Final report

# Promoting trade and investment in Sierra Leone

International Growth Centre


Philip English
Abou Bakarr Kamara
Herbert Mcleod
Wilbourne Showers



November 2019

When citing this paper, please use the title and the following reference number:
F-19118-SLE-1

DIRECTED BY

LSE

UNIVERSITY OF OXFORD

FUNDED BY

UKaid from the British people

# PROMOTING TRADE AND INVESTMENT IN SIERRA LEONE

## Some Issues to Consider

Philip English
Abou Bakarr Kamara
Herbert P. Mcleod
Wilborne Showers

November, 2019

## Table of Contents


Section One: Background ..... 3

Section Two: The Challenges of Diversification ..... 4

Section Three: Misconception of the Concept of Value-Addition ..... 6

Section Four: The Disadvantages of Export Taxes and Prohibitions ..... 8

Section Five:The Importance of Foreign Investment and its Associated Controversies ..... 9

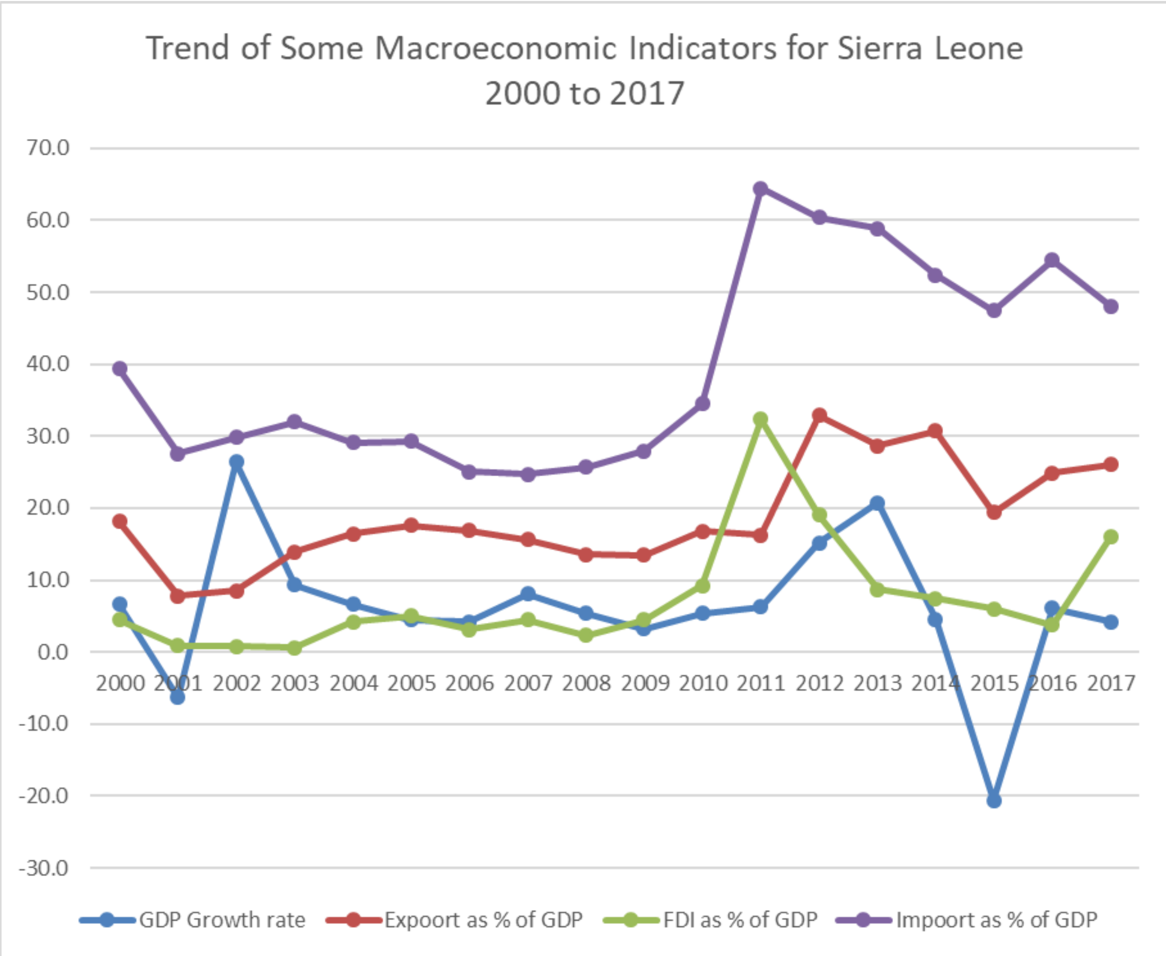
Section Six: Conclusion ..... 9

References ..... 10

## Section One: Background

The Sierra Leone economy is small, open and largely undiversified. Since the end of the war in 2002, the country has registered some progress in several fronts. Poverty has declined from 66 percent in 2003 to 56.8 percent in 2018[1] while expansion and growth of the economy have been characterised by wild swings in GDP growth rates punctuated by short periods of relatively stable growth as shown in figure 1.

The country's GDP growth fluctuated in 2001-2004 as a result of the civil war which was followed by rebound after peace was restored. Immediately after the war, the agricultural sector was the main driver of GDP growth providing a period of stable growth. The start of iron ore exports led to a boom in 2012-14. The outbreak of Ebola in 2014 coincided with the slump in mineral prices including the drastic decline in prospecting for oil. By 2015, the economy virtually collapsed with a double-digit drop in GDP growth. Measurements of most metrics except inflation reflect this volatility and vulnerability.




***Source: World Bank Database***

However, a short-lived recovery occurred in 2016 with a positive growth of 6.1 percent recorded, slowing down to 3.8 percent in 2017, and 3.5 percent in 2018. GDP growth in 2018 was largely driven by the agricultural and services sectors. Increased production of key agricultural goods (rice, cassava, maize and oil palm) contributed 2

[1] SLIHS, October, 2019

percentage points to GDP growth[2], followed by services with a contribution of 1.79 percentage points.

The main components of outputs on the demand side were gross fixed capital formation and private consumption. However, private consumption had a notable effect on aggregate growth as it decreased by 3 percent between 2017 and 2018. The fall in private consumption was largely as a result of limited access to private finance, post-election adjustments that saw a decrease in spending and inflationary pressures.

The wide fluctuations shown in the figure above, may well explain the inability to attract additional investments that can further propel growth and create employment opportunities while the negative trade balance has contributed partly to inflation, hovering around 18 percent in 2018 and the depreciation of the country's currency against the dollar and other major foreign currencies.

It is against the above background that this report seeks to review and analyse some of the issues to consider with a view to promoting trade and inclusive growth. Specifically, the paper will discuss:

1. The challenges of diversification;
2. Misconception of the concept of value-addition;
3. Disadvantages of export taxes and prohibition; and
4. The importance of foreign investment and its associated controversies.

The analysis is based on a review of the literature and a series of consultations (bilateral and group) with key stakeholders (policy makers, private sector and civil society organisations).

Section two discusses the challenges of diversification, while the misconception of the concept of value-addition is analysed in section three. In section four, the disadvantages of export taxes and prohibition are discussed, and the importance of foreign investment is presented in section five.

## Section Two: The Challenges of Diversification

Despite several policy statements by successive governments emphasizing the need for diversification, to date very little has been done as the country's economy remains largely undiversified. Diversification of an economy is an integral part for transformation. It would require moving into new fields as well as stimulating and expanding production of existing traditional products (Iniodu, 2005). In Sierra Leone, this has proved to be an enormous challenge, as observed with successive regimes. The production levels of existing products are very low, manufacturing as well as the private sector base are narrow and do not generate enough jobs in the economy. The evidence from elsewhere has shown that economies that are well diversified have seen rising per capita income up to US$9,000 after which the marginal benefits begin to taper off (World Bank, 2018).

While diversification fosters sustainable growth, this does not happen by itself. Government must create the enabling environment for diversification to be translated

[2] Macroeconomics, Trade and Investment Global Practice, Sierra Leone Economic Update, June 2019 Don't think this is complete

into reality. Diversification requires a shift to a more varied structure of domestic production and trade to increase productivity, create jobs and lay the foundation for shared growth. It can take various forms. First, there is domestic production diversification that arises from a shift of domestic output across different sectors, firms and businesses. This occurs when domestic economic resources are reallocated within and between industries from low productivity areas to higher ones. Second, there is trade diversification that happens in three ways: export of new goods or services; export of existing products to new markets; and quality upgrading of exported products (Amurgo-Pacheco and Pierola, 2008).

For a small economy like Sierra Leone, the export sector could be strategic in promoting structural diversification of economic activities and sustainably drive shared prosperity. The liberalized global trading environment has made this possible as significant trade opportunities and new partnerships exists. These opportunities also bring possibilities to move into the more lucrative components of the service industry, with the potential to transform poverty levels as long-term productivity is enhanced. However, to take advantage of such opportunities requires the development of clear policies that articulate effective strategies for export trade and include investments that provide support services to firms to be able to address the challenges associated with trading across borders. Such a move has the potential to expand exports into becoming an engine for diversification and inclusive growth.

There are several factors that are inhibiting progress towards the expansion of economic activities in Sierra Leone. Some of the well-known constraints are mostly related to the poor infrastructure, including high transport, high trade and energy costs, as well as existence of non-tariff barriers, an uncompetitive service sector, dominance of the informal sector and fragility concerns. Also, there are challenges related to human capital and weak institutional capacity. In addition to these, there are structural challenges that impede diversification and policy issues that serve as a barrier for business expansion. These include a weak incentive framework, inadequate investment and policy reforms and ineffective policies to support resource reallocation.

Several regulatory reform steps have been undertaken to improve the investment climate in Sierra Leone. Trade diagnostic analyses have also been conducted and trade policies reviewed to promote exports. However, these reform measures have not been deep enough to foster effective competition in product markets. Three areas are key for supporting diversification. The first is transparent and predictable business regulatory frameworks that are non-discriminatory.

Regulations that support the credit market, quality standards, licensing requirements, and contract enforcement, to name a few of the incentive frameworks that promote investment in new ventures, are all in place in Sierra Leone. However, the enforcement of these regulations has been very problematic. Although progress is being made in some aspects of the financial system, the investment climate remains very challenging. Competitive suppliers in the domestic economy are in short supply while institutional governance capacity constraints to enforce a level playing field are pervasive in all sectors. These hinder diversification efforts and limit productivity potential.

The application of regulations to firms in a non-discriminatory manner serves as an indicator of investor protection, which in turn enhances investment in riskier ventures with long-term payoff potentials. Also, investor confidence in the effective enforcement of market rules serves as an incentive to firms as the economic benefits of innovation are internalized, which fosters increased investments. These are critical elements that are absent in the business environment in Sierra Leone and could be argued are impediments to diversification. Changes in governments have meant changes in the policy environment. Recent handling of resource contracts by the government are classic cases in which investors have felt hard done by, when contracts are cancelled though they have previously been ratified by Parliament. As a matter of fact, the evidence shows that there is a positive correlation between policy certainty and investments, more so for large firms that incur high sunk costs that are irreversible (Baker et al, 2016)

Another important element for diversification is a well-functioning financial sector. A deep financial sector with the required financial instruments and intermediation facilitates trading as well as risk pooling when firms decide to diversify. In Sierra Leone, however, the financial market is shallow with very limited instruments and intermediaries. Lending costs are high, collateral registry not fully automated and functional and the sector is dominated by instruments with short-term maturities. These make it a challenge to get long-term capital financing for business expansion and diversification through investment beyond the immediate term.

## Section Three: Misconception of the Concept of Value-Addition

There are several discussions among policymakers and advocacy by civil society organisations on the concept of value addition. However, the discussions and advocacy suggest that the concept is not quite understood. It is typically employed to promote processing, and to downplay the importance of raw material production. In both cases, it can be misleading. Cultivation of basic agricultural products using little more than labour and a few simple inputs adds value to the soil, water and sun of Sierra Leone. Producing a high-quality product, in sufficient volumes to generate a surplus, avoiding spoilage, and getting it to market adds more value. Packaging fresh fruit or vegetables – with no processing – which meet demanding health and safety standards in, for example, Europe, and which are ready for the supermarket shelf, adds even more. Some rich countries export billions of dollars of basic agricultural raw materials each year and make sizeable profits which support middle-class farmers.

While further processing can generate more profits, in most cases, it requires more capital investment, more electricity, and more skilled labour. The cost of these factors could pose a major challenge for an investor in a low-income country like Sierra Leone and put the investor and, by extension, the country at a disadvantage. As a result, further processing can actually lead to negative value added. In other words, the extra cost of processing may be higher than the additional price which can be charged.

Processing cassava into gari has been shown to be commercially viable and the entire proceeds when exported represents net foreign exchange flows. It requires virtually no capital, power or skilled labour. Sierra Leone has already proven that it is competitive in the sub-regional market. Some processing of oil palm is inevitable since it cannot be traded in an unprocessed form. Production of red palm oil is viable because the process is relatively simple, the market price is attractive, and there is little competition. Processing of yellow palm oil is more challenging for the opposite reasons – a more complicated process, lower price, and more competition. It also requires a certain volume in order to be efficient. But under the right conditions, including investment by an experienced and well-funded company, competitiveness on the sub-regional market should be possible.

The situation is completely different in the case of cocoa. Processing is highly capital-intensive and requires significant volumes in order to be efficient. Furthermore, the additional value earned through intermediate processing into cocoa paste or cocoa butter is small and may not be worth the investment. The real value comes at the level of chocolate production and marketing. However, the cost of exporting to international markets increases significantly and the competition becomes potentially prohibitive. Even the largest producers, Côte d'Ivoire and Ghana, are struggling to be viable processors without subsidies. Sierra Leone should therefore concentrate on raising the quantity and quality of the raw cocoa it produces.

Cashew production is somewhat different in that basic processing is far more labour-intensive than is the case for cocoa. However, it still requires capital to finance the purchase of inventories necessary to run the processing plant throughout the year. It is also necessary to achieve a certain scale of operations in order to be able to supply overseas clients on a consistent basis. In spite of a much longer history of cashew production, much larger volumes, and repeated attempts, Guinea Bissau has found it difficult to sustain a viable processing operation. Hence in the short term, it makes commercial sense for Sierra Leone to focus on developing the production of raw cashew.

Fish products are an entirely different case. Catching fish, preserving it and getting it to market is certainly adding value at each level. However, when the entire process is conducted by foreign fleets who trans-ship at sea, there is little or no value-added for the domestic economy. The only value is in taxes or fees charged by the government, and perhaps some employment of local labour. A fishing agreement with a foreign government may allow for somewhat higher royalty payments. However, more value-added can typically be achieved through landing and processing of fish domestically before export. This may include freezing, canning or packaging fresh fish, with the latter, least "processed" product actually commanding the highest price. But given the complexity of these stages, including the need to meet stringent quality standards, Sierra Leone will have to proceed prudently to ensure that it has the capacity to be competitive. Here again a comprehensive strategy, based on a full analysis of the entire value chain is advisable.

Extractive industries present yet another variation. Extracting minerals and precious stones out of the ground adds huge value, but typically at huge cost as well. The same is true of oil and gas. However, the extractive phase of the mineral remains the least remunerative of the entire value chain. Some minerals are processed in Africa; others are exported in raw form. Processing, or beneficiation, is often very expensive, notably in terms of energy consumption. This is true for iron ore and bauxite. Instead of pushing for processing, many African countries have focused on increasing the domestic content of mining through training of skilled labour and linkages to local suppliers. However, this situation is now bound to be changed following the adoption of the African Mining Vision (AMV) by all member states. The AMV enjoins member States to conceive value addition in sub-regional and regional terms. Sierra Leone already has a mining policy that is compliant with the AMV and will proceed with that policy. While there has been some interest from private companies to start the cutting and polishing of diamonds, this requires highly-skilled labour that will have to be trained. The developmental gains (particularly in terms or employment creation and revenue generation) from a diamond cutting industry might be small.

In the case of tourism, once again there is some value-added for every tourist that arrives. While many countries aspire to high-end tourism which generates the most spending per visitor, it inevitably requires more costs, including imported materials and personnel. Sierra Leone has attracted some high-end tourism in the past and this can be pursued but must be entirely private sector driven. At the same time some support measures in the form of hotel tourism training and entrepreneurial support can be entertained.

To summarize, every profitable export activity generates some value-added, which increases with the extent to which local labour and capital are used, and/or taxes and royalties are paid. Whether one moves up the value chain will depend on the activity and needs to be assessed on a case-by-case basis. In particular, a full diagnosis of the value chain is the first step to ensure government support leads to positive and sustainable outcomes. Open-ended subsidies or taxes intended to promote further processing are risky and most times penalize the poor.

## Section Four: The Disadvantages of Export Taxes and Prohibitions

Some of Sierra Leone's most promising exports are basic food items such as gari, palm oil, rice and fish. These have significant value-addition - most of the links in the value chain are internal, because they are labour-intensive, and processes use little or no imported inputs. They also benefit many poor producers and traders, notably women. Sierra Leone's marketing prospects, particularly for goods produced by low-skilled workers, lie in the wider Mano River Union market of 45 million people. Imposition of export taxes to protect consumers may be counter-productive, and in any case could attract similar action by neighbours. The porous nature of the borders also mean that exports are likely to continue regardless. Most importantly, such a policy will have a dampening effect on the farmgate price enjoyed by producers. This has the perverse effect of discouraging investment in improved farming practices and higher productivity. Furthermore, such impediments to regional trade are contrary to ECOWAS rules (and now the AFTCA) which call for the free movement of basic food stuffs.

One must learn from the history of the Sierra Leone Produce Marketing Board (SLPMB) when farmers were effectively taxed by the policy of buying at lower prices on the guise of providing stable prices to farmers. Other agricultural exports such as cocoa, coffee and cashew should not be subject to export taxes. Taxes on these exports will inevitably reduce the farmgate price which traders can afford to pay the farmer. While a small export levy might be useful for research and extension services, this may discourage the export being promoted.

The situation is quite different in industries where foreign corporations exploit local resources and extract significant rents in the process. This applies to much of the modern fishing and mining sector in Sierra Leone. It will also apply in the eventual case of oil and gas production. In order to obtain its fair share of these rents, the country needs to impose certain taxes, levies, or royalties. These will have to be set in the context of global markets and competing sources, and will need to adjust to fluctuating prices at least in the case of extractive industries. Reputable investors will expect to pay reasonable taxes, but will want tax policy to be predictable and stable. As part of its policy for good governance, taxes and subsidies must be set and managed in a transparent and fair manner.

The case of tourism is more complicated. Hotels, tour operators and other modern sector companies should be expected to pay profit taxes like any other enterprise in the country. They should also pay the standard value-added tax on inputs in order to avoid leakages – for example, where tour operators are able to import vehicles at a lower cost, and then resell them. Sierra Leone is now a high-cost destination and government will endeavour to set fees and related taxes for visitors as low as possible.

## Section Five: The Importance of Foreign Investment and its Associated Controversies

Foreign investment has proven to be critical in the development of exports across Africa. This is especially true for non-traditional agricultural exports, fish, extractive industries, and tourism. It brings in not only financial resources, but also technical know-how and market access. At the same time, however, it often brings controversy. Land grabs, excess profits, environmental degradation, labour exploitation and corruption are some of the allegations made. In principle, all of these potential problems can be managed through effective regulation. Indeed, domestic investors may be equally prone to abuse and require similar attention.

The many agricultural and mining concessions currently being developed will require close supervision. Cooperation with out-growers should be encouraged wherever feasible to minimize the need for large estates and associated displacement. Where relocation of farmers is unavoidable, it should be accomplished with careful negotiation and appropriate compensation. Efforts must be made to hire locally and establish linkages to local suppliers. Environmental damage should be avoided. In principle, everyone should benefit.

Controversy is often the result of suspicion fed by lack of information. But obscurity also favours special deals and kickbacks. Transparency will be important to clarify the terms of any agreement with foreign investors, avoid corruption, and enable proper monitoring by civil society. Continued adherence to the Extractive Industries Transparency Initiative is an important first step, which will be all the more critical as the oil and gas industry develops.

## Section Six: Conclusion

The policy for trade and investment should focus on expansion of existing opportunities by first enhancing production through support to local producers in many forms, including direct support through extension workers, incubating entrepreneurs and supporting links with established global firms. Producers will be encouraged to exploit the neighbouring Mano River Union market initially, while also attempting access to developed markets through initiatives such as AGOA. The impact on small businesses will be immediate and poverty reduction rapid. At the same time, new and emerging areas such as fintechs and internet technology-based firms or other opportunities for advanced technology based firms such as solar units or others where a significant component can be found in the country should also be considered. The AGOA Strategy highlights a number of measures that can be taken relatively easily to overcome bureaucratic bottlenecks and refine or rationalise regulations. Rapid implementation of these and similar recommendations contained in the Ministry of Finance's Study on Taxes and Duty Waivers will send a strong signal of government's determination to support private sector expansion and export promotion. At the same time, transparency and predictability in rules and regulations governing investments will encourage both local and foreign investors to exploit the opportunities currently existing in production and exports.

## References

Amurgo-Pacheco, Alberto; Piérola, Martha Denisse (2008): Patterns of export diversification in developing countries: Intensive and extensive margins, HEI Working Paper, No. 20/2007, Graduate Institute of International Studies, Geneva

Iniodu, P. U. (2005). Diversifying Nigeria's Non-Export Base for Sustainable Development. External Trade and Economic Development in Nigeria, Selected paper for the 1995 Annual Conference of the Nigerian Economic Society, pp. 277-285.

Macroeconomics, Trade and Investment Global Practice, Sierra Leone Economic Update, June 2019

Scott R. Baker, Nicholas Bloom, and Steven J. Davis. 2016. "Measuring Economic Policy Uncertainty." Quarterly Journal of Economics, vol 13, pages 1593-1636.

Sierra Leone Integrated Household Survey (SLIHS) Report 2018; https://www.statistics.sl/images/StatisticsSL/Documents/SLIHS2018/SLIHS_2018_New/sierra_leone_integrated_household_survey2018_report.pdf

Sierra Leone's Medium Term National Development Plan (2019 – 2023)

Sierra Leone National AGOA Response Strategy 2019 to 2025 (February, 2019), https://www.theigc.org/event/national-agoa-response-strategy-launch-forum-on-trade-and-private-sector/

World Bank (2018). Economic Diversification Guidance Note. Trade and Competitiveness Global Practice Draft.

The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research.

Find out more about
our work on our website
www.theigc.org

For media or communications
enquiries, please contact
mail@theigc.org

Subscribe to our newsletter and
topic updates
www.theigc.org/newsletter -signup

Follow us on Twitter
@the_igc

Contact us
International Growth Centre,
London School of Economic
and Political Science, Houghton
Street, London WC2A 2AE

IGC
International
Growth Centre

DIRECTED BY
LSE
UNIVERSITY OF OXFORD

FUNDED BY
UKaid
from the British people

Designed by soapbox.co.uk