

# **The Fundamentals of Economic Management and Governance in the Drive for Economic Transformation**

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# Outline

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  - Economic Growth: Thinking Causes
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# Outline

- Fundamentals in Economic Management:  
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- Economic Governance to Improve  
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# The Fundamental Problem

- Sierra Leoneans are about to set ambitious targets to be met in 2035 or very soon thereafter.
- To achieve those objectives requires rapid economic growth.
- Rapid growth will require tremendous improvement in economic management and governance.
- Sierra Leone has been weak in policy formulation, policy implementation, and governance in general. This record must change.

# Economic Growth-Thinking Causes

The growth rate of real per capita GDP over some extended period of time is typically thought to be a function of the following:

- initial (start of period) level of GDP
- initial level/quality of human capital
- population growth rate
- investment level (investment in physical and human capital relative to GDP)
- efficiency of investment
- technological change and innovation

# Economic Growth-Thinking Causes

- a number of 'policy' variables
- a number of 'political and institutional' choice variables
- several structural and environmental economic and socio-political variables
- external variables (terms of trade, dependency)

# Economic Growth-Thinking Causes

- In this listing, the basic variables are the first six.
- The other variables tend to work mainly through investment, efficiency of investment, and technological progress and innovation.

# Economic Growth-Thinking Causes

As regards the six important variables, the growth rate during any future period tends to vary:

- inversely with the *initial (starting date) level of per capita GDP*, because of 'catch up' effect;
- positively with the *initial level of education*;
- inversely with the *population growth rate*;
- positively with the *investment ratio*,
- positively with the *efficiency of investment* and
- positively with *technological progress and innovation*.

# Economic Growth-Thinking Causes

- Sa Leone must focus on:
  - investment level (investment in physical and human capital, relative to GDP)
  - efficiency of investment
  - technological change and innovation
  
- For all three variables, the performance has been poor. Better economic management and governance can change this.

# Economic Growth-Thinking Causes

- Sierra Leone's *investment* in physical capital, for which data are available, has in the last few years hovered in the 13-16 ½ percent range and is currently expected at best to stay around 17-18 percent in the next few years.
- Sierra Leone's investment should rise to 23-25 percent in the next few years and move a little higher after that, to at least 25-28 percent, or so, for some time.

# Economic Growth-Thinking Causes

- The *efficiency of investment* is a product of the productivity of investment in producing capital and the productivity of capital in producing output.
- To raise the efficiency of investment, economic management and governance should do something about the fundamental factors are at play.
- For instance, one should look at certain public policies, government efficiency, education, markets, general corruption, and political stability.

# Economic Growth-Thinking Causes

- The underlying factors responsible for slow *technological change and innovation* also need to be addressed.

# **Economic Management: Building Firms' Capacity**

One set of underlying factors to influence growth are those that build firms' capacity to produce output. Hence one must look at:

- Enabling environment for innovation
- Human capital
- Infrastructure and public services

# Building Firms' Capacity: enabling environment for innovation

## *Enabling environment for innovation*

- Sierra Leoneans need to ask:
  - what kind of environment does the country need to foster innovation?
  - What does the world-wide experience indicate?

# Building Firms' Capacity: enabling environment for innovation

## *Innovation will involve :*

- copying and catching up in general;
- investment in new equipment;
- organizational reforms;
- learning new skills and moving up value chains;
- and
- adopting new approaches in marketing and cooperation with firms around the world.

# **Building Firms' Capacity: enabling environment for innovation**

Strengthening the system that clearly supports innovation of domestic firms in the various sectors would involve:

- Strengthening training and research facilities (the quality of secondary schools; programs at universities, research centers and institutes; technical and vocational training in the country; and training and research programs within firms)

# **Building Firms' Capacity: enabling environment for innovation**

- Motivating major actors in the different sectors to inculcate habits and practices which encourage innovation. Hence, the incentive structures within the firms and organizations matter.

# Building Firms' Capacity: enabling environment for innovation

- In addition the following matter
  - The competitive environment
  - Labor-management relations
  - availability of finance to support innovation (especially acquisition of equipment and training)
  - cooperative arrangements among firms and organizations in the country, including policies that support clusters.

# Building Firms' Capacity: Human Capital

The main arguments about the importance of human capital are well-known. But a couple of thorny issues:

- labour policies, and
- personal income taxation

# Building Firms' Capacity: Human Capital

- On labour policies the main issue is the degree of freedom and flexibility that the top management will have with respect to hiring and firing, overtime pay, minimum wage, leave, treatment of unions, and hiring of foreigners at all levels of the firm.
- A cautious approach: take a survey of what middle-income and high-income countries are doing and adopt a mix of policies sufficiently flexible and also fair to the workers in light of normal practices in the leading countries.

# Building Firms' Capacity: Human Capital

- Similarly for personal income taxes, Sierra Leone should survey middle-income and high-income countries and get a good idea of their personal taxation, both of nationals and of foreign nationals who are residents in the country, and modify domestic taxation laws to become competitive.

# Building Firms' Capacity: Infrastructure

- The importance of infrastructure to Sierra Leone's development is also well-known as is the blatant lack of that infrastructure. To some, if there is a binding constraint to development in Sierra Leone infrastructure is it. But I think that infrastructure and human capital are in a tie for that honor.
- Infrastructure will be covered by others in this workshop.

# Economic Management: Promoting Strong Firms

- To raise investment, productivity of investment and foster innovation and technological change, economic management also needs to promote strong firms. For this, important are:
  - openness,
  - taxation,
  - administrative obstacles, and
  - the legal environment.

# Promoting Strong Firms: Openness

- Strong firms, by definition, are firms that can survive in open competitive markets and hence are, inter alia, capable of exporting.
- To attract such firms and keep them, an overarching requirement is the maintenance of an economic environment (markets, institutions, immigration laws, information flows, ideology, and access to the authorities) that is open.

# Promoting Strong Firms: Taxation

- There is corporate taxation; taxation of wages, salaries, interest, and dividends; taxation on capital gains; and taxation of specific transactions.
- The taxes mentioned above cannot, in their total burden on the firms and the highly talented employees, be higher than appropriate competitors in the international arena.

# Promoting Strong Firms:

## Administrative barriers

As regards administrative barriers:

- the authorities must take steps to ensure that what is written in the law is being implemented;
- the barrage of licenses, approvals, permits, and other requirements should in reality—not merely in principle—not unduly raise the costs of setting up and doing business in the country.

# Promoting Strong Firms: Legal environment

The legal environment is extremely important.

- The law, the courts, and the police all need to be reviewed in light of the requirements to make Sierra Leone a good place to do business.
- The Sierra Leone legal system is very inefficient. There should be a total reform of the whole system and especially the personnel, the record keeping and the procedures.

# Promoting Strong Firms: Macroeconomic policies

Macroeconomic policies are also important for attracting and building strong firms. Again, the main message is well-known:

- Market participants benefit from low inflation, stable exchange rates, capital mobility, and convertibility of the domestic currency or at least an absence of exchange controls.
- Market participants monitor macroeconomic policies to project the effects on the real rate of return on their efforts and investments over time, and their ability to transfer assets and earnings from the domestic economy to another country.

# Economic Management: Selective Intervention in Markets

- The fundamentals, discussed above, are *neutral*--by themselves they do not deliberately bias incentives towards any particular area of activity.
- But there are policies that a country could use to bias incentives in order to achieve certain objectives, such as enhanced industrialization or export promotion and diversification, because ***the market*** and ***the neutral fundamentals*** left to themselves do not result in the kind of industrial development or export volume and composition that the policymakers think “optimal” for the country over the long run?

# **Economic Management: Selective Intervention in Markets**

- In a country like Sierra Leone the objectives of intervention, the extent of the intervention, and the instruments chosen in the intervention, should all be calibrated taking into account three interrelated principles, in order to ensure good value for money in selective intervention.

# **Economic Management: Selective Intervention in Markets**

These principles aim at making sure that :

- that the objectives of a particular intervention policy makes economic sense;
- that the policy supports strong firms; and
- that normally the focus in assessing value should be on production and output.

# Economic Governance to Improve Policymaking and Implementation

Good governance benefits economic management:

- selection of appropriate economic policies
- implementation of policies
- absorptive capacity to benefit from implemented policies

# Economic Governance to Improve Policymaking and Implementation

- Good governance involves putting in place processes, rules, and organizational arrangements to ensure these above-mentioned benefits.
- This in turn requires appropriate: (1) leadership, (2) cooperation, (3) institutions, and (4) organizational structure and capacity.

# Economic Governance: Leadership

- Sierra Leone needs transforming leadership at all levels: political, civil society, and business.
- A transforming leader is able to unite the separate interests of the followers in the pursuit of 'higher goals,' in this case including the goals set for 2035 and thereafter.

# Economic Governance: Leadership

- Transforming leadership from *civil society* will help put pressure from below for good economic policies. Such civil society leadership will engage in mobilization activities to build agency on the demand side for good economic policies.

# Economic Governance: Leadership

- Transforming leadership in *business* will spot and exploit profit opportunities; apply the appropriate business models, build the supporting business organizations, motivate workers and mobilize the capital; and help put pressure on the political leadership to improve economic policies and ensure the appropriate enabling environment.

# Economic Governance: Leadership

- In a poor country like Sierra Leone, *political leadership* is key.
- Sierra Leoneans must tinker with their selection processes at all levels to ensure political leaders with the appropriate:
  - moral character (honesty, integrity, discipline),*
  - societal understanding;*
  - persuasive communicative skills; and*
  - innovative ability.*

# Economic Governance: Leadership

- Among other things, from an economic growth perspective, transforming political leadership will help: (a) reduce business risks and uncertainty felt by entrepreneurs; and (b) put in place appropriate signals for inducing efficient allocation of resources in the economy.

# Economic Governance: Leadership

- When assessing countries on corruption and socio-political governance on the whole, many analysts resort to surveys and indices purported to measure, for instance, *risk of expropriation*, *general governance*, and *constraints on the executive*.
- Analysts will also look at the global corruption reports of *Transparency International*.
- The authorities in Sierra Leone should try and understand what go into these reports and what they can do to improve their ratings.

# Economic Governance: Cooperation

- *Cooperation* in the present context is the willingness to communicate, negotiate, and reach agreement, on the design and maintenance of institutional and organizational arrangements, procedures, and mechanisms, including how to share the ensuing benefits and costs, without fighting, coercion, or total domination by one party.

# Economic Governance: Cooperation

- Of importance in producing cooperation are not only trust and self-interest but also certain evolutionary processes.
- Sierra Leone suffers from *cooperation deficit*.
- Low generalized trust, due to corruption and ethnicity, is mainly to be blamed here.
- Ways must be found to reduce corruption and ethnicity.

# Economic Governance: Cooperation

- Getting the community to understand the link(s) from trusting behavior to generalized trust to cooperation and finally to economic development would help.
- The community must also be able to find feasible ways to begin the process and get onto the virtuous circle involved.

# Economic Governance: Cooperation

- Thus, Sierra Leoneans cannot help but address, head-on, ways to reduce corruption and free-riding at all levels and in all relationships in the society. This would involve, among other things, creating effective monitoring and sanctioning devices, especially via raising the efficiency of the legal system. Also, *prevention* should be stressed over *punishment* in addressing corruption and free-riding.

# Economic Governance: Cooperation

- At another level, the state could take the leadership in encouraging greater cooperation among private sector firms. Indeed, in developing the private sector, firms could be made to become more productive by helping them organize in well-functioning formal associations and clusters. Business leaders and the state can help educate private firms in general about the resulting gains from collective efficiency, which can accrue to them, via *external economies* and *joint action*.

# Economic Governance: Institutions

- ***Institutions*** are *rules* governing behavior in human interaction. Institutions coordinate expectations and constrain behavior in interactions of individuals. Hence institutions are at the core of the incentive structure that motivates behavior of the kind that creates wealth. Institutions are, of course, themselves outcomes of cooperation.

# Economic Governance: Institutions

- Institutions require *legitimacy*. Institutions that are not legitimated by the populace at large will not be willingly obeyed and promoted by the people at large; there will be no sense of loyalty to the institutions.
- Hence, Sierra Leoneans need to find ways always to make sure that rules are legitimated.
- In all such situations, legitimation involves citizens' consent/approval without coercion. Such consent comes via several procedures, namely, open discussion and deliberation, voting, and overwhelming demonstration of support in Parliament, in the newspapers, and in civil society voluntary organizations.

# Economic Governance: Institutions

- Another major requirement in institution building is *implementation*.
- Laws and conventions need to be resolutely implemented to achieve their objectives.
- Hence, it is always useful to find out how implementation can be facilitated.

# Economic Governance: Institutions

- Take, for example, the problem of controlling corruption. Despite all the formal institutional and organizational actions taken by many African countries, corruption has been very difficult to control and indicators of the perception of corruption are not making much dent in many of these countries. There are clearly implementation problems.

# Economic Governance: Institutions

- The primary reason for this, I believe, is inadequate support from the population at large. For low-level corruption this is obvious—Africans are willing to blame low salaries for widespread corruption.
- For high-level corruption, the underlying reason is inadequate appreciation by ordinary Africans of the economic costs, because of a focus on the distributional aspects.

# Economic Governance: Institutions

- At best, the ordinary citizen appreciates that a good fraction of the money stolen gets siphoned off into foreign countries rather than being invested in the country concerned. This growth effect they can understand.
- But the ordinary citizen does not fully understand that the attempts of the governing team of politicians, and their allies in the government bureaucracy, civil society and the business community, to capture corruption revenue magnify distortions and misallocation of resources in the economy as well as discourage investment, with serious adverse growth effects.

# Economic Governance: Institutions

- The behavioral consequences of high-level corruption cause aggregate output loss to the rest of the society to be of greater magnitude than the real revenue realized by those who share in this corruption revenue.

# Economic Governance: Organization

As regards the fundamentals, in governance, special attention needs to be paid to four particular organizational issues, namely:

- (1) the organizational structure best suited to achieve the task at hand;
- (2) capacity building to ensure that the tasks assigned to the organization can be accomplished;
- (3) political and fiscal decentralization, especially the optimal degree and nature of such decentralization; and
- (4) the role of government versus non-government operators (private sector, nongovernmental organizations, and self-help community organizations or so-called people's organizations).

# Economic Governance: Organization

- These issues will be addressed in some other presentations in this workshop. I have also written a blog that addresses these issues.