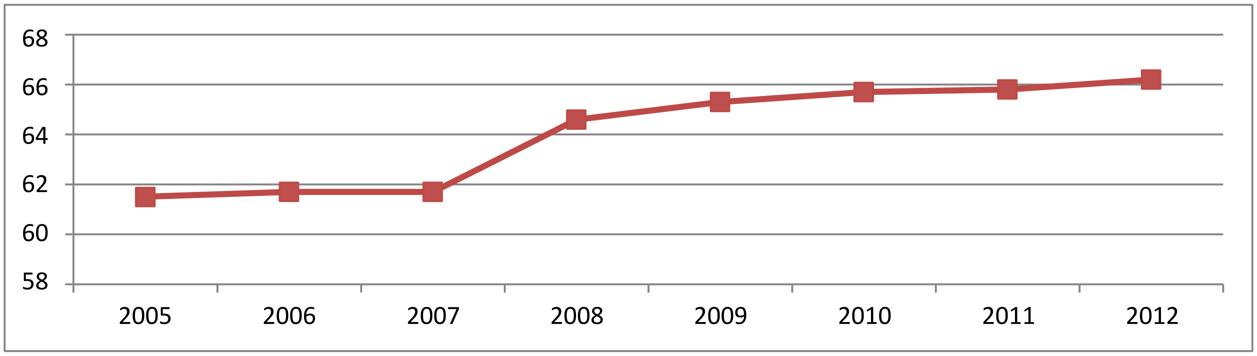

Figure 3: Improvement in Doing Business Index /DTF/ of South Africa (2005-2012)

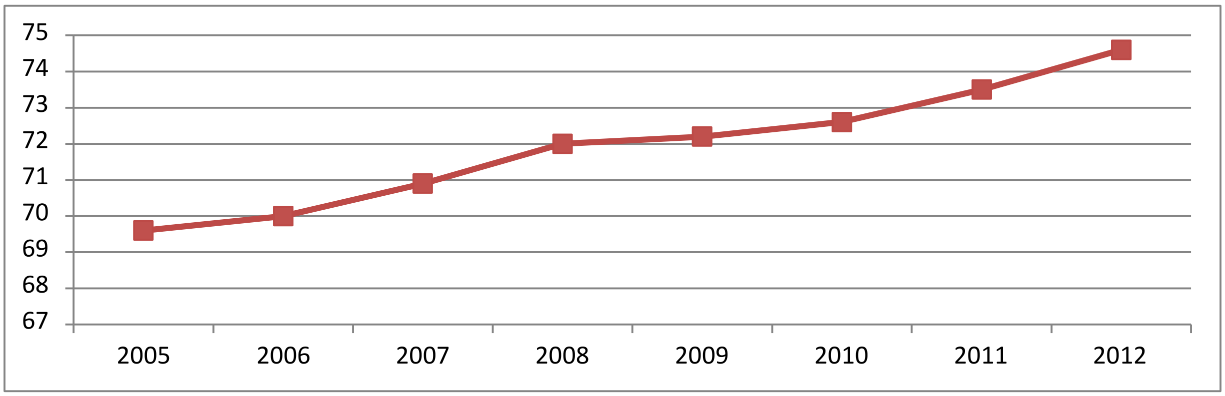

Figure 4: Improvement in Doing Bu Index /DTF/ of Ghana (2005-2012)

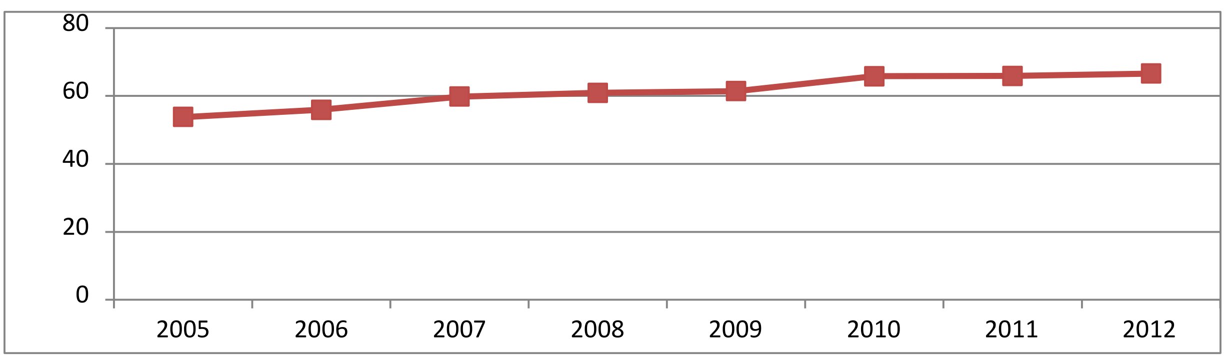

Figure 5: Improvement in Doing Business Index /DTF/ of Mauritius (2005-2012)

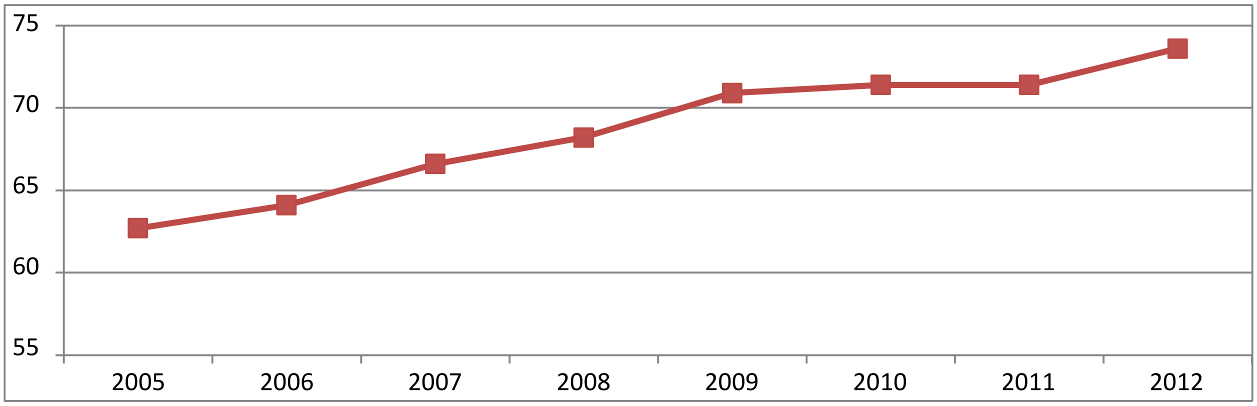

Figure 6: Improvement in Doing Business Index /DTF/ of Rwanda (2005-2012)

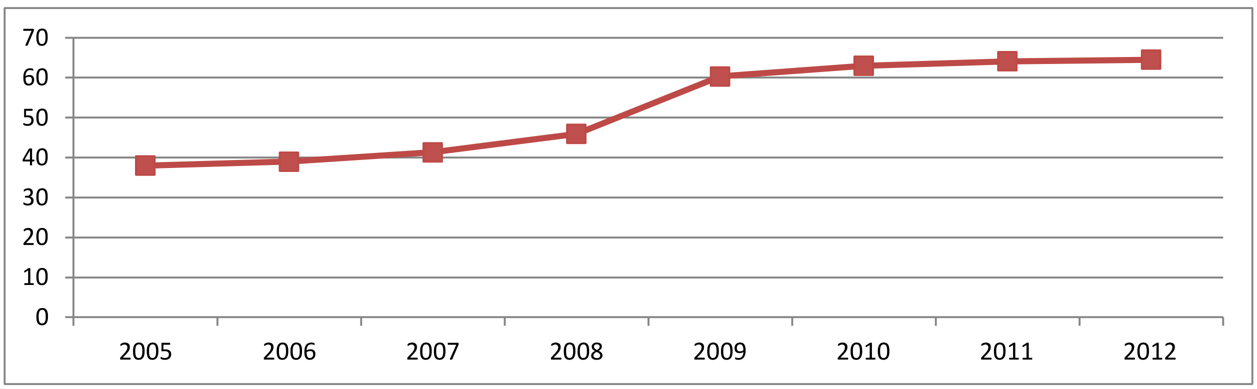

Figure 7: Improvement in Doing Business Index /DTF/ of Uganda (2005-2012)

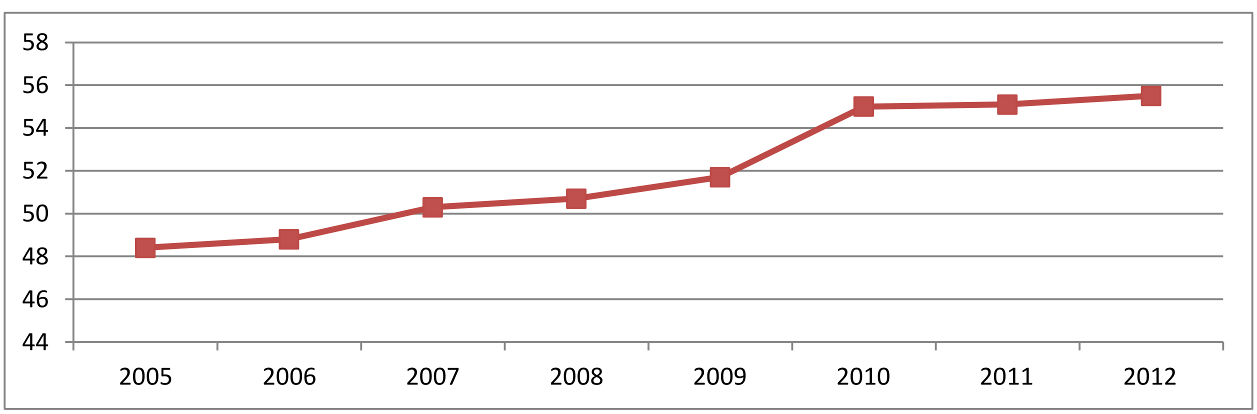

Figure 8: Voice and Accountability Index in 2005 and 2012

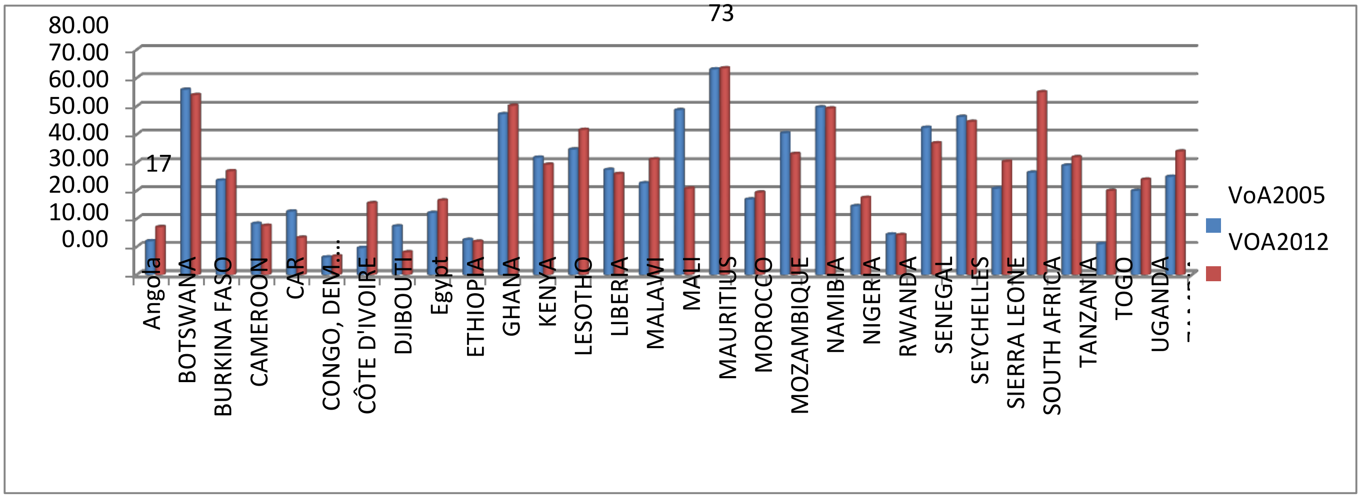

Figure 9: Political Stability Index in 2005 and 2012

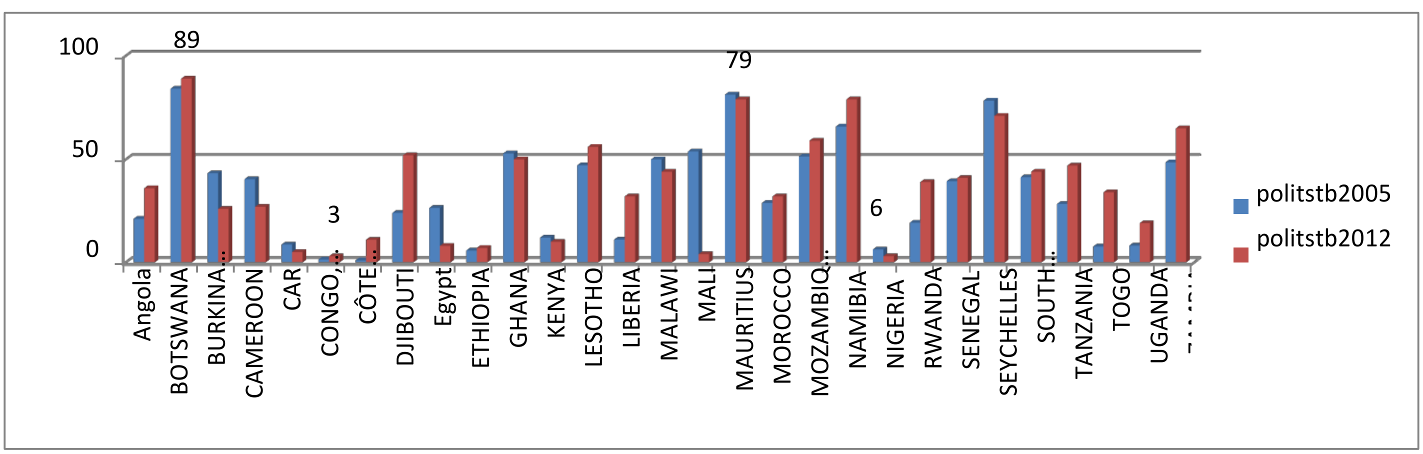

Figure 10: Government Effectiveness Index in 2005 and 2012

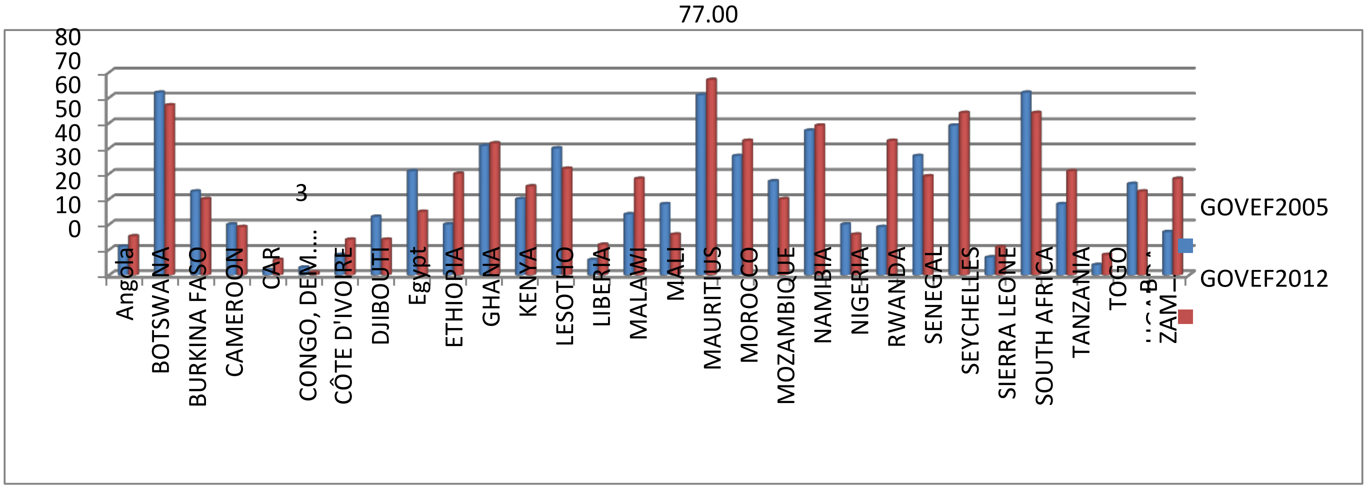

Figure 11: Rule of Law Index in 2005 and 2012.

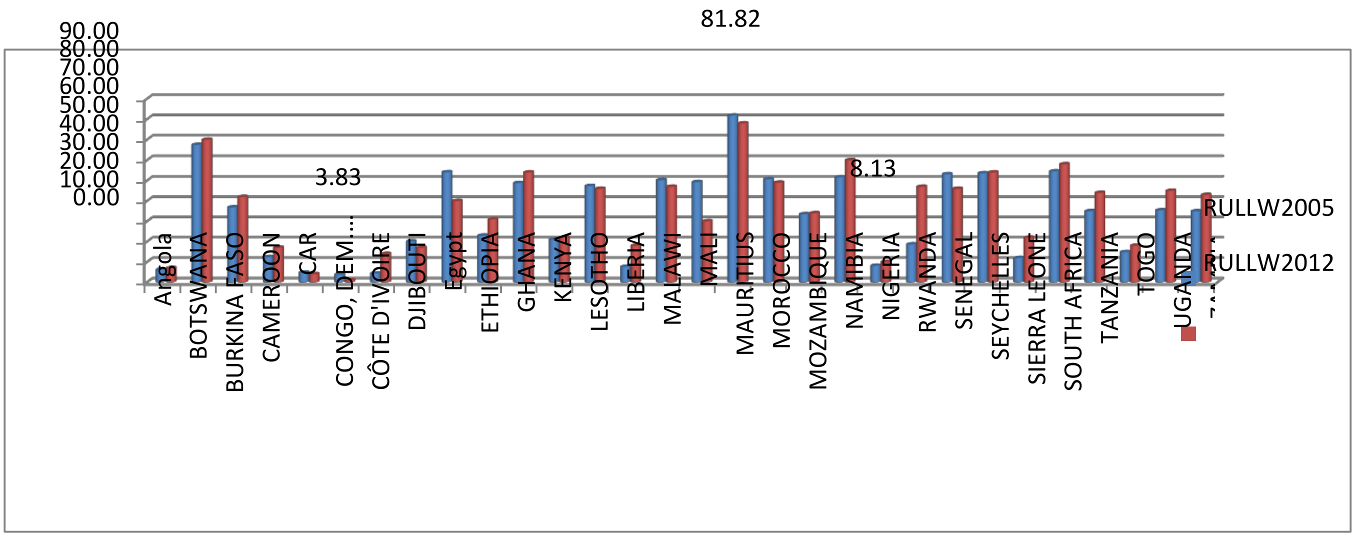

Figure 12: Regulatory Quality Index in 2005 and 2012

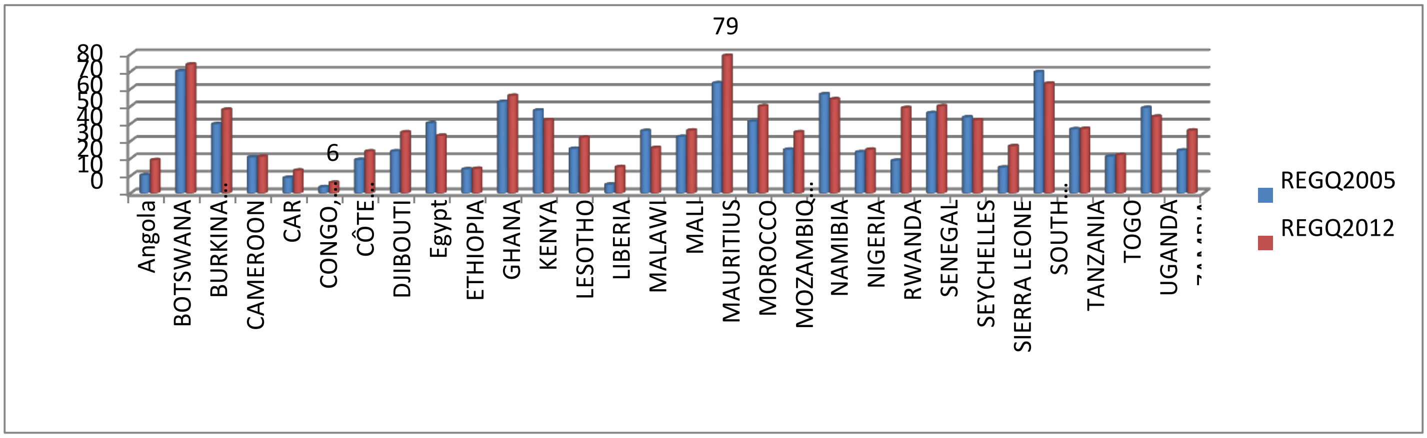

Figure 13: Control of Corruption Index in 2005 and 2012