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How to strengthen the contribution of the private sector to African development by improving its financing ?

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The private sector plays a crucial role in promoting the sustainable development. It is generally accepted that firms creates wealth, generates jobs and thus contributes to improving the living conditions of populations; while being able to increasingly ensure the preservation of natural resources, biodiversity and the climate and promoting the emancipation of women.

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A sustainable strengthening of the economic structure in Africa implies addressing the difficulties faced by African entrepreneurs. Poor access to credit is one of the most important constraints to private sector development, particularly for small and medium-sized enterprises (SMEs), and new firms (start-ups).

Private financial intermediaries have difficulty supporting SMEs and start-ups, which are at the heart of the structural transformation of African economies. The action of donors is to complement and support local initiatives in order to direct funds to firms that can initiate a growth dynamic. However, the current situation is far from satisfactory. Donors' risk-taking is limited and, in the end, few SMEs and start-ups directly or indirectly benefit from their financing, particularly in fragile states.

It is therefore necessary to rethink international public aid to the private sector by (i) increasing the amounts of official development assistance (ODA) destined for the private sector and (ii) using these resources to compensate for the increased risks and insufficient profitability of investments. Only a paradigm shift in ODA in favor of the private sector will make it possible to support the emergence of formal private enterprises, the only ones capable of creating jobs on a large scale and generating wealth directly at the bottom of the pyramid.

The formal private sector, an essential link for development in Africa

The importance of formal enterprises for wealth and employment creation

The African Development Bank estimates that only 3 million jobs are created each year in Africa while 10 to 12 million young people enter the labor market at the same time. This imbalance is not likely to be reversed according to the United Nations' demographic forecasts, which predict a doubling of the African population by 2050 with a majority of young people.

Faced with this situation, the majority of the workforce operates in the informal sector, which accounts for more than 80% of jobs in Africa, compared to 65% in Asia and 40% in South and North America (ILO, 2018). Informal enterprises, while serving as a safety valve, cannot be a support for the development of a dynamic private sector in Africa. Indeed, informal activities are often developed as survival solutions in the absence of more profitable alternatives in the formal sector. Informal enterprises are not very productive and create little value added (La Porta and Shleifer, 2014, IMF 2017). For employees in the informal sector, this leads to low-paying and unstable jobs with little protection (Bocquier et al., 2010). In addition, informal businesses create almost no jobs beyond the family circle and struggle to grow over their life cycle (Ulyssea, 2020).

The development of private sector is mainly driven by a handful of formal firms accounting for the majority of jobs and wealth created (Grover Goswami et al., 2019). In addition, these high-growth firms (HGFs) primarily drive innovation (Audretsch et al., 2014).

The development of HGFs also has positive effects on other firms. The positive effects spread along the value chain by stimulating demand from suppliers and the supply of better quality products at lower cost to their customers, whether they are final consumers or companies downstream in the value chain. In addition, the presence of HGFs promotes the dissemination of knowledge and best practices to all firms in the value chain (De Nicola and Muraközy, 2019). For instance, the diffusion of the use of digital tools has positive effects on the activity of firms in the same sector (Cariolle, 2020). These spillover effects can also relate to other aspects such as formalization or social and environmental practices.

Positive effects beyond the productive sector

The existence of dynamic firms not only changes the productive structure but also has important indirect impacts on the rest of the economy.

The existence of dynamic firms facilitates the insertion of an economy into global value chains. Having productive enterprises improves the country's export performance. This openness to the international market allows access to goods that are essential for the country's development (thanks in particular to the inflow of foreign currency) but also to improve the performance of local firms in return through technology transfers and competitive pressure (Amendogaline et al., 2013). The example of Southeast Asian countries in the 1980s is eloquent from this point of view, as it clearly demonstrated how domestic firms considerably improved their performance through contact with their foreign counterparts.

The accumulation of both physical and human capital is facilitated by the existence of a private sector that creates job opportunities. Future employees (or current workers) have a greater incentive to invest in their education (or continuing education) if the prospect of finding gainful employment for the more skilled is increased (Bobba et al. 2020). This improvement in human capital in turn benefits society as a whole by improving health indicators or fostering innovation.

Private sector development also increases fiscal resources and better spreading the tax burden. Caldeira et al. (2019) show that tax revenues average 13.2 percent of GDP in Africa, whereas this ratio could reach 23.2 percent if the full tax potential were exploited. A large number of formal enterprises allows the government to broaden the tax base for both direct taxes (corporate and personal taxes) and indirect taxes (value added tax). These additional revenues are essential to enable public investment, which is crucial to support the development of a national infrastructure, including education, health and transportation systems.

Firms are at the heart of innovation in many areas, such as the environment. Firms have always had to innovate in order to maintain their presence on the market, and their innovative approach is at the heart of the consideration of the environmental impacts of their activities and their mitigation. The need to continuously improve processes and to innovate in their products and services makes companies a key player in reconciling technological innovation and respect for the environment.

Finally, private sector development is also particularly important where it is most lacking: in fragile states. Many studies have shown that poverty is a breeding ground for conflict by spreading discontent among populations and reducing the opportunity cost of abandoning a productive activity to join a rebel movement (Rohner, 2018). The creation of productive activities in fragile or post-conflict countries is therefore a strong tool for pacification and development of these regions (Collier et al., 2019). The strong economic development in Western Europe after World War II is a perfect example of this pacification process on a continental scale.

The lack of access to credit penalizes SMEs and start-ups in Africa

The preponderance of the informal sector in Africa reflects the poor performance of formal firms. Formal firms struggle to grow over their life cycle[1] and their productivity is twice as low as the productivity of similar firms in other developing countries (Baraton et al., 2021).

Limited access to credit is one of the most

1. Using a survey of firms around the world, it was found that it takes an average of 20 years for an African firm to double in size, while it takes only seven years in other developing countries to double in size (data from the World Bank Enterprise Surveys, available at www.enterprisesurveys.org. Calculations made by the authors).

common obstacles cited by entrepreneurs in Africa to explain their difficulties. This is particularly true for small and medium-sized enterprises, as illustrated in Figure 1. While not unique to Africa, this lack of access to credit for small and medium-sized enterprises is more pronounced on the continent[2].

These figures are consistent with an extensive academic literature on the importance of improved access to finance in stimulating not only entrepreneurship but also fostering firm growth (see: Bloom et al., 2010; Kersten et al., 2013, among others).

Improving private sector financing, especially for SMEs and start-ups, is therefore a public policy priority in order to enable the growth of private enterprises in Africa as well as to improve their productivity, which is a condition for the creation of sustainable jobs and the improvement of living conditions in these countries (Restuccia and Rogerson, 2017).

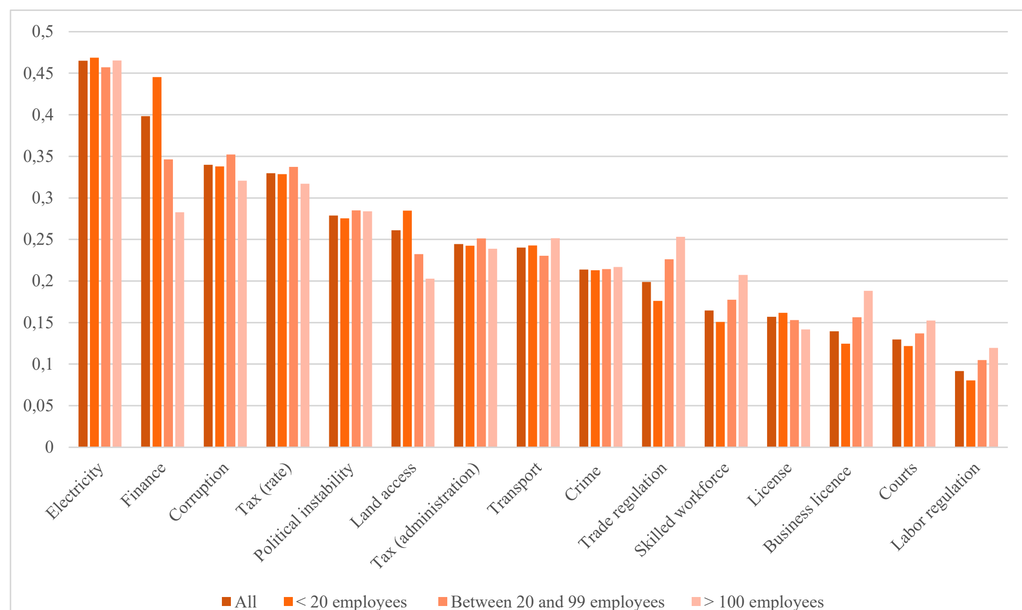
2. This finding is confirmed by more objective measures of access to credit. It appears that 88% of companies with less than 20 employees declaring a need for external capital do not have access to it. This ratio is 73% for medium-sized firms (between 20 and 100 employees) and 51% for large firms (more than 100 employees). The difference with other developing countries is 20 points. The data are from the World Bank Enterprise Surveys (last wave of surveys conducted from 2015 to 2020). A firm is reported as financially constrained if it cannot access credit despite needing financing (see Léon and Zins, 2020, for an explanation of the measure used).

Why SMEs and start-ups cannot access to credit in Africa?

Information asymmetry at the heart of financial difficulties

The main risk faced by creditors is counterparty risk due to the asymmetry of information between the borrower and the lender (Stiglitz and Weiss, 1981). Lenders have imperfect knowledge of the project's prospects and of the entrepreneur's ability and desire to carry it out. This asymmetry is accentuated in Africa because of the difficulty of producing and sharing reliable information. Banks can hardly reduce the information asymmetry from quantitative data in Africa. Indeed, many African SMEs and start-ups

Figure 1. Key barriers to business growth in Africa



Note: Sources: WBES (latest wave for each country, 2015-20), authors' calculations. The survey was conducted among 35,000 firms in 42 sub-Saharan African countries. Each bar reports the percentage of firms reporting that the barrier considered is a major obstacle to the development of its business. All refers to the total number of firms surveyed. «<20 workers» refers to small firms with 0-19 employees, «Between 20 and 99 workers» refers to medium-sized firms and «>100 workers» refers to large firms with 100 or more employees.

are unable to provide the financial information required by creditors to assess their creditworthiness because they lack a credit history or audited accounts. Furthermore, even when firms are able to produce the documents, information provided is subject to caution (unreliable accounts, questionable title deeds, lack of or inadequate mortgage or bonding systems, etc.). Indeed, many "formal (i.e., registered) firms" adopt informal practices such as under-reporting of activity, non-registration of part of the workforce, or multiple accounting (Benjamin and Mbaye, 2012; Ulyssea, 2020).

This difficulty in producing credible information is accentuated by other factors, both internal to the company and environmental. Many African SMEs are family businesses with limited delegation. The managers, who come from the family, are not always able to put together a financing plan that can be validated by a lender. In addition, in many African countries, it is difficult for an entrepreneur to obtain essential documents to apply for credit in the absence of an efficient administration.

Burdensome procedures

As a result, banks tend to be very cautious in granting credit in Africa. Creditors are particularly demanding in terms of procedures in order to be able to correctly assess the borrower's creditworthiness (especially if they are aware of the shortcomings of the legal system that will not allow them to recover their funds in case of non-repayment). As a result, only a few firms are able to meet the criteria required to access credit. Collecting all the required documents is a high cost for SMEs, especially in countries with inefficient administrations[3]. These requirements are particularly difficult, if not impossible, for start-ups that do not have financial history. Similarly, the most innovative projects are difficult to finance because of the lack of risk/return analysis due to the uncertainty that is difficult to quantify.

In addition, banks will often ask entrepreneurs to pledge significant amounts of equity in order to ensure the financial capacity of the borrower (to avoid adverse selection) and to reduce moral hazard behavior. Many entrepreneurs do not have these funds and are therefore excluded from bank financing by this new constraint.

As a consequence, there is a vicious circle. The difficulty in distinguishing good projects from bad ones, due to the lack of reliable information, encourages lenders to increase their requirements in terms of procedures and equity, excluding firms that could have obtained credit under less drastic conditions.

The «missing middle» problem

Banks use not only quantitative data («hard information») to evaluate an investment project, but also qualitative information («soft information»). The latter requires a significant investment in human capital (in situ visits, meetings with owners, etc.). The use of qualitative information is essential in Africa due to the lack of reliable qualitative data. However, it involves significant fixed and sunk costs because qualitative information is extremely expensive to produce and cannot be easily reused[4]. Making these initial costs profitable therefore implies financing investment at large scale capable of absorbing these sums. Thus, only large, often foreign-owned and well-structured firms really benefit from bank financing. On the one hand, these firms can provide the required quantitative information (audited accounts, credit history) and the use of «soft information» is less crucial. On the other hand, their financial needs

3. African firms more often refer to the burden of procedures to justify why they refuse to apply for bank credit. Firms from other developing countries more frequently refer to loan conditions to explain their discouragement in application (source: enterprise surveys, authors' calculations).

4. Obtaining qualitative information requires a dense network of well-trained loan officers who are able to properly evaluate financing applications. The information collected is usually project/enterprise specific and not easily reusable for other financing.

are sufficient to cover the fixed costs. Given the moderate number of «bankable» firms in Africa, there is a competition between local banks, foreign banks, investment funds and even donors to finance the projects of these companies in Africa.

As a result, SME, which have financing needs ranging from a few tens of thousands of euros to several million euros, are not eligible to either microcredit or bank credit[5]. Indeed, more and more quasi-informal microenterprises are able to obtain financing (at least in urban areas) through microfinance, which is still often the preserve of NGOs and nonprofit associations, which very often benefit from grant resources and are therefore not subject to profitability criteria. The microfinance model, however, is not suited to supporting fast-growing businesses. The tools of microfinance (maximum amount cap, short grace period, frequent repayment schedules) were not created for firms who need to mobilize long-term resources. For commercial banks or investment funds, SMEs are not very attractive. The investment projects are small, which does not allow them to cover the high fixed costs. Banks therefore prefer to turn to large investment projects, well-established companies and/or other financing activities (purchase of treasury bills), which are relatively profitable and much less risky for them.

In other words, there is a «missing middle» in the financing of firms in Africa due to the difficulty of SMEs but also young start-ups with potential for strong growth to obtain financing from existing financial institutions (microfinance institutions, banks, investment funds).

5. In some countries, there is a movement towards closing this financing gap through various initiatives (Baraton and Léon, 2021): upgrading of microfinance institutions; products dedicated to SMEs developed by some banks; setting up of investment funds dedicated to these intermediate tickets. However, this change is slow and far from widespread.

The limits of official development assistance to the private sector

Official development assistance (ODA) to the private sector is channeled primarily through Development Finance Institutions (DFIs), which are development organizations that specialize in financing firms in low- and middle-income countries. DFIs use financing that combines a subsidized (aid) component with a market component. This «blended finance» allows them to provide loans or equity with long maturities and below-market costs. In addition, grants are also used to finance the technical assistance that most often accompanies financial investments.

A study by Ferdi (2020)[6] found that DFIs were not very involved in financing SMEs and start-ups in Africa. That is explained by both the current aid modalities and the insufficient amounts dedicated to the private sector.

DFIs intervene either by directly supporting non-financial enterprises (direct financing) or by supporting financial intermediaries (indirect financing). Through their direct investments, DFIs can hardly target SMEs directly. DFI financing, whether in the form of loans or equity investments, is rarely less than EUR 5 million, which implies investment projects of around EUR 10 million at least (DFIs never finance more than 50% of the total cost). Projects of this size in Africa are rare[7].

While indirect financing tools are undoubtedly more effective in reaching SMEs or start-ups, they are not a panacea. Indirect financing has the advantage of allowing large amounts

6. The study focused on an analysis of the investment policies and projects financed for four European DFIs (CDC, DEG-KfW, FMO, and Proparco). It was also extended to other DFIs (such as IFC of the World Bank Group).

7. By way of comparison, an investment of EUR 10 million in Côte d'Ivoire is «equivalent» to an investment of almost EUR 650 million in France, on the scale of the Ivorian economy. This discrepancy is even more marked for poorer countries such as the Sahelian countries. For example, an investment of EUR 10 million in Mali would correspond to an investment of EUR 1.3 billion in France.

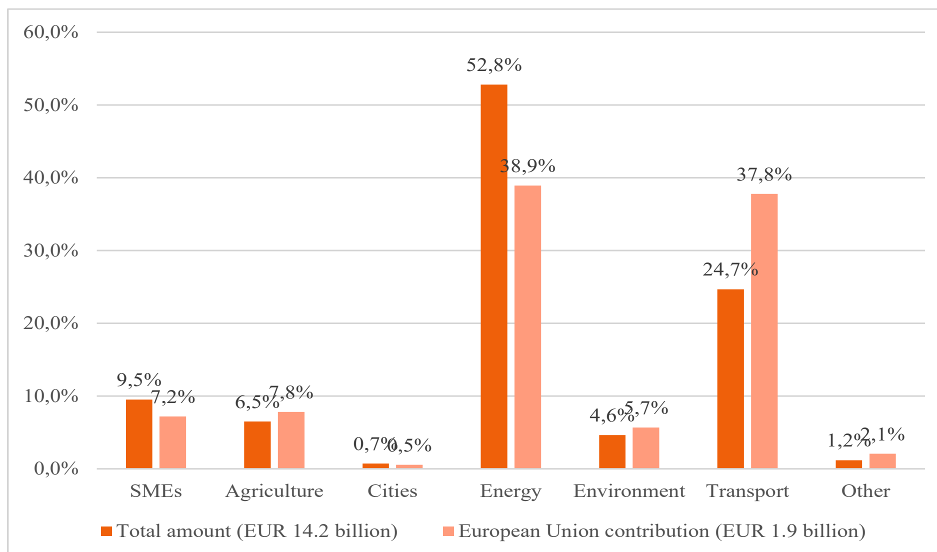
of funding to be channeled to smaller firms through local financial intermediaries. Nevertheless, by relying on existing actors (banks, microfinance institutions), DFIs can only act on the margins of SME and start-up financing. Tools such as guarantees or lines of credit can attract new clients, but the change in scale is too small to have a transformative impact. In particular, these instruments are ineffective in targeting firms located in remote areas without bank branches.

Moreover, while we might expect public institutions to take more risk than the private financial intermediaries, this is not the case. In addition to the usual requirements demanded by banks, DFIs tend to include other procedures in order to reduce their exposure to all risks (fiduciary, counterparty, reputational, AML/CFT, environmental, social, climate, biodiversity). An analysis of European DFIs' procedures shows that they require their clients to respect social, environmental and governance standards that are close to the highest international standards (Ferdi, 2020). Compliance with these procedures implies that only large companies and international banks can access DFI financing. The above-mentioned study shows that more than half of the banks that receive financing from one of the main European DFIs are international banks. However, these large international banks are not always the most effective in promoting access to credit for SMEs in Africa (Léon and Zins, 2020). In addition, focusing on a limited number of well-established players can have perverse effects, particularly in terms of competition, with the risk of slowing down the entrepreneurial dynamic.

In addition, the aid provided to support the private sector remains modest. Thus, an analysis of the European Investment Plan (the main source of subsidies for DFIs) shows that funds are allocated in priority to large infrastructure projects (in the energy and transport sectors, carried out within the framework of major concessions with international operators). Support for SMEs received only 7% of the total amount allocated by the European Commission (Figure 2). These funds could usefully serve development in Africa if they were used more to support the productive private sector. SMEs, TMEs, and start-ups are essential to Africa's development and to addressing situations of extreme fragility.

The diagnosis of the current functioning of official development assistance to the private sector therefore implies rethinking the modalities of this support.

Figure 2. Distribution of European funds under the European Investment Plan



Note: Data from the EIP website, authors' calculations. Percentages represent the distribution of total funds for each project (total volume) or the contribution in the form of European Union aid. The total volume corresponds to the funding provided by the lender (AFD, EIB, ADB, etc.), which includes the Commission's share of the grant (EU Contribution) and the other sums used to finance the project (loans, equity, etc.).

The need to rethink the support needed for private enterprises in Africa

Increase ODA in direction to private enterprise in Africa

The challenge for DFIs is to reconcile three imperatives: profitability; risk management; and impact. Currently, DFIs are constrained by market-like return requirements and risk control, forcing them to limit their ambition in terms of impact (Gössinger and Raza, 2011; Ferdi, 2020). As exposed above, Africa faces a demographic challenge that can only be fully met by spurring firms' development. However, the majority of best-placed firms in Africa to generate endogenous growth and create jobs (SMEs and startups) suffer from a lack of financing (private and public).

ODA should be used to finance private enterprises that have a strong impact on African economies. The controversy over the use of public funds to support the private sector is not new. Opponents argue that public funds should not be used to enrich private shareholders. However, this vision of aid ignores the fact that productive enterprises have not only economic effects (jobs creation, diffusion of knowledge) but also strong impacts on the rest of society (innovation, fiscal mobilization, pacification). The use of the government funds to support companies is hardly questioned when the stakes go beyond purely private contingencies, such as maintaining jobs in the current crisis or the massive support of many countries to strategic sectors (agriculture, aeronautics, health, etc.). This is also the situation in Africa today because of the importance of the private sector for its development.

Public resources should therefore be used to support firms that have significant economic, social or environmental impacts. However, as the previous analysis illustrates, ODA directed towards supporting the private sector remains modest, given the challenge (creation of millions of jobs). It is therefore necessary to change scale to hope to have a real impact.

Proposal 1:
Increase ODA volumes to support the private sector in Africa

Increased mobilization of public funds to private sector will require demonstrating the proper use of these resources. This implies being able to properly measure their impact. DFIs must continue their efforts already developed to better measure the economic, social, and environmental impacts of their investments (Attridge et al., 2019). In addition, care must be taken to ensure that ODA complements the local supply of finance and is not diverted to exclusively private purposes. Audit and traceability tools exist to ensure the proper use of public grants.

Beyond increasing the volume, rethinking the use of ODA for private enterprises is central to increasing its impact on African economies. In particular, public resources should be used to encourage greater risk-taking (de-risking investments) and reduce financial constraints (compensating for lower short-term return) in order to have a strong long-term impact.

Using ODA to de-risk investments

Increasing the positive effects of public support to the private sector in Africa involves targeting impactful firms. These include HGFs, which account for most of the wealth and job creation and innovation (Grover Goswami et al., 2019), as well as pioneering firms that explore new markets (Collier et al., 2019). Yet, investing with these firms involves high risk due to radical uncertainty about their intrinsic initial potential and the multiple exogenous shocks they will face over their life cycle[8].

8. For example, identifying high-growth firms is a complex exercise, especially in Africa due to multiple sources of uncertainty, even using «big data» methods (McKenzie and Sansone, 2019) or based on past performance (Léon, 2021).

In other words, directing investments to high-impact enterprises implies high risk-taking, with failure at least as likely as success. DFIs, and private banks, struggle to target these enterprises because of a conservative approach to risk. Aid to these firms needs to be rethought as a means of de-risking part of the investment. Two approaches, not necessarily mutually exclusive, can be explored.

One way is to improve existing tools or the way DFIs operate. Guarantee tools could be expanded to cover new risks (first loss risk, political risk, security risk, etc.). DFIs could also devote part of their resources to financing impactful enterprises (HGFs, pioneering enterprises). The individual risk is low because the amounts involved remain moderate, which should not jeopardize these institutions. This approach is certainly interesting, but it does not seem to be sufficient to meet the challenge. Guarantees will thus be useful for financing SMEs in markets where banks or investment funds are present (major cities in the most stable countries). On the other hand, it is unlikely to support start-ups. Neither local banks nor DFIs will be able to take the risk of supporting firms in fragile areas because of risks that are difficult to control (notably reputational risk) or a lack of presence in these areas. In addition, local DFIs and creditors will find it difficult to get out of their procedures (e.g., record tracks) that force them to de facto exclude many potential clients (e.g. operating in exposed sectors; start-ups).

A more ambitious solution would be to create a new financial vehicle, which is more flexible. This financial vehicle could mobilize public resources in the framework of a public-private partnership. The contribution of subsidies would thus make it possible to assume the necessary risk-taking and thus guarantee the sustainability of the system. The jobs could cover the financing needs of the targeted private firms. The vehicle would thus offer lines of credit or guarantees to local private banks, more or less subsidized direct loans, equity investments and, when justified, subsidy support. The instrument would thus make it possible to de-risk (through guarantees, a mix of grant and loan resources) certain investments which, would present a delayed profitability or would not be made without this support. The combination of loans and grants, as well as their maturity, would depend on the level of profitability of the operation, the risks involved, and the expected impact of the investment. The fund would be managed by a private entity. The advantage of this new financial vehicle is multiple. It allows for significant leverage by including private investors. It also offers a flexibility allowing to accelerate the procedures (avoiding a round of creditors for each investment project) and to free oneself from the internal rules of each investor (in terms of compliance or due diligence).

Proposal 2:
Create a new financial vehicle dedicated to the development of high-impact firms (high-growth firms, pioneering firms)

Using ODA to reduce financial constraints

Operating in emerging markets involves additional costs due to the moderate size of investments, high default rates and additional financial risks (such as currency risk). These specific conditions imply lower returns. Public resources could be used to reduce the financial strain on both lenders and borrowers.

An investment in a start-up company can sometimes take several years to be financially profitable. The patience of capital is therefore essential. Even if a firm is not financially profitable in the short term, monitoring its economic evolution (growth, jobs, etc.) makes it possible to evaluate whether the investment is worth maintaining (or even increasing). The advantage of public funding is to build long-term relationships. The long-term relationship created makes it possible to wait for the fruits of the investment to materialize and to support clients

in case of temporary difficulties. This long-term support could take the form of direct equity investment (which offers the possibility of recovering a significant part of the gains generated by the investments, unlike a loan contract) or increased support for impact funds, which are undoubtedly better equipped to invest in moderate amounts than DFIs.

Proposal 3a:
Use public funds to allow long-term capital investment and to compensate for the lower (short-term) return on investment

Increased public resources for private sector financing may also serve to reduce the financial strain on potential clients. The main obstacle is the inability of firms to provide credible information. Public subsidies could take the form of funding feasibility studies or pilot phases that would allow firms to prove that their project is viable. Too often lenders intervene when enterprises have been able to prove the viability of their investment. Yet many well-structured companies with profitable projects struggle to raise external funds to finance this first step.

ODA could also develop pre-investment technical assistance for potential clients. This approach would have the advantage of preparing potential clients to apply for financing (construction of a business plan, etc.) without absorbing too much money.

Donors could also support innovations to build credit-scoring models to assess the creditworthiness of small clients based on original (big) data. Several initiatives exploit previously unused data (transaction data, financial flows in the context of mobile money, satellite information for the agricultural sector, etc.) to create credit-scoring models. These innovations involve a significant cost to create the tool, but the implementation is then inexpensive. DFIs could support these innovations through their expertise and funding (during the tool construction phase and/or for data collection).

Proposal 3b:
Reduce information barriers by expanding pre-investment technical assistance, funding pilot projects, and supporting financial innovations to tap untapped information sources

Using ODA to support firms throughout their life cycle

Part of these public resources are used in technical assistance, which is usually provided free of charge as a complement to the investment. Technical assistance is essential to enable firms to upgrade their technical and organizational skills. The DFIs, originating from countries at the production frontier, could make in relation their clients with enterprises in their country of origin. This sharing of knowledge, expertise and technology is undoubtedly essential to quickly achieve economic and financial viability (which remains the ultimate objective of the investment). Technical assistance could also be used to access other sources of funding so that donors are gradually drawn away from successful enterprises (and into funding new ones). Finally, technical assistance support can also be used to help enterprises upgrade their regulatory (formalization) or social and environmental standards.

Proposal 4:
Increase the amounts allocated to technical assistance throughout the life cycle of the investment

Conclusion

Improving private sector financing, particularly for SMEs and start-ups, is essential for Africa's development. The current architecture of official development assistance is struggling to fulfill this mission. To improve the situation, we advocate a substantial increase in ODA to private enterprises in Africa, which implies breaking the taboo around aid to the private sector. We recommend using these additional public resources to de-risk investments for firms in Africa, notably through the creation of a dedicated financial vehicle. We also propose using part of ODA to reduce the financial burden of supporting SMEs and start-ups. Finally, we suggest that support for supported enterprises be stepped up through increased technical assistance.

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