

THE GROWTH-JOBS-POVERTY NEXUS:  
UNDERSTANDING THE BINDING CONSTRAINTS ON THE GHANAIAN ECONOMY

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## ***Executive Summary***

Historically, employment and related labour-market policies in Ghana (and across sub-Saharan Africa, for that matter) have been premised on the assumption that wage employment best describes employment dynamics in the economy. Equilibrium earnings have thus been understood to be determined by interaction between the private supply of labour and the private demand for it, in a well-defined, formal wage-labour market.

In Ghana--and much of Africa outside of South Africa--however, private wage employment in the formal economy is the exception, and informal self-employment (mainly in agriculture, but significantly in non-agricultural activities, as well) the rule. The structure of non-public employment tends to be that agriculture, both formal and informal, absorbs the largest percentage of the work force, followed by self-employment in the informal non-agricultural sector, and then, in last place, private manufacturing and industry. In Ghana, total *formal* wage employment only absorbs 5.1% of the workforce, 80% of whom are employed by the public sector. In contrast, *informal* (agricultural and non-agricultural) employment absorbs 90% of all workers.

Jobs policies crafted on the assumption of the dominance of wage employment in formal labour-market settings are bound, in practice, to affect only a tiny slice of the country's labour market, no more than 10% of the workforce, at best. For a *national* jobs policy to have both coherence and efficacy in addressing the country's persistent unemployment problem, it needs to depart from the "standard" analyses and solutions, with their implicit bias towards formal, well-defined, markets, and move towards solutions that accord with the actual, *existing* structure of employment and jobs-dynamics on the ground. It would be a policy that is informed by a clearer understanding of the linkage between employment and poverty, a policy comprehensive enough in scope to encompass the entire spectrum employment possibilities in the country and, above all, a policy that would not conceive of employment as being distinct from the broader economic-development agenda.

Ghana has endured a long period of jobless economic growth. To translate growth into the reduction of poverty that the country seeks, however, enough jobs must be created by the growing economy. But the quality of jobs matters as much as the quantity, because just having *a* job is no guarantee against poverty. The optimal employment policy, under these circumstances, would be one that routinely moves the average worker into better-quality jobs (i.e. higher productivity, higher wage, adequately secured jobs) from his present employment in the informal economy, or one that improves productivity and employment conditions for the average worker in his present employment in the informal sector or, ideally, both.

The first option would entail the creation of large numbers of private-sector, formal-economy jobs; the second would involve a jobs policy that is anchored in, and focuses on addressing the peculiar constraints of, agriculture and the self-employed informal sector.

Currently Ghana's private, formal sector of predominantly small- and medium-sized enterprises is so hamstrung by a myriad of structural and policy-induced issues that it cannot be realistically expected to, in the medium term, create these high-quality jobs in the requisite numbers. Nor is the public sector, the largest single source of formal employment, a likely alternative source of expanded, secure, high-productivity employment. There is thus, *over the standard policy horizon*, very little chance that the formal sector in Ghana can absorb more labour than it has historically done.

The optimal jobs policy for Ghana, it therefore appears, would be one that, in the medium term, focuses on the second option *while taking a very long-term view on the first*. But focusing on improving the quality of employment in the informal economy would entail the implementation of *new* policies that target sectors outside of the labour-market proper. To boost (the quality and quantity of) self-employment in agriculture and informal non-agricultural work, for instance, would entail reorienting policy in, at least, the following three major areas of economy and society—the financial sector, the use of urban lands and public spaces, and issues of market access.

The justification for this approach to employment is basically this: the challenge to creating decent and plentiful jobs in Ghana is a *developmental* challenge writ large, not simply a labour-markets challenge. As such it requires a comprehensive set of employment-centred policies contextually attuned to Ghanaian economic realities. Neither the mere restoration of efficiency or equilibrium in the formal labour market, nor the sheer sustaining of macroeconomic stability and growth—as the economic orthodoxy proposes—will do. Poor labour absorption and utilization in Ghana have proved to be remarkably consistent through the decades. Un- and under-employment have remained intractable, mostly because labour-market dynamics in the country have turned out to be immensely more complex than can be understood with standard labour-market models. Problems of poor labour utilization have revealed themselves to be, in actuality, a set of interdependent economic problems often involving non-linear relationships and unpredictable change processes, not to mention the wide assortment of actors and stakeholders directly implicated.

The approach to tackling the unemployment issue, therefore, must be equally multidimensional, multisectoral, and experimental (i.e. dynamic). It requires policies, in short, that go beyond the labour market.

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## **CHAPTER I**

### ***Introduction***

We might begin non-controversially by stating the obvious: Ghana's potential to be an economic powerhouse, if only at the regional or continental level, has long been recognized by astute observers of the African economic scene. Yet Ghana's economic performance since independence in 1957 has been indifferent and uneven, at best, marked as it is more by fits-and-starts than by solid, sustained, stable, or even, growth.

For all its much-vaunted ability to rise from the economic ashes—especially in recent decades—Ghana is still poor; and with its income in real terms in 2010 not substantially different from that at independence in 1957, it is in a very real way only back at the beginning, in a manner of speaking. One would be forgiven for thinking that half a century has not seemed a sufficient amount of time for the country to emerge from its low-income status and move on to the next stage of development.

It is true that in recent decades Ghana has, by a considerable margin, been the star pupil of orthodox, market-based, policy reform in Africa. Yet it has failed to generate the investment response from the private sector, both foreign and domestic, that was promised by the underlying theory and the proponents of those reforms. Consequently, two decades of solid macroeconomic performance has not succeeded in generating (what economist Dani Rodrik has called) the 'investment transition' that would trigger and sustain the growth acceleration that could produce the desired changes in the structure of economic activity.

Not surprisingly, therefore, employment expansion, at least in the formal sector, has not kept up with the broad macroeconomic gains of recent decades. The majority of employment opportunities continue to come from low-income agriculture and the non-agricultural informal economy. Formal, public- and private-sector, jobs have declined; persistent (but often disguised) open unemployment, underemployment, and growth in precarious forms of employment remain central features of the jobs market. As the Ghana Living Standards Survey 4 indicated, of all workers in the 15-64 age range at the beginning of the year 2000, 52% were "self-employed" in agriculture, 34.3% worked in some form of informal activity, and only 13.7% had formal (public or private) employment. There is little reason to expect that this distribution has changed markedly in the ensuing decade.

This is not to say that no real growth of any consequence has been achieved; on the contrary. *Real* GDP has expanded by an average of around 4%

per year since the reforms began in 1983, and it is poised to be kicked up a gear with the beginning of crude-oil production in 2011. There was even a similar growth spurt in the decade of 1966-1975; and a recent re-basing of the national-income accounts actually makes Ghana a statistical middle-income country. But as the rates of employment creation fell far short of the economic growth rates achieved in both of these periods (1966-75 and 1983-2010), we may fairly conclude that all Ghana has succeeded in producing in fifty years of independence are, in essence, two classic episodes of 'jobless growth'.

The problem is that economic growth has not been transformational for the economy, in that it has been accompanied neither by productivity gains nor a transformation of the century-old structure of production. The economy is still dependent on primary commodity exports, which account for nearly two-thirds, on average, of export earnings, even as manufactures account for a tenth, on average. Value-added in agriculture today accounts for the same third of GDP it accounted for in the 1960s, and the dependence on external financial flows has not abated with the improvement in the growth performance.

The failure to achieve a transformation of the economy has itself brought into question two issues: 1) the country's ability to *sustain* its recent economic growth performance, and 2) the *quality* of that growth. Indeed it is almost certainly true that both of the growth episodes of recent history would not have been achieved but for one-off capital injections—the one from reserves passed down from the colonial era, the other from copious injections of foreign inflows to the star adjustor of the continent. Total factor productivity did not change in either period, there was no spurt in job creation, and productive activity was not diversified away from the three 'traditional' primary sectors of cocoa, gold and timber. The failure to transform the economy, in turn, constrained the fuller utilization of the labour force, in that it prevented both the generation of new and better employment opportunities, and the improvement of the average remuneration of the already employed.

Periods of sustained economic growth in Ghana, therefore, never translated into sustained improvements in average living standards because they yield neither substantial jobs creation, nor improvements in labour productivity and wages. The regional disparities that have characterized the spatial distribution of income and poverty in the country for a century persisted through both growth spurts. Indeed, growth may even have worsened economic inequities across the country: so, for instance, in the 1990s and 2000s, poverty rates *increased* in the northern territories (already the poorest regions of the country) even as they declined in the rest of the country outside of the Central Region.

Granted, there was a welcome overall decline in rural poverty, but the decline in most rural areas was significantly and consistently lower than it was in

the urban centers. And those employed in food-crop production--food production being one of the largest labour absorbing sectors of the economy--actually recorded the highest poverty rates, accounting for nearly 60% of the poor countrywide.

As it turned out, therefore, rural poverty actually *grew* even as the economy as a whole was expanding, a reflection, most likely, of the decline in the absolute level of agricultural productivity. Over two decades of decent economic growth rates, in other words, have not yielded a proportionate reduction in mass poverty, as would be expected; and the likely explanation for that is that the spurt in growth was accompanied neither by significant job-creation, nor significant improvements in the economy's productivity.

But with the stability of the macroeconomic environment largely restored over the past decade-and-a-half or so, the opportunity now exists for the creation or discovery of more durable drivers of *dynamic* (i.e. transformational) economic and employment growth across all economic sectors and geographical regions of the country.

#### *A. Why Structural Transformation? Why Now?*

There are several reasons why structural transformation is both necessary and possible at this time. The first, and most obvious, is that for any developing country, diversifying economic activity away from primary production into higher value-added lines is normatively desirable. Secondly, economic history teaches us that poverty is reduced only when economic growth and structural change work complementarily to generate broad-based employment opportunities across all sectors of the economy. Economies that just grow, even in a sustained manner--as Ghana more-or-less has done for better than two decades--with no significant change in the patterns of productive activity, hence in the structure of the economy, tend to not generate or sustain massive employment opportunities. Ghana cannot hope to attain *and retain* the solid middle-income status that it is shooting for by 2020 if the economy is not so transformed, because efficient, balanced and sustained overall growth cannot be assured any other way.

Thirdly, the elimination of mass poverty, which is the very basis of the development process for any poor country, cannot be otherwise achieved. And lastly, the creation of good job opportunities, not only in terms of quantity and quality, but also their widespread distribution across the economy--all necessary, by the way, for poverty alleviation, economic growth and distributional equity--will not be forthcoming unless this structural transformation is achieved. And it is in this last regard (of adequate and widespread employment creation) that,

given the focus of this paper, a thorough analysis and understanding of the constraints on the country's future growth prospects are warranted.

As perhaps a secondary issue, it is also important to ascertain, for future analytical probity but also for policy clarity, why the economy is ostensibly able to grow but unable to structurally transform itself onto a sustainable, long-term, growth path. Could it be that all that can be achieved has already been achieved, in which case new efforts would constitute a criminal waste of resources; or is it simply a question of lag time, and that it is only a matter of time before economic agents update their perceptions and expectations and begin to react positively to the good macroeconomic environment that has been achieved? Or could it be that the Ghanaian economy is only capable of producing episodic growth cycles, with no ability to metamorphose onto higher planes of sustained dynamic performance?

In one sense the task may already have been simplified for us. As the World Bank's recent reviews of the thirty-year-old adjustment processes in the developing world have come to conclude (echoing, incidentally, critics like Dani Rodrik, Ricardo Hausmann, Joseph Stiglitz, and others), often the best policy reformers were *not* the best economic performers<sup>1</sup>. In most instances, countries that implemented targeted, intelligently contextualized, less comprehensive, narrower-than-Washington-Consensus reforms achieved better and more sustained development results. Growth accelerations, it turns out, rarely coincided with comprehensive policy reform packages of the SAP<sup>2</sup> variety.

Ghana also, it would seem, having already commendably done the broad, 'macro' reforms in the decades of the 1980s and '90s, is perhaps primed to narrow its policy gaze towards more specific, targeted, 'micro', context-specific interventions that would be complementary with these earlier, more comprehensive efforts. This may, in fact, be inevitable as a corrective measure, seeing that the very tools of macro-stabilization that were deployed to achieve the current growth regime may be themselves largely responsible for the economy's inability to effect the necessary transition to institutionalize job creation.

To arrive at these policies, we need to, among other types of analysis, conduct a "growth diagnostics" of the Ghanaian economy, in the spirit of Hausmann, Rodrik and Velasco (2005)<sup>3</sup>, to uncover and discover the specific

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<sup>1</sup> See World Bank, *Economic Growth in the 1990s: Learning from a Decade of Reform* (Washington, DC: World Bank, 2005); and D. Rodrik, *One Economics, Many Recipes* (Princeton: Princeton University Press, 2009).

<sup>2</sup> SAP = Structural Adjustment Programme

<sup>3</sup> Hausmann, R., D. Rodrik and A. Velasco, *Growth Diagnostics* (mimeo: March 2005).

constraints that are binding on the economy<sup>4</sup>. This should offer some indication of what factors directly inhibit the growth of the *formal* economy and, perhaps by inference, the informal sector, too. We would need, however, a more targeted set of analyses to identify the specific job-creating constraints faced in the informal economy which, for sheer jobs creation and labour absorption in Ghana, should be the logical target of much of the policy effort anyway.

It would also be important to understand the essential structure of Ghana's labour market. All indications are that it is a *multiply* (not just dualistically, as is often supposed by orthodox labour economists) segmented market, which also happens to be heavily gendered (see Table 2). Its formal and informal segments appear to constitute a continuum, even complements, and not separate entities functioning autonomously of each other. A jobs policy for sustained growth, distributional equity, and (therefore) poverty alleviation should be equally comprehensive in scope and outlook: *it must focus on both the formal and informal segments of the economy*, even though historically there has been a consistent analytical and policy bias against the latter, the reasons for which are explored below.

### *B. Organization of the Paper*

Given the breadth of issues outlined above, the paper proceeds as follows: after this introductory chapter, the second chapter offers a comparative analysis of jobs structure and employment policy across the continent of Africa (which happen to be consistent with jobs structure and employment policy in Ghana) to reveal the locus of the systematic policy preferences that make it difficult for Ghana and its development partners to think beyond certain preferred positions when seeking to tackle unemployment.

It must be observed right away, in this regard, how remarkable and disappointing it is to read in the GoG's "*Shared Growth and Development Agenda 2010-2013*" document--which is the current government's formal blueprint and policy framework for growth, poverty reduction and human development for Ghana--that, because "employment is a cross-cutting issue", it is not given formal attention in its own right, but "treated in all the other thematic areas of the policy framework".

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<sup>4</sup> It is important, for both analytical and policy purposes, to understand 'binding constraints' in relative rather than absolute terms. Clearly all the constraints on an economy, especially a poor one such as Ghana's, are binding to one degree or another. The 'binding constraints' we are at pains to identify here are those with the highest 'shadow price'—that is, those constraints that, when removed, are likely to yield the highest positive impact on economic growth. Also, binding constraints are necessarily dynamic, in that the removal or neutralization of one opens the door for another one to become binding. For that reason, a growth diagnostic necessarily has a short-term horizon, as it needs to be done with some regularity or in an iterative manner in order to discover and uncover new or emergent constraints.

This is tantamount to arguing that employment creation will derive *automatically* from success in all the “other thematic areas” of policy. Put another way, this is the standard economic argument that a rapidly growing economy will cause enough changes in incentive structures to compel employers to hire more workers. But as Ghana’s own recent experience with consistent macro growth has shown, employment creation does *not* automatically come with economic growth. What is needed, therefore, is a policy framework that targets employment creation as a policy objective *in its own right*, and not as a derivative of other--presumably more important--“thematic areas”. Ghana needs to create, in short, an *employment-intensive growth path*, not just macro-growth in the abstract, in the hope that jobs will be created in the wake of such growth. That an issue is cross-cutting does not make it an improper direct target of policy.

DANIDA, as a quintessential Development Partner of Ghana’s does, in its “*Support to Private Sector Development-Phase II*” (SPSD II) programme strike the right balance, in many ways, between enhancing incentives for formal-sector jobs creation--by seeking to “improve conditions for business operation including enhanced local and foreign investor confidence” (Component 1)--and improving skills acquisition and productivity-enhancing training for workers in informal and small-scale formal enterprises (Component 2). The “Agricultural Value-Chain Facility” and the provisions for “Rural Finance” are obviously aimed at improving sectoral productivity in the rural and/or informal economy; but, if successful, they will also help in leveraging formal-sector investor interest in agro-industry.

This approach seems largely consistent with both the history of jobs creation in the Ghanaian economy, and the sectoral distribution of employment extant. It is also in large part in accord with this author’s long-held view that achieving a jobs-intensive growth path for Ghana would require “raising the expected returns to work for the average Ghanaian worker across the economy as a whole; but, even more importantly, in the two dominant labour-absorptive sectors of the economy—agriculture, and informal non-agricultural enterprise--as these two together account for 83.5% of all employment in the country”<sup>5</sup>. This contrasts sharply with the primary jobs strategies of successive Ghanaian governments, which have tended to, inexplicably, focus on *formal* private-sector jobs creation, even though the *non-public* formal sector in Ghana has never accounted for more than 9% of total employment in the country. A bias in favour of informal-sector employment would, in fact, be more consistent with Ghana’s current economic realities and historical employment structure.

In the third chapter, a growth diagnostic of the Ghanaian economy is conducted to identify with a rigorous methodology the binding constraints on the

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<sup>5</sup> See Nikoi Kote-Nikoi, *Informality, Employment Policy and Poverty: Choices and Strategies for Africa*, CPP Occasional Papers No. 10/001, (Accra: Centre for Policy Priorities, January 2010).

private commercial sector that prevent it from being the engine of structural transformation and jobs creation that it has (by and large) been in likely comparator countries in Asia and Latin America. A second objective, flowing logically from this, is to show why focusing the country's entire jobs strategy on this sector may, in fact, be flawed; and yet a third is to tease out an outline—however tentative—of what a more optimal jobs policy for the country might look like.

The fourth chapter presents a critical analysis of Ghana's monetary and anti-inflation policies to show how the conduct of a key policy with a particular focus adversely affects crucial economic behaviour (like productive capital formation) and "real" magnitudes (like jobs creation). An alternative set of policies are advanced instead, keeping in mind that the purpose of monetary policy is to keep inflation in check *in order to achieve other real-economy outcomes*, like full employment.

The analyses of the fifth chapter show how the informal sector—the more dynamic sector of the economy when it comes to jobs creation—could become the source of high productivity, high labour-returns employment with the correct policies and incentives from government. Indeed, it is argued that focusing employment policy on the informal economy may not be as economically unjustifiable as mainstream economists would have us believe.

The paper concludes with a summary of the principal lessons issuing from these analyses, and some policy options for tackling the factors that inhibit the Ghanaian economy from creating high-quality jobs and in greater quantities.

## **CHAPTER II**

### ***Jobs Structure and Employment Policy: A Comparative Analysis***

The structure of non-public employment in much of Africa, Ghana included, tends to be of the following sort: agriculture (both formal and informal) absorbs by far the largest percentage of the work force, followed by self-employment in the informal non-agricultural sector<sup>6</sup>. Private industry or manufacturing, which comes in third, has historically accounted for a relatively small share of total employment (see Table 1 below).

There are notable exceptions to this, of course, the South African case being the most obvious in our sample of comparators. There also exists identifiable heterogeneity in jobs distribution among (even) countries with similar economic structures.

What is often missing across the continent, however, are coherent employment policies that take due cognizance of this structure of employment. Historically, labour market policies in sub-Saharan Africa have assumed that wage employment best describes employment dynamics. Equilibrium earnings are thus understood to be determined by interaction between the private supply of labour and the private demand for it, in a well-defined, formal wage-labour market. However, as Table 1 indicates, in Ghana and much of Africa outside of South Africa, formal private wage employment is the exception, and *informal* self-employment (mainly in agriculture, but significantly in non-agricultural activity as well) is the rule.

Thus the standard labour-market model, and the policy conclusions that logically flow from it, can apply, at best, only to a small fraction of the labour force. It cannot form the basis of a coherent jobs policy for the entire nation. In other words, it is only by departing from "standard" employment policies, with their implicit biases towards formal and well-defined markets, to develop policies that accord with the *existing* structure of economy and employment dynamics, and which also recognize explicitly the importance of the employment-poverty linkage in poor-country settings, that we can hope to give coherence to a poverty-reducing jobs strategy for Ghana and the rest of the continent.

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<sup>6</sup> Individuals who are self-employed are considered informal workers if the enterprise they run is not officially registered. Wage employees are considered informal if they have no access to basic social protections such as social security payments, paid sick leave, pension plans, or even a specified employment contract. They are formal if their employers are considered part of the formal private sector.

TABLE 1

*The Structure of Employment in Ghana and Four Comparator Countries (%)*

	Ghana (1998-9)	Kenya (2005)	Mali (2004)	Madagascar (2005)	S. Africa (2004)
Formal Employment					
Formal, private wage employment	1.0	6.9	NA	2.5	40.8
Formal, public wage employment	4.1	5.4	NA	2.7	16.5
Total formal wage employment	5.1	12.3	5.8	5.2	57.3
Formal self-employment	3.6	1.3	5.1	1.6	4.2
Informal Employment (agric. and non-agric.)					
Informal wage employment	9.3	18.0	11.0	9.3	22.8
Informal self employment	81.6	64.8	78.1	83.8	14.4
Other/Undeclared	0.4	3.6	0.0	0.0	1.3
TOTAL	100	100	100	100	100
of which...					
Agric. wage employment	1.2	NA	0.9	3.3	10.6
Agric. self employment	52.3	50.0	41.2	77.2	4.7
Additional Ratios					
Informal non-agric. self employment (% of total)	29.3	14.8	36.9	6.6	9.7
Informal as a % of non-agric-employment	80	66	81	65	27

*Sources*

Kenya: author's calculations based on the 2005 Household Integrated Budget Survey.

Ghana: author's calculations based on the 1998/9 Ghana Living Standards Survey.

Mali: ILO Bureau of Statistics

South Africa: Heintz and Posel, Revisiting Segmentation and Informal Employment in the South African Labour Market, South African Journal of Economics, Vol. 76, No. 1 (2008), pp. 26-44.

A related rationale for departing from the standard formulations is that earnings tend to be lowest and the poverty incidence highest among workers in informal employment and in agricultural production. The concentration of the Ghanaian workforce precisely in these two sectors, where returns to labour are shockingly and consistently low, helps explain the intractability of mass poverty in the country. For Ghana's economic growth to translate into the reduction of poverty, it must succeed either in routinely moving workers into better employment opportunities in the formal economy (i.e. jobs with consistently higher returns to labour), or in *improving productivity and employment conditions in the informal sector* or, ideally, both.

The first option will entail the creation of greater numbers of private, formal-sector jobs (on the assumption that such jobs are more likely to be of a better quality than public sector ones)<sup>7</sup> and the subsequent movement of workers into them from their current informal employment; and the second would involve a jobs policy anchored in agriculture and the informal economy (and therefore informal employment as such), as much of agricultural production in Ghana remains, in fact, 'informal'. But as the growth diagnostics and our critical review of Ghana's monetary policy regime show, the formal sector is so hamstrung structurally that to craft a jobs policy that relies preponderantly on it would strain credulity; and, in any case, as mentioned earlier, the non-public formal economy in Ghana has never been able to provide employment for more than 9% of the work force.

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To set the context for evaluating the jobs-policy option being advocated here, we must first seek to understand how other analysts who understood how the African labour-market actually functions, have historically approached the issue.

The observation that an optimal African jobs strategy can ill-afford to ignore the informal-sector was first made in the early 1970s by economists Keith Hart (who had studied urban employment in Ghana) and Paul Streeten (as part of the Basic Needs strategy of the World Bank), and by the ILO (which had done an influential bit of research on employment conditions in Kenya)<sup>8</sup>. These seminal studies sought to highlight the variety of livelihood activities that African workers were routinely involved in beyond the standard categories of wage-

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<sup>7</sup> By "better quality" we mean more sustainable jobs of higher productivity.

<sup>8</sup> See Keith Hart, *Informal Income Opportunities and Urban Employment in Ghana*, Journal of Modern African Studies, Vol. 1, No. 1 (1973), pp. 61-89; Paul Streeten, *First Things First* (NY: Oxford Univ. Press, 1981); and ILO, Employment, Incomes and Equity: A Strategy for Increasing Productive Employment in Kenya (Geneva: ILO, 1972).

employment and farming activities that then dominated economists' and policymakers' thinking. They ended up putting economic "informality" and informal-sector employment on the policy map: as it happened, an economic sector in which all the relevant formal regulations did not *de facto* apply, and in which important formal economic institutions of all sorts—commercial banks, public goods and services, legal services, etc.—were either non-existent or severely curtailed, was proving to be the single greatest absorber of the African work force. In very short order, similar findings were cropping up in studies of labour-market activity all over the developing world. Indeed, informality remains, even today, a defining characteristic of employment in many of these economies.

This was a new conception of non-formal work, supplanting to a large extent the surplus-labour models of developing-country labour markets associated with the works of W. Arthur Lewis and other neoclassical structural-change theorists<sup>9</sup>. In the surplus-labour model, the demand for labor in the formal sector falls short of its supply at the prevailing wage. Individuals who cannot, thereby, secure formal-sector employment are forced to work in subsistence (re: informal) activities. Informal employment thus becomes an undifferentiated residual, a kind of employment-of-last-resort. As the economy develops, productivity gains in the formal sector induce increases in labor demand, thus reducing the stock of surplus labour and, in time, the informal residual disappears altogether. Informality, in this characterization, thus becomes a marker of under-development and economic 'backwardness', and economists who subscribed to this concept of informality-as-residual came to associate informal employment with inefficiency and sub-optimal resource utilization, since labour tends to get allocated to activities with very low levels of productivity.

Now, contrast this with the conceptualization of the informal sector in Hart's 1973 study of urban Ghana and the ILO's 1972 study of Kenya. Here the informal sector is seen as consisting of a diverse set of activities that constitute a vital source of income and employment for, especially, the urban poor and the rural landless. Hart's analysis emphasized the heterogeneity of informal employment, and the fact that entry barriers may exist for certain types of activity. Informal employment was also often used to supplement income from formal employment, particularly in times of rising inflation and therefore falling

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<sup>9</sup> See W. Arthur Lewis, *Economic Development with Unlimited Supplies of Labour*, Manchester School of Economic and Social Studies, Vol. 22, No. 2 (1954), pp. 139-91. We employ, in this paper, a distinction between *informal employment* and *employment in the informal sector* first made at the seventeenth International Conference of Labour Statisticians. The informal sector is defined in terms of the nature of the enterprises functioning therein: informal enterprises are neither registered with the requisite government department or agency, nor are they subject to the full panoply of government regulations that apply to registered enterprises. By contrast, informal employment uses a jobs-based definition: *informal employment* refers to jobs (in whatever sub-sector of the labour market) that are not covered by a basic set of social and legal protections.

real wages. The ILO report, in addition, argued that informal activities could be seen as an important element of a country's overall jobs strategy, and *therefore economic policies could be explicitly focused on improving working conditions and earnings in the informal sector*. As the report had it, "the informal sector is not a problem, but [rather] a source of future growth."<sup>10</sup>

This alternative formulation suggested that problems of low productivity, precarious earnings and intractable poverty that characterize the informal sector cannot be solved by eliminating the sector altogether, but rather by improving working conditions for workers in the sector. Instead of seeing informality as an indicator of 'backwardness' and 'underdevelopment', this approach saw a potential for improving job opportunities with the appropriate policy interventions<sup>11</sup>. These conflicting views of informality—as a constraint on development or a viable livelihood and employment strategy—continue to inform employment policy in Africa to this day.

And there are two principal reasons for this: firstly, the structure of employment across the continent has not changed significantly since these studies were completed in the early 1970s; informality, in other words, remains widespread if not dominant. Secondly, productivity and earnings in the informal sector remain intractably low, and poverty is still endemic. Given this, the question of what the parameters of an optimal employment policy ought to be for economies like Ghana's, characterized as they are by widespread informality and low earnings, looms as large today as it did in the 1970s. This paper will attempt to provide some direction to potential answers.

#### *A. The Employment-Poverty Reduction Link*

The vast majority of Ghanaians depend on employment of one sort or another for (often) their sole household income. To reduce poverty across the country, therefore, not only must the economy grow in a sustained fashion, but it must do so while creating employment opportunities that improve workers' productivity and income, and therefore standards of living. Just having access to a job—any job—is not enough to reduce poverty: after all, the labour force participation rate in the country is pretty high already, yet a large number of working Ghanaians seem unable to lift themselves and their households out of poverty.

This is not a uniquely Ghanaian phenomenon, of course: as the U.N. Economic Commission for Africa (ECA) reported in 2005 in its *Economic Report on Africa*, half of all employed workers across the continent are best described as "working poor"—they are employed, but their living standards still remain below

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<sup>10</sup> ILO, op. cit., p. 505.

<sup>11</sup> See Hart, op cit., p.61.

a basic needs threshold (see Table 2 below). Reducing poverty requires emphasizing both the quantity *and quality* of employment. Recent research suggests that economic growth succeeds in reducing poverty *only if the growth has an employment focus*<sup>12</sup>. In other words, economic growth in-and-of-itself cannot be relied upon to generate the right quantity and quality of poverty reducing job opportunities; what is required is an *employment-centred approach* to growth.

Still, the case remains that sustained economic growth is indispensable to the reduction of poverty. But growth only translates into poverty reduction and the mitigation of inequalities if the benefits of such growth are widely, if not equitably, shared among the population. In Ghana and other poor countries, improved employment opportunities are *the* critical channel through which the additional income associated with faster growth can be distributed more equitably among the population. Labour, after all, is the one factor-of-production poor and low-income households possess in relative abundance; therefore policies which enable the fuller employment of labour, or which raise the productivity of, and therefore returns to, employed workers, are a necessary foundation for the establishment of more balanced, egalitarian and poverty reducing growth<sup>13</sup>.

As such, policies designed to ensure the widespread distribution of the benefits of growth through employment must function on several fronts simultaneously. Firstly, they must address the core problem of the insufficiency of labour demand. In Ghana and much of sub-Saharan Africa, problems of open unemployment may not be as significant as widespread *underemployment*, especially in the non-urban areas and in the informal sector<sup>14</sup>. But both types of labour under-utilization share a common cause: an insufficiency of demand for labour, which itself (at least partly) derives from an insufficiency of demand for (especially locally) produced goods and services.

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<sup>12</sup> A.R. Khan, *Employment Policies for Poverty Reduction*, in R. Islam, ed., Fighting Poverty: The Development-Employment Link (London: Lynne Rienner, 2006), p. 63-103.

<sup>13</sup> See R. Islam, *The Nexus of Economic Growth, Employment and Poverty Reduction: An Empirical Analysis*, in R. Islam, op. cit; A.R. Khan, op. cit ; and L. Squire, *Fighting Poverty*, American Economic Review, Vol. 83, No. 2 (1993), pp. 377-82.

<sup>14</sup> By 'underemployment' we mean the usual: a situation in which workers are working fewer hours than they would prefer, or are working in positions for which they are over-qualified. But it is also being used here to describe individuals who work long hours in low-productivity jobs that pay them very little; they are 'underemployed' in the sense that there is not enough demand for their labour, which explains why they are paid meager wages for long hours of effort. A recent study of poverty in Kenya, for instance, found that among individuals working at least 40 hours per week, nearly half of them lived in poverty (based on their earnings and the official consumption poverty threshold). Poverty rates for Kenyans working fewer hours were higher; but the point here is that simply working longer hours does not, in-and-of-itself, free the average Kenyan worker from poverty. See Robert Pollin, Mwangi Githinji and James Heintz, An Employment Targeted Economic Program for Kenya (Cheltenham: Edward Elgar, 2008).

Secondly, poverty-reducing policies should aim at improving the quality of employment, which is often constrained in Ghana by low productivity or the inability of workers to capture the benefits of productivity gains. Raising the returns to labour is much akin to improving workers' terms-of-trade—that is, the income they receive from work relative to the costs of sustaining themselves and their families. Heretofore, Ghanaian workers have consistently faced unfavourable terms-of-trade, in that the average remuneration has been low relative to the average worker-household's costs of living<sup>15</sup>.

Thirdly, these policies must ensure sufficient worker mobility to take advantage of new or better or emergent opportunities. Barriers to mobility—including labour-market segmentation that tends to exclude individuals from certain employment relationships or activities—tend to limit the re-distributive impact of an employment-centred growth strategy.

And, finally, in crafting a poverty-reducing jobs policy, the following two facts must be kept in mind constantly: while poverty is typically defined and measured at the household level, the attributes of employment are assessed at the level of the individual or job. Thus the two most important institutions that shape the employment-poverty connection would appear to be the labour market and the household—two institutions not only inextricably intertwined but also severely gendered (see Table 2). Thus, for example, women's participation in remunerative employment outside the home is determined partly by conditions in the household; and women's access to paid employment also impacts the total household income and (thus) the risk of poverty.

Similarly, the dominance of extended-family networks in Ghana frequently means that the benefits from a single source of employment are distributed widely. The impact of a single job on poverty rates is thus much more dispersed than would be the case if we only focused on individual earnings and welfare.

Thus, in Africa—perhaps more than any other part of the world—differences in household composition, the structure of employment, returns to labour, and the segmentation of the labour force all tend to influence and shape the dynamics of employment and poverty in very significant ways. An optimal jobs policy would take due cognizance of this.

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<sup>15</sup> See L. Fox and M. S. Gaal, Working Out of Poverty: Job Creation and the Quality of Growth in Africa (Washington, DC: World Bank, 2008).

TABLE 2

*Ghana: The 'Working Poor' Share of (over 15) Employment,  
By Sex and In/Formality Status, 1998/9 (%)*

	Women	Men	Total
Formal Employment, non-agriculture			
Formal private wage employees	NA	26.5	25.8
Formal public wage employees	36.5	43.9	42.0
Formal, self employed	52.0	45.8	49.2
Formal Employment, agriculture			
Formal wage employees	NA	NA	65.6
Informal Employment, non-agriculture			
Informal, self-employed	57.4	58.8	57.7
... of which:			
own account workers	57.4	58.8	57.7
Informal wage workers	40.3	43.8	42.8
... of which:			
public wage workers	39.4	46.2	44.4
Unpaid family workers	70.0	60.0	67.0
Informal Employment, agriculture			
Self-employed	74.4	72.9	73.5
Informal wage workers	NA	56.9	57.7
Unpaid family workers	87.8	80.7	85.8

(1) NA = Too few observations for statistically significant estimation.

(2) A household is deemed poor if its income from all sources falls below a poverty datum line calculated on the basis of the household's composition and an adults equivalency scale.

Source: Calculated from the Ghana Living Standards Survey 4, 1998-99.

## *B. The Structure of African Employment: Evidence from Ghana and Four Comparators*

In-depth knowledge of the structure of employment in Ghana (or any other country, really), specifically in terms of the economic dynamics and institutional settings in which labour is exchanged, is indispensable to the effective crafting, focusing and prioritizing of a jobs-based development or poverty reduction policy. Labour in Ghana (as elsewhere in much of sub-Saharan Africa) is exchanged through a variety of channels. The labour of paid employees, for instance, is directly exchanged for a wage, whereas returns to the labour of the self-employed are realized through other forms of market exchange. But there are other, more hybrid forms, as well: piece-rate workers, for example, may effectively be working as paid employees even though they are treated essentially as self-employed—very highly dependent self-employed, but self-employed all the same.

In addition, employment relationships are differently regulated: for instance, the employer-paid employee relationship is regulated largely through various national labour laws covering things like collective bargaining, pension schemes, occupational health and safety standards, and the like. Even then, not all paid employees are always thusly covered by such statutory protections and collective agreements<sup>16</sup>: for instance, informal-sector paid employees often lack these basic legal and social protections. The self-employed are typically not covered by wage regulation, but if they work in the formal sector the enterprises they work in would often be covered by the appropriate regulatory regimes. If the enterprise falls outside the regulatory system, self-employment would more-than-likely be of the informal variety; in other words, it would belong to the informal sector<sup>17</sup>.

Table 1 (p. 11) contains estimates of the distribution of jobs by employment status and informality status for Ghana and four other African countries. It gives a useful overview of the structure of employment in Ghana, Mali, Kenya, Madagascar and South Africa, while allowing us to draw a number of useful indicative inferences about employment structures across sub-Saharan Africa. Firstly, the table shows that the agricultural sector is a critical source of employment opportunities; secondly, informal employment accounts for a significantly larger share of total employment than does formal employment; thirdly, informal self-employment, both agricultural and non-agricultural, provides a large number of economic opportunities; and fourth, the public sector remains

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<sup>16</sup> Such workers may be understood as having *de jure* but not *de facto* regulatory cover.

<sup>17</sup> For a detailed discussion of the international definitions of informal employment, see R. Hussmanns, Statistical Definition of Informal Employment: Guidelines Endorsed by the 17<sup>th</sup> International Conference of Labour Statisticians. Paper presented at the 7<sup>th</sup> Meeting of the Expert Group on Informal Sector Statistics (Delhi Group), New Delhi, February 2-4, 2004.

an important source—in many instances, *the* most important source—of formal jobs across the continent.

Table 1 also highlights South Africa's difference. In comparison with the rest of the continent, wage-employment in the formal *private* sector *is* the dominant form of employment in South Africa; informal self-employment and agricultural employment are significantly less important. Wage employment accounts for a larger share of agricultural employment than does self-employment, whereas in the other four countries of the sample agricultural self-employment is dominant. The public sector remains an important source of formal employment, but the private sector dominates the formal employment picture. Finally, South Africa has high measured rates of open unemployment, suggesting, as argued by Heintz and Posel, that the unemployed do not necessarily enter informal self-employment (as they do in the other countries) at a significant rate<sup>18</sup>. The distinct structure of employment in South Africa has important implications for the political economy of employment policy; we return to this later.

That South Africa's uniqueness stands out among all the countries in the sample cannot be gainsaid. What is not so obvious, however, is the fact that the other four countries also exhibit some diversity in their employment structures, suggesting that employment in Africa cannot be assumed to be invariant across countries. For example, in Ghana and Mali, informal non-agricultural self-employment is particularly important as it accounts for a quarter to a third of all employment. In Kenya and Madagascar, however, informal non-agricultural wage employment is as important as informal self-employment outside of agriculture. And whereas in Ghana, Mali and Madagascar formal wage employment represents a small fraction of total employment, in Kenya the share of formal wage employment is twice as large as in these three other countries<sup>19</sup>.

As earlier mentioned, in Ghana (and across sub-Saharan Africa), earnings are typically lowest and the poverty incidence highest in agricultural employment<sup>20</sup>. In informal non-agricultural employment, both self- and wage-

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<sup>18</sup> James Heintz and Dorrit Posel, *Revisiting Segmentation and Informal Employment in the South Africa Labour Market*, South African Journal of Economics, Vol. 76, No. 1(2008), pp. 26-44.

<sup>19</sup> North Africa is not represented in the sample whose estimates appear in Table 1. Countries in the *Maghreb* tend to have a structure of employment noticeably distinct from that of sub-Saharan Africa. For instance, official measurements of women's labour-force participation rates, and hence rates of employment, are significantly lower across the North African economies. Indeed, in much of Arabia, a particularly large share of the adult female population works as unpaid family workers in informal (agricultural and non-agricultural) enterprises. See James Heintz, The Structure of Employment in the Arab States: A Comparative Statistical Analysis of Informality, Gender Equity, and Social Protection. (Paper prepared for the Project of the ILO and Center for Arab Women Training and Research on Gender Equality and Workers' Rights in the Informal Economies of the Arab States, Beirut Office of the ILO, 2007).

<sup>20</sup> See Nikoi Kote-Nikoi, Sins of Our Fathers: The Distributional Impacts of Structural Adjustment in Africa, IEA Occasional Papers No. 30 (Accra: Institute of Economic Affairs, Oct. 2001); M. Chen et.al.,

employment, earnings are higher than in agricultural employment but lower than in formal employment. Exceptions exist, of course—for instance, informal-sector workers who hire other workers can earn more, on average, than formal-sector wage-workers—but generally formal employment affords the highest earnings and the lowest risk of poverty.

Given these patterns of earnings, migration out of agricultural into non-agricultural informal employment often represents a step upwards, in terms of earnings and economic mobility, on the economic ladder, even though poverty rates remain high among households that depend on informal employment for their primary incomes. Movement into (rural or urban) non-agricultural informal activities, therefore, represents an intermediate step in the transition out of agriculture/rural poverty, which helps explain (1) the rural-to-urban streams of young workers leaving rural agriculture for informal non-agricultural employment in the urban centers, and (2) the preference, in their employment policies, for formal-sector job creation by African policy makers and their Development Partners. However, the more appropriate short-term jobs-policy response, we would contend, would be to shore up the economic viability of, and enhance worker productivity in, the non-agricultural informal sector.

### *C. Labour Market Regulation and Employment Policy*

Mainstream economists often blame rising unemployment or the lack of employment growth on labour market rigidities, the rigidities themselves arising ostensibly from such extra-market interventions as excessive government regulation or trades union activity. It is argued that these rigidities increase labour costs, and reduce the demand for labour relative to its supply. Since wages cannot drop to allow for the 'mopping up' of the excess supply, there tends to be an overall reduction in labour demand, resulting in persistent un- and under-employment. Labour market institutions (including the laws and other interventions that regulate activities in the market), in other words, undermine the development process. This is the reason why the economics orthodoxy exhibits such a strong preference for the elimination of labour-market rigidities as *the* solution to Africa's persistent un- and under-employment problems. Indeed, this was the approach espoused and implemented by the neo-liberal "Washington Consensus" policy reforms of recent decades in Ghana.

Some dualism theories of labour markets present a more nuanced version of the same argument. Being dualist models, they argue that the high labour costs associated with such induced labour-market rigidities tend to constrain

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Progress of the World's Women 2005: Women, Work and Poverty (NY: UNIFEM, 2005); Epstein et.al., Employment, Poverty and Economic Development in Madagascar: A Macroeconomic Framework. Policy report prepared for the ILO, 2008; and Pollin et.al., An Employment-Targeted Economic Program for Kenya (Northampton and Aldershot,: Edward Elgar, 2008).

employment growth in the formal economy<sup>21</sup>. Formal-sector job opportunities thus tend to get rationed, and those not fortunate enough to obtain such employment are forced to work in 'traditional' activities (i.e. agricultural or informal activities), or become openly unemployed.

Thus, in these mainstream models, labour market rigidities cause either informal employment or open unemployment, which would imply that informalization and unemployment can be reduced or eliminated by eliminating the rigidities. But if the rigidities are caused, as they contend, by existing regulations, they are in effect proposing—paradoxically--that we 'informalize' formal jobs by removing the regulatory structure.

The evidence on which this argument rests, however, is thin and unpersuasive, at least in the Ghanaian case and, we suspect, the African context at large. Rather than constraining economic growth, labour-market institutions, because they are important for distributional equity and the general well-being of the workforce, are rather promotional of economic development<sup>22</sup>. And certainly for Ghana and much of Africa, even if the mainstream argument is correct, it could only hold narrowly for the tiny slice of the non-public labour market in which formal wage labour operates. After all, it is only in this segment of the market that (1) regulations are generally *de jure* binding, and (2) the supply of labour (by workers) can easily be distinguished from its demand (from employers).

Outside of this segment of the market, the argument that high and sticky (union) wages or regulatory oversight are responsible for the dearth of formal employment opportunities, or for high open unemployment rates, or for widespread underemployment and informal-economy jobs is not only of questionable validity in general, it is particularly of limited significance to Ghana's labour-market dynamics. As Table 1 shows, formal (i.e. regulated) private wage-employment accounts for only a small portion of total employment in Ghana, something on the order of 8.7%. So even if labour-market regulations slow the growth of formal, private-sector employment, that can only account for a tiny bit of the open unemployment or informal employment in the country.

The overwhelming majority of Ghanaian workers are self-employed in the informal sector, and informal employment is (at least partially) outside the regulatory structure. By the mainstream's own arguments, the informal labour

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<sup>21</sup> See J. Harris and M. Todaro, *Migration, Unemployment and Development: A Two-Sector Analysis*, *American Economic Review*, Vol. 60, No. 1 (1970), pp. 126-142; and G. Fields, *Rural-Urban Migration, Urban Unemployment and Underemployment, and Job-Search Activity in LDCs*, *Journal of Development Economics*, Vol. 2, No. 2(1975), pp. 165-187. For a comprehensive review of the various theories of informality, including dualist approaches, see D. Kucera and L. Roncolato, *Informal Employment: Two Contested Policy Issues*, *International Labour Review*, Vol. 147, No. 4 (2008), pp. 321-48.

<sup>22</sup> See J. Berg and D. Kucera, eds., *In Defence of Labour Market Institutions: Cultivating Justice in the Developing World* (Geneva: ILO, 2008).

market cannot be said to be subject to market rigidities of the sort they identify. Besides, self-employed individuals are both the suppliers and demanders of their own labour; so the notion of an equilibrium wage being determined by the interaction of an independent labour supply and demand does not appear to be relevant. Labour-market rigidities, in short, cannot explain employment dynamics in Ghana and much of Africa.

Only in South Africa, with its large share of regulated wage employment, would labour market institutions and regulations have the potential of huge impacts on employment dynamics. This, by the way, partly explains why conflicts about employment policy in South Africa have often been about the regulation of wage employment. This is not to say that labour market rigidities are the primary cause of unemployment in South Africa; it is rather to assert that the structure of employment does (and should) determine the political economy of employment policy. For Ghana, therefore, that the emphasis for job creation should be on the informal and agricultural sectors should be easily self-evident.

It is also easy to show that not all imperfections in labour markets are attributable to the presence of formal regulations; indeed, market failures not related to regulation are quite common in *all*, not just African, labour markets<sup>23</sup>. The major non-regulatory causes of labour-market failure include: positive transactions costs stemming from the real costs associated with labour-market participation, job search and monitoring; imperfect information; costly contract enforcement, of both explicit and implicit labour contracts; and unequal degrees of market power among market participants, including the numerous intermediaries operating in the informal sector. Recently, also, researchers have found evidence of barriers to mobility between formal and informal employment<sup>24</sup>, and among different forms of informal employment, in some African countries, echoing effectively the entry barriers that Hart identified in his 1973 study of Ghana<sup>25</sup>. Arguably, such non-regulatory barriers can be more important in determining access to employment opportunities than the regime of official labour-market regulations in operation, especially in Africa where markets tend to be ill-defined.

*The upshot of the story then is this: contrary to what economic orthodoxy would have us believe, limited employment opportunities in Ghana do not necessarily or primarily result from the over-regulation of the entire labour market, or rigidities in the governance of wage labour. This implies that solutions for the country's employment problems very likely lie outside of the formal wage-labour market institutions, and would likely involve additional*

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<sup>23</sup> See J. Heintz, *Revisiting Labour Markets: ...*, *IDS Bulletin*, Vol. 39, No. 2 (2008), pp. 11-17.

<sup>24</sup> Heintz and Posel, *op. cit.*; I. Günther and A. Launov, *Competitive and Segmented Informal Labour Markets*, IZA Discussion Paper No. 2349.

<sup>25</sup> Hart highlights the role of kinship networks for determining access to informal employment opportunities in Ghana, for example.

*factors such as market access, financial services, agricultural dynamics, and even urbanization policies—non-labour-market factors that, nonetheless, deeply affect a wide swath of employment activities in the country, including job creation.*

In other words, the challenge of creating decent and plentiful jobs in Ghana (and much of Africa) is a *development* challenge *writ large*, one that requires a comprehensive set of employment-focused policies, and not merely the restoration of efficiency or equilibrium in the formal labour market, or the sheer attainment of macroeconomic stability and growth. Poor labour absorption and utilization in Ghana has proved to be remarkably consistent over the decades. Un- and under-employment have remained intractable, mostly because labour market dynamics in Ghana (and across Africa) have proved to be immensely more complex than can be understood with standard, neoclassical-economics labour-market models. Problems of unemployment have revealed themselves to be, in actuality, a set of interdependent economic problems often involving non-linear relationships and unpredictable change processes, not to mention a wide assortment of actors and stakeholders.

The approach to solving the unemployment issue must therefore be equally multidimensional, multisectoral, and experimental (i.e. dynamic). It requires policies that, in short, *go beyond the labour market*. And if the effort to create more and better employment opportunities is centred on the informal sector—which has historically been the most labour absorptive sector of the Ghanaian economy—the necessity of targeting complementary sectors and economic activities becomes that much more obvious. But the underlying challenge for Ghana remains this: how to shift from the successful recovery and macro-stabilization strategy of the past twenty-five years or so to one of deep *structural* change over the next decade or two.

### **CHAPTER III**

#### ***Ghana: A (Partial) Growth Diagnostic***

It was stated in earlier sections of this study that, although Ghana has made major strides towards macroeconomic stability, the sustainability of that achievement is very much open to question. Equally worrisome is the fact that (more than) two decades of solid growth, mild inflation, and a non-capricious policy environment have not produced much new employment, nor have they attracted the necessary investment flows, domestic or foreign, that would trigger a growth acceleration that will help consolidate the broad gains made. Growth has been achieved, but it has not been accompanied by the productivity increases, structural transformations and employment gains that are desired and were expected. In fact, the development gap between Ghana and select groups of comparator economies has actually widened over those two decades, calling into question whether Ghana's growth is more episodic and cyclical than transformational and ecdysic.

What are the factors that seem to be preventing Ghana from moving on to a higher, sustained level of income and economic transformation—indeed, towards its own objective of a solid middle-income country by 2020? What are the implications of this for a poverty-reducing jobs strategy? What does Ghana need to do to consolidate the gains already made? These are some of the questions we seek answers to with the growth diagnostics.

#### *A. The Scope of the Challenge*

That Ghana has stabilized its macroeconomic environment and has even managed a long period of positive growth has been well established. But the scope of the economic challenges it still must overcome to achieve sustained job creation and poverty alleviation is brought into sharp relief when Ghana is assessed using global economic-development trends, generally, or in comparison with specific countries facing similar economic and structural challenges as Ghana faced in 1960, at about the beginning of its nationhood. For example:

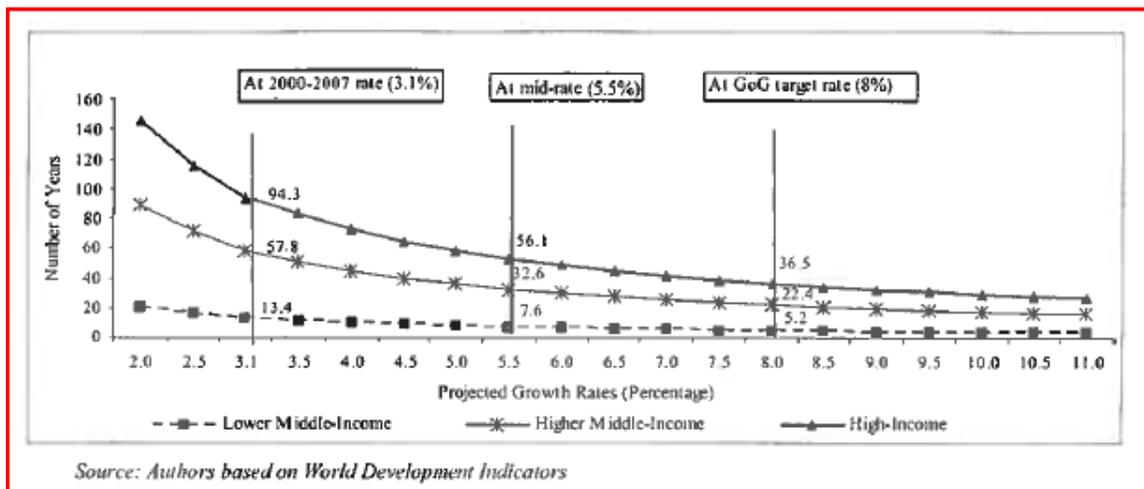
- (1) Ghanaians' average (real) income has not changed much since 1960, even though per capita GDP worldwide has shifted dramatically upwards;
- (2) Consistent growth over the last two decades has only enabled the country to catch up, in absolute terms, with its immediate post-independence income level, even as comparator countries like Kenya, Egypt, Malaysia, Morocco, Sri Lanka, Thailand and Ecuador have tripled, quadrupled, even

quintupled their average incomes. Thailand, for one, is eight times richer now than it was five decades ago;

- (3) For all these countries (which were similar to Ghana in terms of coastal geography, resource endowment, agriculture-dominated economies in the 1960s, and had the same per capita income in 1960) their strongest economic growth has occurred only since 1988, when Ghana was economically and politically stable enough to have had a similar growth experience but did not;
- (4) If, in 1960, Ghana's per capita GDP was \$2506 below the global income mean, today the gap has increased to \$6565;
- (5) By 2010, Kenya had achieved a higher average income performance than Ghana, even though it started with a lower per capita income than Ghana did fifty years ago;
- (6) Ghana's GDP levels and economic growth rates since 1983 have been consistently lower than the average for every region on the African continent, including the West Africa region;
- (7) Since the nation's overarching development objective since the mid-1990s has been to reach middle-income status by 2020, we present in Figure 1 below projections of how long it will take to achieve this objective under different growth scenarios.

FIGURE 1

*Achieving Middle-Income Status in Ghana: Projections with Different Growth Scenarios*



What the projections suggest is this: if Ghana were to stay on its recent (2000-2008) growth path of 3.1% per year on average, it will take 13.1 years to attain lower middle-income status, and nearly 58 years to reach high middle-income status. The government's growth target is an average 8% per year which, if attained, should get the country to the lower middle-income threshold in just five years (i.e. by 2015, if you think of Year 0 on the graph as representing 2010 when the "Vision 2020" blueprint was published). If, for the sake of argument, we take a midpoint between these two growth rates (say, 5.5% per year) as the most likely realizable growth rate, then Ghana should become a lower middle-income country in 7.6 years, or around the year 2018, and a high middle-income country in 32.6 years, or around 2043.

### *B. Where is the Growth to Come From?*

An argument has been made by this author and others that the salient lesson of the post-World War II international development experience is that the countries that succeeded in transforming their economies on to higher growth and income paths were those that focused sharply on improving four variables: human capital, fixed or productive capital, institutions that help stabilize the economy after a shock, and good governance<sup>26</sup>. With the recent development of a crude-oil sector in Ghana, the prospect of 'Nigerian disease' (the African cousin of 'Dutch disease') is a very real worry if care is not taken to reinvigorate entrepreneurship and private investment across the non-oil sectors of the economy. Indeed, the kind of structural transformation that is needed to enable the creation of good jobs is necessarily multi-sectoral; the burden cannot be foisted on any one single sector, no matter how strategic. The oil sector, in other words, cannot be seen as Ghana's economic saviour, neither for jobs nor systemic growth. Private investment across all sectors of the economy holds the highest promise for the factor productivity increases that sustain growth and shift production structures.

This is implicitly recognized in both the GoG "*Shared Growth...*" document and DANIDA's *SPSD* programming. Indeed the success of these two initiatives may well be judged—and rightly, it would seem—by the extent to which they are instrumental in reinvigorating private-sector productive investment and employment creation.

What, then, should (and could) be done to invigorate entrepreneurship and private investment in fixed capital? The data on Ghana's recent investment outlays suggest that it is not the quantity but the *quality* of investment that

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<sup>26</sup> Nikoi Kote-Nikoi, *Optimal Development Policy in the Age of Globalization*, IEA Occasional Paper No. 29 (Accra: Institute for Economic Affairs, July 2001).

needs attention if this transformation is to happen. Since the economic reforms of 1983, the investment share of GDP has grown substantially—an average of 14% between 1984 and '94, and 24% between '95 and 2006. (It is generally accepted that an investment-to-GDP ratio between 15% and 30% is needed to sustain economic growth). What is striking, however, is the composition of this investment expenditure: it is excessively weighted towards *public* investments. For the comparator countries mentioned in this paper thus far, the average share of capital formation attributed to the public sector is less than 5% of GDP, while the private share is around 20%. In Ghana, public investment makes up 20% of GDP, while the private sector's share hovers around 10%.

And even though private investment flows have picked up considerably over the past eight years or so, the quality of the investment (in terms of its ability to create sustained economic and employment growth), has not improved much, in that the bulk of it is flowing into the primary-resource sectors, especially mining (of gold and crude oil). These types of investment generate very little dynamic gains, nor are they particularly absorptive of labour. If there is one thing we have learnt from the endogenous growth theory in recent years, it is that in this era of economic globalization and cross-border capital flows, countries that specialize in sectors with no dynamic scale or other benefits—precisely the kinds of technologically-deficient sectors such as agriculture and mining that Ghana and most African countries tend to have their initial comparative advantage in—risk the possibility of permanently reduced growth rates from these flows. The task for Ghana therefore remains how to attract *higher quality private investment* that will be productivity enhancing systemically.

In this regard, findings from a plethora of surveys of the Ghanaian business scene over the past several years can help us with an initial identification of the binding constraints on private investment activity, i.e. to find the disincentives within the economy at large that seem to be hampering firms' planned and actual investment spending.

### *C. Why Are Private Investors Not Responding to Market Opportunities?*

There is an old truism, around since the mid-1980s, that private investors were not taking advantage of market opportunities in Ghana because they feared that the policy reforms could be reversed in short order: in other words that the country was suffering from a credibility deficit. While this may have been likely true in the early years of the reform—say, from 1983 to 1990—it is not likely to still be the case that investors' expectations are overwhelmed by the risk of policy reversal, as the reforms have been doggedly pursued, deepened and institutionalized over nearly three decades by governments of different ideological persuasions.

Indeed, if a credibility deficit were still operative, we would expect the bulk of new investment to be short-term commitments: that is, investments in short-term assets in sectors with high but quick turnover, such as trading. But most recent private investments have actually been in long-term projects with high sunk costs, like mining, oil exploration and other extractive activities. These are not sectors in which investment commitments are easily undone; and the sectors with higher potential for the quick reversal of investment expenditures—such as services—are, by comparison, not attracting a lot of investment interest.

There, fortunately, exist pretty reliable data from some twenty different surveys of businesses operating in Ghana, conducted by researchers ranging from the World Bank and the Association of Ghanaian Industries (AGI) to individual researchers and institutions, from the early 1990s to the late 2000s (see Appendix A). Because these are survey-based data, they reflect solely the reported constraints (or perceptions of constraints) of individual entrepreneurs, and may therefore be prone to sample-selection bias. The surveys also used different methodologies, covered different aspects and ranges of business activity, had different sample sizes and firm characteristics, and did not cover all sectors of the economy or all geographical regions consistently, which therefore limits the comparability of their findings. Nonetheless, they give us an important glimpse of what potential investors (would) perceive to be the most important constraints on their investment commitments.

The results of these surveys are summarized in Table 3 (made up of 3A, 3B and 3C) and may be explained as follows, under four broad themes. (1) By far the most important constraint on investment appears to be the high cost of credit and the unavailability of affordable finance. This reflects, in large measure, the access limitations to local credit markets and poor intermediation mechanisms that are discussed in some detail in Chapter IV. (2) Next come issues of appropriability, particularly micro-level risks. For instance, inadequate property rights or procedural problems in acquiring and registering landed property are both identified in several of the surveys as major constraints. (3) Then come human-capital inadequacies, and problems with finding workers with the appropriate skills. Skills shortages, generally, and the lack of technical skills in particular, are perceived as a major constraining factor in some sectors. Closely related is the issue of the inadequacy of training for workers, and the workforce's generally poor work ethic. Finally (4) business tax obligations are reported to be too high, creating a major disincentive to business expansion. Related to this are the problems with tax administration that show up in several of the surveys.

It is telling, however, that macroeconomic risks are not identified as constituting a major constraint on investment despite rising inflation and expanding budget deficits through much of the survey period. Also not heavily cited as a major obstacle are the quality and quantity of infrastructure, though

the problem of intermittent energy/electricity shortages is highlighted by a substantial majority of correspondents, especially in the ICA survey of 2007.

TABLE 3

*Firms' Perceptions of the Constraints on their Investment Activities,  
Survey Data*

**3A: Cost of Finance**

Researcher (year)	Domestic Savings	Intermediation	International finance
AfDB-WEF (2009)	*		
AGI (2009)	*	*	
Aryeetey (1994, 2000)		*	*
Asante (2000)	*	*	*
Barthel et al (2008)		*	
EMPRETEC (2001)		*	
ICA-WB (2007)	*	*	
Mensah (2007)		*	
Rankin et al (2002)		*	*
Steel et al (1992)		*	*

*Source:* The surveys listed in Column 1.

### 3B: Social Returns

Researcher (year)	Geography	Infrastructure	Human Capital
AfDB-WEF (2009)		*	*
Aryeetey (1994,2000)		*	
Dawson			*
EMPRETEC (2001)		*	*
ICA-WB (2007)		*	
Mensah (2007)		*	*
Steel et al (1992)			*

Source: The surveys listed in the first Column 1.

### 3C: Appropriability

Researcher (Year)	Gov't: Macro-risks	Gov't: Micro-risks	Self-discovery	Miscellaneous
AfDB-WEF (2009)		*		
AGI (2009)	*	*		
Amponsah (2000)		*		*
Aryeetey (1994,2000)		*		*
Asante (2000)	*	*		*
Barthel et al (2008)		*		
Dawson (1992)	*		*	*
EMPRETEC (2001)		*		*
ICA-WB (2007)		*		
Mensah (2007)				*
Patillo (1997)	*	*		
Rankin et al (2002)		*		*
Steel et al (1992)		*		*

Source: The surveys listed in Column 1.

Placed in the 'Miscellaneous' column of Table 3C are variables that, though do not quite map on to the formal 'Growth Diagnostics' framework are, nonetheless important for completing the business perceptions picture. These cover issues such as the low demand for firms' products: the complaint here is that the small size of the local market and weak purchasing potential of the average Ghanaian consumer are a major disincentive for investment expansion. Many businesses explain that they could not even sell their existing inventory because the demand was "just not there". The AGI survey of 2009, in addition, identified the lack of "Export Marketing" or exports facilitation as a top challenge to industry.

#### *D. Are There Investment Opportunities in Ghana, Anyway?*

Just as a thought experiment, let us suppose that all the constraints and disincentives to investment identified by Ghanaian entrepreneurs in all the surveys summarized under Table 3 were resolved overnight. Would it be discovered that there are, in fact, profitable opportunities for entrepreneurs to invest in?

A quick perusal of the data suggests that Ghana has a low-returns economy since aggregate productivity has been consistently lower than in comparator countries that may be competing for the same quantum of investments. The country's incremental capital-output ratio (ICOR) between 2003 and 2008 averaged 5.0, according to the *2009 World Development Indicators*, but its trend growth rate was -1.8%. This means that, in Ghana today, it takes \$5 of investment in productive capital to produce \$1 of extra output, as compared to an average of \$4.3 in all of low-income sub-Saharan Africa, \$4.2 in low-income countries worldwide, \$3.8 in South Africa, and only \$2.6 in Tanzania. Investments in Ghana, it would therefore appear, are relatively inefficient.

The comparative total factor productivity (TFP) figures in Table 4 are also suggestive—"suggestive" because, as TFP is computed as a residual, it contains not only productivity indicators but also other factors not directly captured in growth accounting--of Ghana's competitive disadvantage against the comparators when it comes to general productivity and, therefore, attractiveness as an investment destination. Ghana's TFP, though rising since 1983 when it troughed at 0.58, in fact peaked as far back as 1960, and has remained lower than the TFP of any of the comparator economies ever since.

TABLE 4

*Total Factor Productivity Trends: Ghana and Comparators, 1960-2008*

	Ghana	Kenya	Egypt	Moz'bique	Thailand	Ecuador
1960	1.00	1.00	1.00	1.00	1.00	1.00
1965	0.92	1.07	1.07	1.07	1.08	1.09
1970	0.90	1.12	1.03	1.34	1.18	1.15
1975	0.78	1.37	1.04	1.05	1.15	1.67
1980	0.74	1.47	1.18	0.98	1.28	1.74
1985	0.62	1.42	1.20	0.69	1.29	1.60
1990	0.72	1.60	1.19	0.87	1.59	1.52
1995	0.75	1.48	1.19	0.89	1.85	1.51
2000	0.78	1.39	1.29	1.80	1.68	1.41
2005	0.80	--	--	--	--	--
2008	0.85	--	--	--	--	--

*Source:* Author's calculation.

There is likely a variety of explanations for the low social returns in Ghana, some of which may already have been identified in the surveys of the business sector. Certainly geography, human capital problems, and infrastructural inadequacies are good candidates that warrant further investigation. Given the complementarity among these (and many other input variables), deficiency in even one of these would be a sufficient threat to general productivity, and therefore to the expectations of existing firms and potential entrepreneurs. In this section we investigate whether or not (marginal) improvements in these three areas, for instance, would change private investors' expectations of Ghanaian productivity significantly enough to elicit a strong investment response. In other words, we investigate the extent to which geography, skills shortages, and infrastructure inadequacies are binding constraints on business investment, presumably because of their deleterious effects on general productivity.

(i) Geography

Ghana is distant from major international markets. It also sits in a humid, tropical, malarial region rife with political instability. It is somewhat culturally and linguistically isolated in the region, surrounded as it is by French-speaking countries with different regional and global economic and institutional ties. There is the occasional natural disaster such as droughts that undermine agriculture and therefore general economic performance. At first blush, therefore, Ghana's geographical and locational attributes seem to conspire against its desirability as an investment destination.

Distance, of course, is known to influence investment and trade flows, and therefore a country's economic or growth potential. In comparison with its West African neighbours, goods from Ghana must travel a longer distance to major international markets (as must goods and capital flowing in the other direction): some 5200 air-kilometers. In comparison, the distance to these markets from Mauritania is 4200 air-kilometers; it is 4450 from Niger and Burkina Faso; 4700 from the Gambia and Senegal; 4800 from Nigeria, and 5100 from Sierra Leone. Only Côte d'Ivoire (5250) and Cameroon (5470) face longer travel distances to these markets from the region.

But distance alone hardly gives an accurate portrayal of a country's *economic geography*—indeed, other potential comparator countries are much farther away from the same major international markets but are doing quite well on investment outlays.<sup>27</sup> A better indicator of the economic geography of the region to which Ghana belongs would examine, for instance, the 'quality' of markets weighted appropriately by their distance from Ghana. This would be a lot more instructive, in that, done right, it should (1) capture the influence of foreign economic developments (such as growth in the global economy or the European economies) on Ghana's own economic performance—which would have an influence on investors' expectations; and (2) capture the potential demand for Ghana's products on international markets, which would also affect potential entrepreneurs' perceptions of the profitability of investing in Ghana.

The indicator of economic geography used in this analysis consists of the relevant economic variables for all the countries of the world weighted by the inverse of the distance to the referent economies, i.e. Ghana and its comparators. The "relevant economic variables" are GDP growth rates, population sizes, investment levels, and accumulated human-capital<sup>28</sup>. The

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<sup>27</sup> Malaysia, Peru, Chile, Namibia and Mauritius immediately come to mind.

<sup>28</sup> The indicator was constructed as follows:  $G_{X,i,t} = \sum (1/d_{ij}) X_{j,t}$ , where  $d_{ij}$  is the distance between country  $i$  and country  $j$ , ( $j \neq i$ ) and  $X_{j,t}$  is the value of variable  $X$  in country  $j$  at time  $t$ . The first indicator was based on GDP growth rates as  $X$ ; three more indicators were based on the economic growth variables— investment (fixed gross capital formation as a % of GDP), human capital accumulation (gross secondary

intent is to capture the “3Ds” of economic geography-- density, distance and division (see World Development Report 2009)--that might influence investment commitments to Ghana.

If Ghana’s current growth were anæmic or unbalanced, low geographical proximity to high-growth markets with dense demand and low division would create enhanced expectations of investment returns. The distance-weighted indices, though, suggest three things: (1) Ghana’s healthy current growth rates (second only to Egypt’s among the comparator nations of Egypt, Kenya, Morocco, Malaysia and Thailand) should be sustained in the near future given current levels of gross capital formation (again, second only to Egypt among the comparators); (2) Ghana is located in a region of very high external openness and, among the comparator countries, Ghana is second only to Egypt in the degree of its openness to imports. However, the markets in closest proximity to Ghana are characterized by low consumer income, wealth, health, education levels, and consumer sophistication (a low HDI). Thus, *except for this latter fact, Ghana’s economic and investment attractiveness are, in comparative terms, not particularly disadvantaged by geography.* In other words, Ghana is not necessarily a good country in a bad location, investment-wise.

(ii) Skills Shortages or Other Human-Capital Inadequacies

The evolution of educational attainment in the adult population of Ghana over the past several decades has been impressive. Between 1970 and 2000, the mean years of education increased to 8.3 from 3.7 years. Literacy levels by 2008 had risen to 68%, significantly higher than the sub-Saharan African average of 60%. Average (years of) schooling is relatively high for the country’s level of income, a figure that has been improving continuously for three decades; and public expenditure outlays on the education sector since 2000, have accounted for as much as 12% of total discretionary spending.

But educational achievement is not evenly distributed across the population. Male-female, urban-rural and north-south disparities persist, and the gross achievement figures tell us nothing about the quality of education received, or the efficiency with which it was provided. In addition, the greater gains have been made in primary education; secondary and higher levels still display glaring lags and gaps, especially when compared with potential comparators such as Kenya, Morocco, Thailand and Ecuador (Table 5).

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enrolment), degree of external openness (ratio of total imports to GDP), and wealth (Human Development Index).

TABLE 5

*Comparative Enrolment by Level of Schooling, 2007 (% of gross)*

	Primary	Secondary	Tertiary
Ghana	95	44	12
Kenya	110	49	10
Morocco	100	53	14
Ecuador	114	65	69
Thailand	102	80	45
Senegal	80	22	12

*Source:* Calculated from [World Development Indicators 2008](#)

This structure of educational achievement cannot but show up among the workforce. The Investment Climate Assessment (ICA) conducted in 2007, for instance, found that 37% of all small firms in Ghana had managers with only secondary education; only 15% were managed by someone with a university degree. For medium-sized firms, 28% were under the management of secondary-school leavers, while 27% were managed by university-educated individuals. As the country's private commercial sector is made up almost exclusively of small and medium-sized enterprises, it would seem that the bulk of Ghanaian enterprise is in the capable hands of individuals with no more than a secondary education.

For the purposes of attracting new investment, the question that naturally arises is whether this picture reflects a shortage of skills on the supply side—i.e. workers not seeking the training required by the market—or an insufficiency of demand for skilled workers, on the part of Ghanaian enterprises? If there is an excess demand for skilled workers, we would expect the wages of educated workers to be bid up in the marketplace. But even if there is a shortage of such individuals, and the demand for their services is equally lacking, the returns to an additional year of education should not be significant.

We summarize below, in Table 6, econometric estimates (specifically, two specifications of a Mincer regression), using data from the Ghana Living

Standards Survey of 2005/6 (GLSS 5), of the returns to education in Ghana (the returns acting as a proxy for the shadow price of expanding the stock of skills). The purpose of the exercise is to assess whether skilled labour is scarce enough in Ghana to be a drag on private investment and economic growth.

TABLE 6

*Mincerian Wage Regressions for Ghana*

	Coefficient	<i>t</i> -statistic	Coefficient	<i>t</i> -statistic
Years of schooling	0.041	14.100	0.031	8.550
Experience	0.041	15.630	0.041	15.520
Age	0.023	1.700	0.024	1.750
Age <sup>2</sup>	0.000	-1.950	0.000	-1.990
Female	-0.831	-18.580	-1.027	-15.790
Female*Schooling			0.023	4.460
<i>N</i>		8650		8650
<i>R</i> <sup>2</sup>		0.200		0.202

What the coefficients indicate is that (1) the marginal (percentage) increase in wages from one additional year of schooling varies from 3.1% to 4.1% for males; (2) there appears to be a large wage gap between men and women. On the other hand, the interaction of education and gender (in the second specification) shows a higher return to female education, suggesting a reduction in the gender wage gap for more educated women. Nonetheless, the gender gap persists and remains sizable even for high levels of schooling.

But what does this all mean? First of all, the 3.1%-4.1% wage premium for an additional year of education is very low even by developing-country standards. Lance Pritchett showed in a 2004 study that the average returns to education in developing countries runs in the 8%-12% range; so, for its income level, Ghana shows a startlingly low return to schooling.

This is made even more glaring when Ghana is compared to potential competitors like Thailand (16% return on an additional year of education), Kenya (13%), Malaysia, Cameroon and Chile (12%), Peru and Costa Rica (11%),

Mozambique (8.6%), Bangladesh and Bulgaria (7%), and Romania (5.6%). About the only comparator Ghana beats on this issue is Nigeria, where the marginal return to schooling is only 3.6%.

*What this suggests for Ghana is that skills shortages are unlikely to constitute a binding constraint on private investment in the near future.* If the absence of skills were a serious impediment, demand from potential employers will bid up the wages of (the relatively few) skilled/educated workers, which will then be reflected in higher returns to education than were actually found.

There are other bits of corroborating evidence that justify the drawing of this conclusion. Open unemployment among the most educated is relatively high in Ghana, as are the levels of out-migration (the “brain drain”). On the former, the government’s own data indicate that of the 16% of the labour force that was officially unemployed in 2006<sup>29</sup>, 78% of them had better than primary education and 27% had a university degree. Such a high level of unemployment among the most educated of the labour force suggests that there may not be a skills shortage in the economy at large, and that it is rather the demand for skilled labour that may be lacking, or the country has a colossal case of structural unemployment among the most educated.

There is reason to suggest that the problem is a lack of demand for skilled workers by employers. An examination of the distribution of skills across the economy indicates that the public sector (education, health, administration, research, etc.) is, overall, the most skills-intensive sector. The dominant non-public sectors of the formal economy—such as agriculture and mining that provide the bulk (70%) of private wage employment--actually employ very few skilled workers. *Clearly, the existing structure of production of the Ghanaian economy does not generate enough demand for the existing stock of skills.* If demand were generally more effective, we would expect a drop in wages to equilibrate the market. To the contrary, Government of Ghana (GoG) data show (see Table 7) that, between 1990 and 2006, the proportion of wage earnings by both employees and the self-employed, in both the agricultural and non-agricultural sectors, remained pretty much unchanged, suggesting that the labour market is heavily segmented between the formal and the informal sectors, and within the informal sector itself.

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<sup>29</sup> Second only to Kenya (36%) among likely comparator countries such as Morocco, Egypt, Ecuador, Sri Lanka, Thailand and Malaysia.

TABLE 7

*Change in Earnings in Ghana (in 2000 constant cedis)*

	Wage Employment	Self-employment (agriculture)	Self-employment (non-agriculture)
1990/'91	1269.71	497.97	900.13
1998/'99	1142.14	351.66	759.50
2005/'06	1558.24	634.17	1016.70

*Source:* Calculated from the GLSS5.

Given the comparatively low returns to education, the relatively high open unemployment rate among the skilled, and the dearth of demand for the skilled's services, it is hardly surprising that educated Ghanaians have been increasingly looking beyond the country's borders for gainful employment. Out-migration of this segment of the labour force is one of the highest in Africa; indeed, of all the comparator countries only Egypt has a lower Skill Retention Score than Ghana<sup>30</sup>. Paradoxically, Ghanaian households are also some of the heaviest investors in education, spending 5%, on average, of total household consumption on education—one of the highest among countries of comparable consumption expenditure per capita. Clearly, this is more in expectation of the higher returns to education outside of the country than within it: 31% of all Ghanaian households reported in the household survey of 2005/'06 that they had received remittances from a relative working abroad in the preceding twelve months. The "brain drain", ironically, may well be stimulating a "brain gain" in the country<sup>31</sup>.

### (iii) Inadequate Infrastructure

For the past two decades or so, Ghana has invested heavily in its basic (economic and physical) infrastructure. It has spent 10% of GDP, a little over a billion U.S. dollars, annually in an attempt to plug a gaping hole in its water, energy, ICT and transport infrastructure. It is a huge undertaking that is nowhere near completion: the Africa Infrastructure Country Diagnostic estimated in 2010 that it would require annual outlays of \$1.6 billion for the next decade for the remaining gaps to be closed. The GoG itself estimates it would require much more, over \$2.5 billion per year, over the medium term.

<sup>30</sup> The lower the Skill Retention score, the higher the brain drain phenomenon is.

<sup>31</sup> See Nikoi Kote-Nikoi, *Brain Drain or Brain Gain: Theoretical Ruminations on Out-Migration and New Human-Capital Formation*, CPP Occasional Paper No. 05/005 (Accra: Centre for Policy Priorities, November 2005).

The bulk of the spending, it seems, is being directed to the electric-power sector where, in the public's perception, the greatest deficiencies that have forever bedeviled the economy are to be found. And, if what has already been done is any indication, in the government's reading, the major deficiency in the infrastructure network is "hard" investments—i.e. capital expenditures—rather than operational or "soft" ones (Table 8).

The question of interest for us is how sensitive private investment is to good infrastructure; in other words, will a successful bridging of the infrastructure gap induce a sizeable increase in private investment?

In the existing circumstance, Ghana actually receives fairly good ratings for its infrastructure among all countries with the same level of income. It is ranked 76<sup>th</sup> out of 113 countries in the Global Competitiveness Report (GCR), outperforming most of sub-Saharan Africa. Disaggregating these ratings, however, reveals that Ghana's problem is not so much with inadequate "hard" capital stocks as it is with weak management and regulatory capacity. The World Bank's Logistics Performance Index gives Ghana a low overall rating of 2.2, the lowest among a set of comparator nations<sup>32</sup>. (The average rating for all lower middle-income countries--LMICs--is 2.4).

Ghana's score is low not because of the inadequacy of infrastructural stocks—indeed, Ghana does significantly better on stocks (2.5) than the average for all lower middle-income countries (2.2), and better than all the comparator countries except Thailand and Malaysia—but for three other reasons: (1) logistics incompetence (1.8 vs. the LMIC average of 2.4, but worse than all the comparators), (2) lack of timeliness (2.5 vs. the LMIC average of 2.9, but again worse than all the comparators), and (3) other such managerial or regulatory inadequacies.

The popular perception of general and widespread infrastructural inadequacies on the ground thus appears to be overblown. The problem appears to be narrower in scope—for instance, power shortages and general managerial shortcomings—and not a reflection of stock inadequacies across the nation's infrastructural assets. With huge annual commitments already made to bridging whatever stock gaps remain, attention must now shift to improving management and regulatory performance, and assuring on-time service delivery. *Infrastructure in general, therefore, should not be a binding constraint on new investment in the medium term.*

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<sup>32</sup> The comparators are Malaysia, Thailand, Costa Rica, Kenya, Ecuador, Bangladesh, Morocco, Egypt, Côte d'Ivoire, Sri Lanka and Bulgaria.

TABLE 8

*Annual Infrastructure Spending Gaps (U.S. \$ billions)*

Sector	Capital Expenditure	Operations and Maintenance	Total Spending
ICT	0.03	0.03	0.07
Transport	0.27	0.22	0.49
Power	0.60	0.13	0.73
Water	0.12	0.20	0.31
Total	1.02	0.58	1.60

Source: *Africa Infrastructure Country Diagnostic*, 2010.

But what about specific components of the infrastructure network, such as Transportation, Information and Communication Technologies (ICT), and energy/electrical power?

*Transport Infrastructure*

As regards physical transportation infrastructure, Ghana's land and water connectivity are actually rated above the world average. It is ranked 75<sup>th</sup> out of 133 on roads, and an even higher 91<sup>st</sup> of 133 in port facilities. It is only in air transportation that Ghana is decidedly lagging, ranking a meager 65<sup>th</sup> of 133. It has the least number of airports (11) by a considerable margin among its comparators, the least number of them with paved runways (7), and the second lowest airport quality ranking (4.01), just above Bulgaria (see Table 9A). And whereas this probably is a function of history--Ghana's initial comparative advantage has been in heavy-bulk, low value-added exports delivered by land and sea--its persistence may well be preventing the rise of other activities in which Ghana has a natural comparative advantage--tourism, for instance, and the export of time-sensitive products such as fresh fruits, horticultural products and other perishables.

Thus, even though the road sector could use some improvement (for instance, increasing the proportion of paved roads from the current 30% to 50%, and the quality index above 3.45--see Table 9B), it seems that the highest returns to the transport sector may well come from improving Ghana's air connectivity. Among comparators (see Table 10), Ghana has the lowest number of international airports (1), aircraft (21) and out-going passengers per year (about 4% of the population, as compared to 10% for all developing countries).

Moreover, the bulk of air connectivity is within the African continent (56% of air traffic), which may well be exacerbating the inability for new tradable goods to emerge. But, even more importantly for the focus of this study, poor air transport may well constrain the mobility of entrepreneurs, thereby preventing the discovery of new markets, distribution channels and new products...in short, new investment opportunities.

TABLE 9

*Comparative Transportation Infrastructure Characteristics: Ghana and Comparators*

**9A: Airports**

	Number	With Paved Runways	Quality Index*
Bulgaria	212	38	3.75
Costa Rica	151	132	4.65
Ecuador	420	103	4.57
Egypt	85	72	5.29
Ghana	11	7	4.01
Côte d'Ivoire	28	8	4.49
Kenya	181	16	4.68
Malaysia	118	38	5.83
Morocco	58	32	4.65
Peru	201	57	4.09
Sri Lanka	18	14	4.76
Thailand	105	65	5.65

*Sources:* International Roads Federation, the CIA World Fact Book and the Global Competitiveness Report. All figures are from 2007 or latest available year.

\*The Quality Index ranges from 0 (lowest) to 6 (highest).

## 9B: Roads

	Total (km)	Density (km per km <sup>2</sup> of land)	% Paved	Quality
Bulgaria	40,231	0.37	92	2.17
Costa Rica	35,330	0.72	25	2.66
Ecuador	43,670	0.15	19	2.78
Egypt	92,370	0.10	78	3.53
Ghana	62,221	0.25	30	3.45
Côte d'Ivoire	80,000	0.25	10	3.55
Kenya	63,574	0.11	12	3.07
Malaysia	98,781	0.28	75	5.55
Morocco	57,625	0.13	52	3.57
Peru	78,829	0.06	13	3.20
Sri Lanka	97,286	0.35	40	3.89
Thailand	180,053	0.11	97	5.01

*Sources:* [International Roads Federation](#), the [CIA World Fact Book](#) and the [Global Competitiveness Report](#). All figures are from 2007 or the latest available year. The Quality Index ranges from 0 (lowest) to 6 (highest).

## 9C: Ports

	Number	Quality
Bulgaria	2	3.62
Costa Rica	6	2.57
Ecuador	9	3.34
Egypt	28	4.32
Ghana	4	4.04
Côte d'Ivoire	1	4.96
Kenya	3	3.65
Malaysia	25	5.52
Morocco	15	4.24
Peru	14	2.86
Sri Lanka	4	4.79
Thailand	20	4.69

*Sources:* International Road Federation, the CIA World Fact Book and the Global Competitiveness Report. All data are from 2007 or the latest available year. The Quality Index ranges from 0 (lowest) to 6 (highest).

TABLE 10

### *Comparative Air Transport Indicators: Ghana and Comparators, 2006*

	Population (millions)	Passengers	Number of airplanes	Number of int'l airport
Bulgaria	7.76	979,913	105	3
Chile	16.2	1,969,894	91	5
Ghana	21.66	953,787	21	1
Kenya		1,777,727	102	3

*Source:* WTO, Quantitative Air Services Agreements Review, 2006.

### *Information and Communication Technologies (ICT)*

In striving to keep up with an exploding business and household demand for information and communication services, Ghana has made tremendous progress in modernizing its ICT infrastructure and networks over the past twenty years. The African Economic Outlook (AEO) estimated in 2009 that the ICT sector is contributing \$750 million, or 1% of GDP, to the economy annually. It directly employs 2500 people, but as many as 100,000 (at least) earn their living indirectly from the sector. Indeed, the industry is one of the fastest growing in Ghana outside of agriculture.

Ghana currently registers a very high number of telephone lines per 1000 inhabitants for its income level, and has the second highest penetration of mobile phone subscriptions among countries in its income group, according to the International Telecommunications Union (ITU). It also has one of the highest numbers of internet users for its level of development, as well as the most widespread broadband usage. In 2006, about 401,300 people, or 1.8% of the population, used the internet regularly, according to the AEO. This number increased to 880,000 or 3.8% of the population in 2008; and the estimate for 2010 is well over 1 million.

*At its current rate of growth, and the continuous realization of synergies among ICT, governance, education, and international trade, among others, ICT infrastructure cannot be a drag on investment in the medium term; on the contrary.*

### *Electricity and Energy Supplies*

The electric-power infrastructure and service have long been identified as one of the most deficient among all of Ghana's public infrastructure and utility services. It was one of the most frequently cited challenges in the business surveys reviewed earlier on, with as many as 98% of all firms in the Ghana Investment Climate Survey of 2007 reporting having experienced at least one significant power outage in the year leading up to the survey. 82% reported that these interruptions were "very severe" or presented a "major obstacle" to their operations (Table 11). Only 11 of the 494 enterprises surveyed reported experiencing no power outages; but of those experiencing at least one outage, the average firm reported an average of 10 power outages per month—basically one outage every three days. The mean duration of a power outage was 12 hours, and if the frequency was once every three days, then the average firm in Ghana suffers from power outages 1/6<sup>th</sup> (approximately 17%) of the time.

There are obviously direct costs to these businesses of being without power for 17% of the time. Table 12 below details, by sector, the reported annual sales losses attributable to the erratic power supply. Firms reporting at least one episode of power outage reported a sales decline of 6.5% per year as a result, irrespective of firm size. There was, however, considerable variation across sectors, with chemicals and services (including hotels and restaurants) losing the largest sales: 14.7% for the chemicals industry and 9.8% for the service sector. Hotels alone reported 8.1% lower sales. Over the survey period, however, these were the very sectors that posted the strongest growth figures, so there apparently is no correlation between sectors most negatively impacted by power supply problems and growth performance.

Now, if unreliable electricity supplies *are* a major constraint on businesses, we would expect significant importation of power-generating equipment for the private- or self-production of electric power. But not only is there no private power generation of any significance in Ghana (in comparison with countries even within the region), the number of power-generation equipment being imported has actually been falling even as it rises in nearly all the other countries. In 2008, for instance, Ghana imported 5500 generators; but in 2000, it had imported 20,000 of them.

*It is clear from the surveys that unreliable power supply is a constraint on many SMEs, and certainly a nuisance to all of them. The extent to which it is actually binding, however, is not entirely clear. All the same, GoG, in recognition of this, has been making new, major investments in additional power-generation capacity over the past five years to improve the quantity and quality of electricity. If the commitment holds, power supplies should be less of a constraint over the medium term.*

TABLE 11

*Issues Identified as Constituting "Very Severe" or "Major Obstacles" to  
Business Operations in Ghana*

Issue	% of firms surveyed
Electricity/power outages	82
Finance (availability and cost)	66
Tax rates	31
Access to Land	26
Transportation	20
Competition from informal economic activities	20
Tax administration	16
Corruption	11
Customs and Trade Regulations	10
Crime/theft/social disorder	8
Business registration/licensing/permits	4
Poorly educated workforce	4
Court system	3
Labour regulations	2
Political instability	2

*Source:* Compiled from Ghana Investment Climate Survey, 2007

TABLE 12

*Ghana: Annual Sales Losses Attributed to Power Outages, by Sector*

Sector	% of annual sales lost
Chemicals	14.7
Services	9.8
Hotels and Restaurants	8.1
Plastics and Non-Metallic Materials	7.4
Garments	7.3
Retails and Wholesale Trade	5.7
Other manufacturing	5.6
Metals and Machinery	4.9
Food	4.9
Textiles	4.0
Construction	2.0
Electronics	0.5

*Source:* Compiled from the Ghana Investment Climate Survey, 2007.

*E. Appropriability Issues*

The argument was made at the outset that much of Ghana's inability to create the right quantity and quality of jobs is attributable to its failure, even in periods of sustained economic growth, to effect a transformation of the economy away from the traditional *troika* of cocoa, gold and timber that have dominated production and exports for over a-century-and-a-half. Even today, cocoa still dominates exports, accounting for 40% of earnings. Gold still brings in 30% of export revenue, and timber logs and lumber, 10%. But as long as domestic demand remains as shallow and unsophisticated as businesses report on the surveys, the country would need to develop a sizeable and diverse export market

not only to complement the domestic one but, even more importantly, to catalyze the structural transformation of the economy.

There have been intermittent—though, in the end, unsuccessful—experiments with new export products such as horticultural products, shea products, textiles, pharmaceuticals, and even electronics. For reasons that we will attempt to explain below, these “discoveries” were not sustained over time, and the economy appears to slip back with ease into its reliance on the traditional products. The Ghanaian economy, in short, has proved to be remarkably undynamic in its production and export behaviour.

*(i) Dead “Discoveries” and Export-Market Failures*

The lack of dynamism in exports is a reflection of the lack of dynamism in economic activity at large. Manufacturing, which today accounts for 10% of GDP, has not grown much over the past four decades (though industry as a whole has risen from 19% to 25% of GDP). This, at a time when Ghana’s peers and comparators in Asia—which, like Ghana, were largely agro-based economies with similar levels of per capita GDP in the 1960s—have succeeded in replacing agriculture with manufacturing and industry as the mainstays of their economies. In Malaysia and Thailand, for example, agriculture’s share of GDP plunged from around 38% to 10% between 1960 and 2008, while manufacturing and industry rose from nearly 10% to between 30% and 40%. Even smaller Asian peers like Sri Lanka have managed a similar change in their structures of production: agriculture has decreased to 10% of GDP, and been replaced by a service sector that now contributes 60% of GDP and has become the main source of value-added. (The service sector in Ghana, which contributed 38% of GDP in 1965, today contributes about the same, 40%).

Indeed, among its major comparators, Ghana has the least diversified economic and exports production as measured by the Herfindahl-Hirschman Index<sup>33</sup>. By that index, Ghana was actually more diversified in 1980-1986—in the immediate aftermath of the first economic reform and recovery programme—than it is today, and there have been no new, credible signs of diversification since 1992. Today, even low-income competitors like Senegal and Kenya have less concentrated export baskets than Ghana has, even though, unlike them, Ghana has experienced over two decades of decent economic growth.

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<sup>33</sup> The Herfindahl-Hirschman Index is perhaps the most commonly used indicator of export diversification. It ranges from 0 to 1, where 0 connotes the maximum possible diversification of exports and 1 connotes full concentration of exports in a single product. As of 2006, Ghana’s H-H index was 0.28, the highest among its comparators of Egypt, Malaysia, Kenya, Senegal, Morocco, Thailand, Ecuador, Costa Rica, Sri Lanka and Bulgaria. Bulgaria, with the lowest H-H of the group (0.025), is the most diversified exporter.

It is worth noting, by way of caveat, that a highly concentrated export basket need not be *a priori* economically damaging if the sectors represented in that basket are the ones with the highest productivity in the economy. Looking at Ghana's produced and exported goods in terms of their factor intensities, however, it is clear that the bulk of production and exports (including from the emerging petroleum sector) is comprised of raw materials and other primary, low value-added, products. There is very little by way of labour-intensive or capital-intensive products in the basket; and whatever share these might once have had has actually been decreasing since 2001.

Ghana's exports and productive structure, in other words, is not very sophisticated. And this is reflected in the income-value of the export basket, the EXPY<sup>34</sup>. In comparison with the comparator countries (see footnote 16), the weighted income-value of Ghana's export basket, at \$2400, is the lowest of the group. (Malaysia's is highest, at \$10,800). And even among fellow ECOWAS countries—which are all, like Ghana, predominantly agricultural economies, but which, unlike Ghana, have not enjoyed the same level of macroeconomic buoyancy, or for so long—Ghana's EXPY is only just higher than Côte d'Ivoire's (\$1950) and Burkina Faso's (\$1600). (Cape Verde's is the highest, at \$5800).

The implication of all this is that, *prominent among the keys to sustained economic growth (and therefore job creation) in Ghana, are the unexploited opportunities provided by economic diversification.* This, of course, has long been recognized by Ghanaian policymakers and governments, and attempts (of uneven degrees of credibility but all equally widely publicized) have been made to promote economic--and, especially, export--diversification over the years. "Discoveries" were attempted with new products in both new and existing export markets--horticultural products, fresh fruits, shea butter, textiles, pharmaceuticals, among them—but none seem to have taken hold. Ghanaian entrepreneurs appear incapable of moving in the "product space" towards new (and hopefully more technologically sophisticated) discoveries for both home consumption and export.

Part of the explanation for this may be the usual Schumpeterian ones of information externalities and other learning spillovers that tend to inhibit "first movers" from taking the immense private risk of investing in new ventures. There could also exist the dangers of coordination failure, which keep certain firms' products that are inputs for the new, emerging sectors out of entrepreneurs' reach, for whatever reason.

Looking at Ghana's product space more closely, however, genuinely new products and opportunities appear "unclustered" near the traditional ones of

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<sup>34</sup> See R. Hausmann et al, op. cit..

agriculture, gold and timber. This means that there may be limited opportunities for coordination, and firms would need to make huge technological leaps to function in new, often high value-added, sectors. And given Ghanaian firms' profiles as discussed earlier—75% of them are of small or medium size; they are managed largely by risk-averse, non-degreed persons; they face stiff financing constraints; etc.—it is very likely that such technological leaps would entail substantial discovery costs. If there exists no mechanism to protect the eventual profitability of these innovative moves until the firms recover their costs, they would be most reluctant to engage (or persist) in the “discovery” in the first place. This could explain why attempts at export diversification have been unsuccessful in the past. *Some sort of governmental subsidy or incentive structure aimed at attenuating the perception of “private risk but shared gain” among Ghanaian entrepreneurs may well be the best policy for achieving production and export diversification.*

It is quite apparent that Ghanaian entrepreneurs are not completely averse to economic diversification. But their past behaviour in this realm suggests that their enthusiasm for innovatively new—genuinely new—ventures varies inversely with the perceived risk involved, even if the potential rewards are predictably large. Thus, in 1985 for instance, from the agricultural sector Ghana exported mainly cocoa and its immediate products (paste and butter). By the year 2000, however, there were new agricultural products being exported in addition to cocoa: bananas, pineapples, shea nuts, shea butter, palm oil and rubber. In other words, because all these products are “clustered” with cocoa, in the agricultural products' sub-space, their incorporation as “new” products in the export basket was easier for Ghanaian producers already well-versed in the risk profile of cocoa production and export. The risks were familiar and therefore more manageable to them than, say, the risks of exporting from an entirely new line of production such as (non-agro-based) manufacturing.

A similar dynamic can be seen in the forest products “cluster” where, in 1985, Ghana's export of forest products consisted in the main of cut tropical hardwood. Yet by the year 2000, related products such as plywood, veneers, and even furniture were being added to the export mix. This, in turn, is encouraging Ghana to move into related fields but with even higher value-added, fields such as chemicals for the treatment of wood and wood products.

An aluminium “cluster” is also emerging and following a similar trajectory: whereas for decades Ghana used to produce unwrought aluminium from its sizable deposits of bauxite, it is now moving boldly into the production of processed aluminium. Similar unexpected, but tentative, technological leaps are also occurring in machine products and capital-intensive goods, areas for which no “clusters” *per se* have ever existed in the economy.

Ghana's entrepreneurs, in short, have moved around the product space rather extensively in their desire to diversify production and export activity. But they have been typically risk-averse, and stuck to "new" products clustered around existing products and capability. And even though there have been, more recently, some huge leaps into genuinely new, technologically innovative, lines of production, it is too early to tell whether this presages the beginning of the economy's genuine structural transformation.

If firms have a habit of moving around the product space and even dabbling in the cultivation of new lines of production and export, why have these not succeeded in moving (or even attempted to move) the economy towards a different, higher value-added, structure of production and export?

This requires serious analysis, for all the obvious reasons. But it needs to be explained mainly because Ghana has had more new export-product "discoveries" since the mid-1990s than many of its comparators who have gone on to effect lasting transformations of their economies. The Ghana Export Promotion Council estimates that as many as 383 different "non-traditional exports" (NTEs) have emerged in the last decade alone. Indeed, since 1994, Ghana has announced some 10-15 new export discoveries per year, on average<sup>35</sup>.

But—perhaps more remarkably—export "deaths" have been just as high, ranging from 5-10 of these products per year<sup>36</sup>. This would partially explain why attempts at export diversification have not eventuated in genuine structural change: Ghanaian firms *do* develop new export products, but they appear unable to maintain and retain those new export markets. They are, in a sense, victims of export-market failure.

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The Investment Climate Assessment Survey of 2007 may provide an explanation for this persistent failure. First, the Ghanaian business scene is dominated by small enterprises. At 75% of the total, this is the highest concentration of small enterprises among the comparator countries, whose small enterprises account for between 20% (Peru) and 40% (Bangladesh) of all functioning businesses. Now, most of Ghana's small enterprises report on the ICA survey that one of the more serious constraints they face is insufficient domestic demand for their products, and—for the tiny percentage of them that do any exporting at all—poor export facilitation. It is also a known fact that most exporting firms in Africa tend to become efficient producers for the local market

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<sup>35</sup> A "discovery" occurs when a product that has not been part of a country's export basket over the three preceding years fetches better than \$10,000 as an export good in a given year.

<sup>36</sup> A new export product is said to have "died" when it no longer features in the export basket to any significant degree.

*before* venturing into exports. Exporting, therefore, is often just a natural progression from domestic success. Since the Ghanaian market (and the regional one, for that matter) appears to have a small size and low purchasing ability, these Ghanaian enterprises do not, it would appear, attain the level of production efficiency and product sophistication necessary to expand into exports.

The ICA survey data confirms this: of the 494 firms surveyed, only 28 firms, or 5.6% of the total, actually export directly. This makes Ghana the clear outlier among the comparator nations in the share of enterprises that do export: in Cameroon, for instance, 28% of firms are direct exporters; 32% of Bulgarian firms also export, as do 26% of Bangladeshi firms.

The domination by small enterprises also helps explain why Ghana has the highest share of *indirect* exporting—that is, selling products to third parties within the country who then do the actual exporting. This helps explain the AGI survey finding in 2009 that a lot of firms find “export marketing” and export facilitation a binding constraint on their activities (see page 31). Indirect exporting—which is a less costly way of exporting that also helps resolve information asymmetries—seems to be the chosen solution to the problem.

And whereas there is no *a priori* disadvantage to exporting indirectly, it seems that only the large firms—who have already attained the requisite production scale, productivity performance, and product sophistication domestically-- can afford to engage in direct exporting. The survey data show that it is the largest firms (average of 20-100 employees) and the oldest (13-20 years in operation) which are engaged in the direct export of metals and machinery, non-metals and plastics, chemicals, and other manufactures. This contrasts sharply with the indirect exporters, who mainly deal in primary products.

*Considering that the large firms are mainly publicly-owned or quasi-public enterprises, private entrepreneurship in Ghana, though varied, tenacious and open to experimenting with new product “discoveries” for export, appear to not have the ability to grow to medium or large-scale maturity. This would help explain why the non-public formal sector has never absorbed more than 5% of the civilian workforce, and why building a jobs policy exclusively or even principally around the sector in its present form seems unjustifiable.*

#### *(ii) Government Failures: Macro-Micro Risks*

Market failures of the sort analyzed above are obviously a hindrance to investment and innovation, and therefore inimical to the economy’s structural transformation. But government policies and actions could also be as grave a

hindrance, if they lead, however unintentionally, to the expropriation of entrepreneurs' returns-on-investment. "Government failure" of this sort tends to inhibit the expansion of investment activities by existing firms, and discourages the creation of new firms by prospective investors. This, too, could explain why, in Ghana, "discoveries" tend to never mature, or die prematurely.

Government failure can come from both macroeconomic and microeconomic policies. The corresponding macro- and micro-level risks can both, in their own way, militate against the consolidation of new export opportunities. The macroeconomic environment in Ghana has largely stabilized over the last decade or so, even though there is no discernable evidence that entrepreneurs and investors have taken any special advantage of that. And while the business or macro environment as a whole has improved noticeably, the surveys indicate that two particular policy areas, taxation and labour rigidities, are perceived by businesses as posing real micro-risks.

### *Macroeconomic risks*

As far as the macroeconomic fundamentals go, there have been huge improvements since 2000. Inflation in 2010 has fallen to around 10% from about 27% in 2003 and 40% in 1999; government receipts and foreign transfers have been robust enough to narrow the fiscal deficit; and the HIPC initiative helped with a substantial reduction of the external debt.

There has been some fiscal slippage since 2005, however. The primary fiscal deficit rose to 15% of GDP in 2008 and, by 2010, the external debt had risen to \$13 billion or 37% of GDP. Inflation has also pushed up a bit, mainly as a result of import-cost spikes attributable to the depreciating *cedi* and the huge increases in imported food and crude-oil prices. The flow of oil money should help with the fiscal position in the medium term, if the IMF forecast that it will yield 2.5% of GDP of additional revenue per year to the government, and improve the current account by 4% on net over the next twenty years, turns out to be accurate. Indeed, oil could sow the seeds for the eventual transformation of the economy, whether positively (by adding a new strategic export sector to that which already exists) or negatively (if 'Dutch disease' facilitates the killing off of traditional export sectors in favour of oil).

The external position should be improved in the medium term by the recent (and continuing) spikes in commodity prices, as gold, cocoa, aluminium and oil prices have all been trending strongly upward in the past three years. This should then reflect positively on the country's terms-of-trade. Even the slide in the *cedi*'s nominal value over the past three years leaves the currency today actually properly valued, according to the IMF. It therefore does not appear that the macroeconomic risks that could potentially (and would normally) arise from persistent disequilibria in the fiscal and external accounts, or from the usual

African vulnerability to the vicissitudes of international commodity prices, would be much of a hurdle to Ghanaian entrepreneurship in the medium term.

### *Microeconomic risks*

Ghana has had a consistently favourable score on recent "Doing Business Index" tabulations of the World Bank. Published in the *Doing Business* reports, the index attempts to capture a wide range of microeconomic risks that businesses might face in a given country in a given period. In 2007 and 2008, Ghana did particularly strongly in areas like "Registering Property" (33 out of the 181 countries assessed), "Protecting Investors" (41 out of 181), and "Enforcing Contracts" (47 out of 181). Its overall ranking on the "Ease of Doing Business" is 92<sup>nd</sup> of the 118 countries, considerably below Singapore (No. 1) but considerably above the overwhelming majority of the African continent.

The two areas in which business complaints have been loudest and most consistent, however, relate to taxes and labour regulation. We examine next whether government policies in these areas provide potential risk factors that could inhibit investment expansion and general entrepreneurship.

Firms, like individuals, complain (and will always complain) about their tax liabilities. However, cross-country indicators suggest that the corporate tax burden they face in Ghana is a comparatively light one. Ghana's tax rate on corporate profits, at 18.1%, is only slightly above the OECD average of 16.8%, and considerably lower than that of most of sub-Saharan Africa, where the average is 23.9% and ranges from Namibia's 4% to Gambia's 41.4%. In fact, the 2008 *Global Competitiveness Report* gives Ghana an 'A' on the tax-rate issue, a grade which reflects both the corporate profit tax rate and the 12.6% MFN tariff that is imposed on foreign-sourced inputs. The tax rate, per se, should therefore pose no disincentive to investment and business expansion.

The unfavourable business perception of the tax burden in Ghana appears to be related more to tax administration than rates. The World Bank's *Paying Taxes 2010* report indicates that Ghana's "time to comply" with tax laws only merits an 88<sup>th</sup> ranking globally, and 22<sup>nd</sup> out of the 53 countries of the African Union. If the time allowed for the settlement of firms' tax obligations is perceived as unnecessarily onerous, it would explain why Ghana's score on "total number of tax payments" in the same World Bank report is so low, at 107<sup>th</sup> in the world.

There is, in fact, some indication that businesses feel harangued by tax officials. The ICA survey of 2007, for example, details instances of firms being visited five terms per year on average by the tax authorities. The burden of the sheer number and frequency of these unannounced visits is sometimes compounded, according to 20% of the firms surveyed, by requirements from the

visiting official that firms make immediate “informal payments”. Indeed, a third of the responding firms confirmed having made such payments in 2006, the total payments being on the order of 5.9% of gross annual sales. Further, the survey data reveal a strong correlation between the severity of complaint about the tax burden and the receipt of such solicitations for “informal payments”, suggesting that complaints about the tax burden is not only about the general administration of taxes (as suggested by the “time to comply” score), but also about the corrupt practices of tax inspectors, in particular.

Corruption of the sort described above, which is siphoning off 5.9% of firms’ annual sales, is clearly illegally expropriating firms’ returns on their investment and potentially dousing their “animal spirits” for further investment. Formal indicators of corruption, such as Kaufmann’s *World Governance Indicators*, however, give Ghana higher scores on the “rule-of-law” and “control-of corruption” indices than the average for countries at the same level of income.

The *Corruption Perception Index*--which is based largely on investors’ perception of the extent of the corruption they face in a country’s business environment--confirms this when it rates Ghana higher (3<sup>rd</sup>, only after Costa Rica and Malaysia) than most of its comparators (see footnote 32). This suggests that corruption in Ghana (as a general issue) is unlikely to be seen as a serious deterrent to the growth of business.

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The other, survey-identified potential microeconomic risk pertains to regulations on the labour exchange. On “Rigidity of Employment” indices—which measure contract flexibility, the ratio of the minimum wage to value-added per worker, length of the workday, and hiring/firing procedures—Ghana scores consistently and significantly above the sub-Saharan African average. But on “Redundancy Costs” measures—which is an index of the costs associated with severance, penalties, and advance notification requirements for workers who are to be terminated—Ghana performs considerably worse than the rest of the continent, and worse than most low- and middle-income developing countries globally. The data suggest that it costs an average of 178 weeks’ wages to make a worker redundant in Ghana--about the same as in Zambia, but lower only than in Sierra Leone and Zimbabwe. At the other extreme, Uganda and Haiti have the lowest Redundancy Costs, at about 12 weeks’ and 16 weeks’ wages respectively. Indeed, the 2008 *Global Competitiveness Report* generally confirms this relative costliness of Ghanaian labour.

Thus, even though nominal wages and unit labour costs (in manufacturing) are comparatively low, it would seem that labour protection regulations are rendering Ghanaian labour relatively costly. This could, in theory,

present a real constraint on the expansion of existing businesses and the attraction of new investment.

If these labour-related cost constraints were, in fact, binding on the ground, however, the evidence should indicate instances in which Ghanaian firms wished to hire more workers but were prevented from doing so by the prohibitively high redundancy costs. But, not a single firm in all the survey data examined cites redundancy regulations as a “severe” constraint, and only 8 of the 494 in the 2007 ICA survey consider it a “major” constraint. None indicated that they would have liked to hire more workers and were prevented from doing so on redundancy-cost considerations.

But it is also true that if these labour-cost constraints were actually binding on Ghanaian businesses, there would be a noticeable paucity of labour-intensive production activities in the formal sector. From our earlier analysis of Ghanaian firms’ movements in the Product Space, it was revealed that neither labour-intensive nor capital-intensive clusters were present in any considerable numbers, or for any considerable length of time, in either the output mix or the export basket. Indeed, labour-intensive sectors where Ghana would have a natural initial comparative advantage—tourism, textiles, light manufacturing—have neither thrived nor contributed much to the export mix. On the other hand, the sectors with the most rapid growth and export contribution or potential—minerals and chemicals, for instance—are noted for their relatively low-intensity of labour.

*Thus this particular high administrative labour cost may be binding in more subtle ways than first appears, ways of considerable significance for Ghana’s ability over the long run to transform its structure of production.*

#### *F. Can the Private, Formal Sector Deliver Adequate Job Growth?*

Ghana’s publicly declared national ambition is to become a solid middle-income country by the year 2020. It is on the right path towards that goal in all the important particulars: stable macroeconomic conditions, sustained economic growth, generally accountable governance, stable political structures, among others. The major obstacle it faces, however, stems, as was stated early in the study, from the fact that all that stability and growth have not catalyzed the structural change needed to create the right quantity and quality of employment that would root the country firmly on the path to middle-income status.

To reiterate a key argument from the introductory chapter: when employment does not expand along with production, the benefits of growth do not get shared widely among the population. Better employment opportunities provide people with new, often improved, prospects of income. Improving the

quality and quantity of employment opportunities is therefore one important way economic growth links directly with poverty alleviation. Low-income households possess few income-generating assets but their labour. A growth strategy that more fully and productively employs this labour, thereby raising the returns to it, becomes a powerful tool for reducing mass poverty in the land.

To realize this potential, however, government's development strategies cannot relegate employment to the periphery of policy. Employment must become a core objective, in its own right, of any development or growth strategy. Jobs should not be seen as a residual or something deriving from other, presumably more important, policy objectives. On this score, narrowly, Ghana's *Shared Growth and Development Agenda, 2010-2013* is on the wrong track.

The objective of the growth diagnostics is to identify the factors that are preventing entrepreneurs in Ghana from engaging in the right investment behaviour that will effect this change in production structures. It was particularly necessary to understand why there has been little successful diversification of both production and exports, despite many sincere attempts over the decades to, presumably, "discover" the costs and profitability of new lines of production and export.

Ascertaining the cost or profitability of new economic ventures is, of course, necessary for innovation but hardly sufficient. New investments only survive if they achieve sufficient scale economies. The diagnostics reveal that Ghanaian product and export "discoveries" rarely reach the scale that ensures their survival, so they tend to die almost as quickly as they are discovered. Some of the reason, it appears from the surveys, is that the overwhelming majority of Ghanaian firms, being small, do not easily attain the scale of operations that can guarantee their survival in new product lines or export markets. The only firms that have survived as direct exporters are the large firms that are predominantly state-affiliated. Any small, privately held enterprise venturing into exports often does so indirectly—that is, through another, often larger, domestic firm—thereby by-passing the high costs or information asymmetries associated with finding and keeping export markets.

There is thus considerable room for private-sector firm expansion. In other words, the private, formal sector in Ghana *can* lead the economic and export diversification that will form the basis of the transformation of the country's production structures, a transformation indispensable for the creation of those large numbers of high-productivity jobs that anchor a middle-income economy and help reduce the incidence of poverty. Instituting measures to facilitate the export process, as implied in some of the answers to the ICA survey, should encourage firms to successfully jump into the process of

“discovery” for the export market, but also to create new, more sophisticated products for the domestic market.

The diagnostics reveal, however, that the sector faces a variety of obstacles that, if not comprehensively tackled with policy, may well abort the transformational potential described here. For instance, the labour-market regulatory regime in place may be dampening prospective enterprise investment. Even though Ghana has low unit-labour costs relative to its key comparator economies, redundancy costs appear to be inordinately high, the fourth highest among all developing nations, in fact. This might be having a chilling effect on investments in, especially, labour-intensive products, as Ghana has had little success so far in penetrating labour-intensive areas of the product space. For a country relatively well-endowed in labour, this is something of a missed opportunity. Other developing countries have utilized precisely such labour-intensive production strategies as springboards for their economic diversification and re-structuring.

*For Ghana, sectors such as textiles and tourism are particularly ripe for labour-intensive development. Addressing the redundancy cost constraint could be the catalyst for expanded investments in these two areas.*

Financial intermediation and access to credit were also identified as major problems facing the surveyed firms. If this is not adequately addressed, it is certain to become a binding constraint on growth, as firms’ demand for credit increases as they venture into new areas of production or marketing. The problem must be tackled at its roots, however, and the roots are much deeper than first appears. Intermediation and access problems in the financial sector are rooted, to a very large extent, in the monetary and anti-inflation policy regime that was instituted as part of the 1980s’ stabilization and policy-reform packages. Long after stabilization and reform have been achieved, these policies have been kept in place and have even metamorphosed into *de facto* development policies. A critical reexamination of these policies is essential to the resolution of the financing needs of the SMEs, and the consequent creation of sound employment policies and opportunities in Ghana. We undertake this reexamination in the next chapter.

Once expanding firms move strongly into more sophisticated and more diversified lines of production, growth may be constrained by some of the other deficiencies identified in the diagnostic. The (perception of) low stocks of *particular* skills—technical skills, for example—in the workforce, and some of the infrastructural inadequacies pertaining to electric power and air transport, may slow down attempts at economic diversification over the long run if they are not effectively addressed in the near term. *Indeed, any constraint that binds the economic diversification, structural transformation and growth expansion process is a constraint also on the creation of high productivity jobs, poverty reduction,*

*and the attainment of the middle-income goal. Policies that address these hurdles are therefore good employment policies, by definition.*

Unless these obstacles are decisively removed with the appropriate policy interventions, it is almost certain that Ghana's non-public formal sector will forever lag behind the informal sector in dynamism and sheer employment creation. Yet, barring major new policy commitments to the informal economy, too (see Chapter V), the formal private sector will remain the only sector of the economy that can generate the *quality* of employment necessary for long-term poverty alleviation—stable, high productivity, high returns jobs spread widely across all sectors and regions of the economy.

One of the major implications of the growth diagnostic is that, despite there being few major obstacles to employment expansion in the medium-to-long run, the private commercial sector is not expanding rapidly enough, nor is it likely to do so in the near term, to create these jobs in the right amounts and quality. The optimal jobs policy, in these circumstances, should be a two-pronged, comprehensive policy that seeks to boost the creation of quality employment in *both* sectors of productive activity, by neutralizing the obstacles to growth and expansion in the SME sector that were identified by the diagnostic, and by implementing measures such as those analyzed in Chapter V that would enhance labour productivity in the self-employed informal sector. The challenge would be one of sequencing: as the constraints faced by the SMEs are long-term and largely structural, focusing the jobs policy on the informal sector in the near term would yield the more satisfactory solutions for the country.

The issue of quality of employment is the guiding principle here. Ideally, policy should aim at increasing the numbers of formal, non-agricultural wage- or self-employment available to the Ghanaian labour force, while ensuring that all eligible workers have access to these opportunities. Indeed, this would be in keeping with the argument made earlier, that moving workers into these types of employment from their present low-productivity jobs in the informal (agricultural and non-agricultural) economy, will be key to lowering poverty rates across the country.

It is, however, unconvincing to expect, given the results of the growth diagnostic exercise and the history of the jobs performance of the non-agricultural formal sector that, even with more spectacular rates of growth over the medium term, the expansion of formal wage- and self-employment will be large or rapid enough to improve the employment prospects of the majority of the work force—except, perhaps, over the very long run. Hence the necessity of having in place a jobs policy that aims, also, *beyond* the non-public formal economy to raise the returns to labour in agricultural self-employment and in informal employment. One such policy would aim at improving access to credit

and financial services for *all* small-scale producers by forging the proper linkages between formal and informal institutions. This, and other policies, are analyzed in greater detail in Chapter V.

## **CHAPTER IV**

### ***Monetary and Anti-Inflation Policy***

To enable the creation of better-quality employment opportunities in Ghana, monetary policy should be designed to (1) encourage jobs-creating investment, (2) sustain economic expansion, and (3) maintain or easily restore macroeconomic stability. Monetary policy itself may not directly generate new job opportunities, but it is a powerful instrument for creating the enabling environment in which new economic opportunities and employment outcomes arise. Monetary policy has a direct and important bearing on (what may be called) intermediary economic signals--such as the real rate of interest, the average level of prices, and the real exchange rate—which are important determinants of the outcomes of 'real economy' variables such as the levels of economic activity and employment creation. Ill-considered monetary policy is therefore very likely to constrain investment and economic growth, which will then have the effect of dampening the prospects for better employment opportunities. It is therefore crucially important that the Bank of Ghana (re-) consider carefully what monetary policy regime will, at this stage of the country's development, best serve the country's stated, long-term development objectives of accelerating growth, improving the quantity and quality of employment, and reducing the level of poverty.

Across much of Africa, the current preoccupation of monetary policy is with the taming of inflation. In Ghana, in particular, there has been a decades-old fascination with driving the rate of inflation to single digits and maintaining it there. Kenya has set a goal of less than 5% inflation in its Economic Recovery Strategy, and Mozambique targets a predicted annual rate of inflation of 5-6%, beginning in 2007. But South Africa has gone these countries one better, and opted for a formal inflation-targeting monetary regime that will seek to keep inflation in a narrow 3%-6% range.

The particular strategies being used to keep inflation at bay may differ in their particulars from one country to another. For example, countries undergoing macroeconomic stabilization, and which therefore find themselves under the crushing influence of IMF "financial programming", tend to conduct a monetary policy that targets the growth rate of the broad money-supply, usually M3. If inflationary pressures are adjudged to be mounting, the central bank intervenes to reduce the growth rate of the money supply. For this group of countries, then, the growth rate of monetary aggregates is the primary tool for conducting monetary policy.

For others, such as South Africa and Ghana, short-term interest rates are the preferred tools of monetary policy. The South African Reserve Bank, in conducting its inflation-targeting monetary policy, raises the rate on re-purchase agreements (the *repo* rate) when inflation moves outside the target range. Ghana also uses short-term interest rates as its primary monetary-policy tool; we examine comprehensively in the next section Ghana's current monetary-policy regime.

### *A. Ghana's Monetary Policy since 1983*

The current monetary policy regime in Ghana strictly reflects one of the IMF and World Bank conditionalities that the country agreed to in the early 1980s, in exchange for PRGF and other adjustment loans<sup>37</sup>, as part of its economic stabilization and recovery exercise. It has, subsequently, come to reflect also those institutions' requirements for the HIPC initiative<sup>38</sup> that the country undertook in 2001 and the PRSP process<sup>39</sup> that accompanied it, in addition to the requirements of the Multi-Donor Budgetary Support (MDBS) initiative. The nucleus of the monetary policy regime is the standard IMF requirements of limiting government's access to credit and increasing foreign reserves; but the Bank of Ghana was also prodded into seeking to maintain inflation at the low single-digits by the manipulation of monetary aggregates.

There is reason to believe that, in addition to the limitations placed on the central bank by the IMF stabilization and other requirements, this focus on fighting inflation has likely shaved a few percentage points off the nation's annual economic growth, and cost it significant amounts of quality, formal-sector employment opportunities as well. An argument is therefore made in this paper for an alternative monetary policy which focuses, not narrowly or solely on curbing inflation, but, in addition, on achieving a set of broad, real-economy outcomes--such as broad-based employment generation and faster GDP growth--without which the country cannot make the progress it needs to make towards the goal of reducing poverty and becoming solidly middle-income by 2020.

Ghana's monetary policy regime is not uncommon across the African continent. Countries which have undergone macroeconomic adjustment under IFI sponsorship already run this policy or a close version of it; and, more recently, so do HIPC-programme countries or those writing PRSPs. Based on the IMF's "financial programming" (FP) framework, this policy typically connects balance-of-payments constraints, the budget deficit, and central bank policy in

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<sup>37</sup> PRGF=Poverty Reduction and Growth Facility (of the IMF).

<sup>38</sup> The 'Highly Indebted Poor Country' program of debt forgiveness in exchange for a program of poverty reduction and policy reforms that many poor countries undertook with the International Financial Institutions in the 1990s and 2000s.

<sup>39</sup> The 'Poverty Reduction Strategy Paper' process.

order, primarily, to lower a country's external debt exposure by keeping economic growth in line with likely foreign-exchange inflows (from export receipts, private capital inflows and foreign aid). And, as we see in Ghana, keeping inflation low and stable has also increasingly become a central focus of monetary policy.

Ghana's most recent direct experience with FP, according to IMF documents, began just after the 2000 general elections<sup>40</sup>. Between July 1999 and the election in November 2000, the macroeconomic stability that Ghana had struggled for sixteen years to achieve came under threat from, it seemed at the time, all quarters: a devastating terms-of-trade shock, fiscal slippage as election-year exigencies overwhelmed economic prudence, inflation creeping gradually upward to around 40% just prior to the elections, foreign-exchange reserves dwindling to about one-month's import cover, a rapid depreciation of the *cedi*, and reserve money expanding faster than targeted. The elected, new government turned to the IMF for assistance in curbing inflation, the fiscal deficit, foreign borrowing, and the expansion of the money supply. The government also undertook to pursue all measures to stabilize the economy, promote private investment, and seek debt relief through the HIPC programme.

Inflation did fall dramatically on this new stabilization exercise, to about 12% in 2008 (as against the target rate of 5%) and to around 9% by 2010. Real GDP growth stayed in the 5%-6% range between 2005 and 2008, and the quantum of both foreign and domestic declined significantly. Government was not reticent about attributing these gains to its policies, as governments are wont to do, but, in fact, other unforeseen circumstances contributed just as much: for instance, cocoa and gold prices bounded very nicely on international markets, dramatically resuscitating the terms-of-trade.

The question for Ghana's policy makers, however, is whether the traditional stabilization tools employed to restore macroeconomic stability between 2000 and 2008 will best serve the long-term development (i.e. *post*-stabilization) needs of the country—economic growth, the generation of quality employment, significant reductions in poverty--over the next decade or so. That the same policies, especially central-bank policies, have been largely kept in place suggests that they would answer in the affirmative. Whether the evidence on the ground affirms the efficacy of the monetary policy regime, thus warranting its retention over the medium term, is yet to be subjected to systematic examination. We shall attempt to do that here.

#### *(i) Impact of Monetary Policy*

Implicit in IMF 'financial programming' is the assumption that restrictive monetary policies lower inflation but do not have significant adverse, long-run

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<sup>40</sup> IMF, Ghana: Country Report No. 01/141, August 2001.

impacts on growth. There is also the assumption that huge expansions of credit availability stoke inflationary pressures without having any salutary effect on the economy's growth prospects. The question of interest, then, is whether or not these assumptions about the relationship between monetary and credit policy, inflation and economic growth hold in the Ghanaian case.

The Bank of Ghana has done its own investigation of this question; but the results it has published actually raise questions about the validity of these assumptions that underlie the policy it implements. Much of its investigation involves attempts at empirically identifying and measuring the channels through which discretionary changes in monetary policy get transmitted to the real economy, and the impacts and influences of those policies on the ground. Most of the studies utilized standard time-series econometric techniques; but the best of them used Vector Auto-Regression (VAR) models, Vector Error-Correction (VEC) models, or other such advanced time-series techniques to examine the impact of specific monetary-policy tools on inflationary and exchange-rate dynamics, and also on the economy's growth performance.

A 2003 study by Abradu-Otoo et. al, estimating a VEC on quarterly data from the fourth quarter of 1970 to the fourth quarter of 2002, yielded some instructive results. The endogenous variables in the analysis are the rate of inflation, real GDP, credit to the private sector, the 91-day Treasury-bill rate, the real exchange rate measured by the bilateral exchange rate between Ghana and the U.S., and broad money (M2+), defined to include foreign-currency deposits.

Since the Bank of Ghana (BoG) used the short-term interest rate as its main tool of monetary policy throughout the study period, analysis of the impact of an interest-rate change on the economy was of particular interest. The results may be summarized as follows:

- (1) *On economic growth*: a tight monetary policy (i.e. an increase in the short-term interest rate) significantly reduces the rate of growth of real GDP. This is in direct contradiction of the assumption behind the FP-inspired model that tight monetary policies have no impact on growth (and therefore, presumably, employment);
- (2) *On inflation*: the reduction in economic growth did not initially reduce the rate of inflation. Instead, by raising the cost of borrowing, increases in interest rates initially *raise* the rate of inflation—a common result, by the way, in VAR analyses of monetary policy. And the explanation for it is straightforward: interest payments are a cost of doing business, so any increases in the rate of interest initially raises operating costs which are then passed on to customers as higher prices. Eventually, however—at least according to this study—inflation falls back down to its initial level;

*but increases in interest rates do not, in the end, lower the rate of inflation.*

This would imply that there is a cost to Ghana, in terms of decreased economic growth (and presumably employment) rates, of raising interest rates in the name of curbing inflation. Worse yet, the inflation rate does not even come down as a result of the policy; to the contrary, it *increases* in the short-term. But even more worrying is the fact that the decline in output is not a short-run phenomenon: *real GDP growth, according to the study, stays below its baseline amount for three-and-a-half years after the interest-rate shock.*

- (3) *On the real exchange rate:* the response of the real exchange rate to an interest rate shock is to, initially, depreciate. This is an unexpected result that could, perhaps, be explained this way: an increase in the interest rate tends to boost the rate of inflation in the short-term. This could cause an initial depreciation of the nominal exchange rate associated with a transitory real depreciation until prices adjust. Any overshooting of the exchange rate would, however, exacerbate this effect.

Next, the VEC study examines the impact of a monetary shock (i.e. *a change in the money supply*, of whatever origin) on economic activity. It finds that a monetary shock would also induce measurable effects on the economy at large. Indeed, any increase in Ghana's money supply does yield the economic impacts predicted by theory: in the first quarter, inflation rises and the real value of the currency depreciates. The BoG's reaction to the monetary shock and its induced effects on the inflation and exchange rates is to raise interest rates. But this exacerbates the instability in real GDP growth, forcing the growth rate below the baseline for some time in direct response to the central bank's monetary policy.

Private credit shocks are also revealed to affect economic activity at large. Increases in the availability of credit to the private sector, according to the study, have the effect of boosting GDP growth while also lowering inflationary pressures. Interest rates also fall, as does the exchange rate but to a smaller extent. Of course, the most likely channel through which higher credit availability causes an increase in growth rates is its impact on investment spending on fixed-capital formation. Indeed, one other study has since confirmed that, at least from 1987 onwards--in other words, in the era of financial-sector reform--increases in credit flows to the private, formal sector in Ghana (i.e. to Ghanaian entrepreneurs) have tended to have a positive impact on real fixed-capital formation<sup>41</sup>.

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<sup>41</sup> See Epstein and Heintz, op.cit.

Equally significant was the study's findings on the impact of real GDP growth on inflation. It found that increases in real GDP have a relatively small and transient positive impact on inflation. This suggests that in Ghana the inflationary costs of increasing output growth are likely to be small and short-lived—which is not terribly surprising since GDP growth-rate increases have both a demand-side effect (which might raise inflation) and, because it depicts an increase in production, a supply-side one, too (which would tend to put downward pressure on prices).

*The composite story being told by this BoG VEC study is thus quite illuminating for the crafting of an employment-intensive growth policy for Ghana: Increases in interest rates can induce a stagflationary state in the economy, causing both an increase in inflation and a reduction in real GDP (hence employment) growth. This would suggest that a monetary policy that aims primarily at lowering inflation by raising interest rates may (1) rather exacerbate the inflationary pressures it is expected to ease, and (2) have significant costs to the nation in terms of growth, employment and poverty reduction that did not occur. Policies that seek to directly induce faster economic growth, however, have relatively small inflationary impacts. And as far as the relationship between domestic inflation and the cedi's rate of exchange goes, there is a positive pass-through of exchange rate depreciation on inflation, though the impact is not monotonic or one-on-one.*

#### *(ii) A Critique of Financial Programming*

As mentioned earlier, there are two central, often implicit, assumptions that FP-based monetary policy is erected on. The first is that double-digit inflation rates (say, between 10%-20%) are inimical to economic growth; and the second is that reducing government spending is good for the economy, because higher expenditures end up crowding out private investment.

The influence of these two assumptions is easily identifiable in the particular design of monetary policy the IMF advises: for instance, the BoG was required to set target ceilings for monetary and credit expansion, as well as target floors on net foreign reserves. The original rationale for these restrictions, to reiterate, was to enable the country reduce its external debt to sustainable levels and otherwise prevent insolvency. The goals of taming inflation, increasing foreign-exchange reserves, and "creating incentives for private investment" are more recent, *ex post facto* (though not unrelated), additions<sup>42</sup>.

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<sup>42</sup> For descriptions of these programmes and their underlying assumptions and rationales, see Richard Barth and William Hemphill, *Financial Programming and Policy: The Case of Turkey* (Washington, DC: IMF Institute, 2000), and Mario Blejer et.al., *Inflation Targeting in the Context of IMF-Sponsored Adjustment Programs*, *IMF Staff Papers* Vol. 49, No. 3 (2002), pp. 313-338. For a critique of the FP approach, see

But, as Easterly has persuasively argued, the most damaging aspect of the FP-based monetary regime for a policymaker is that there is no condition under which expansionary monetary policy is an option. Even if the economy's performance is sluggish and there is high unemployment or even deflationary pressures, a country is locked into a restrictive monetary policy. This is mainly due to the fact that there is no explicitly stated operational objective for economic growth (and therefore employment creation and poverty reduction) in the financial-programming framework. The inherent bias in FP, in other words, is towards economic contraction, *and contraction only*. Indeed, the recent addition of inflation targeting, or closely related inflation fighting methodologies, to the mix has only reinforced the contractionary bias, and further emasculated monetary policy as an optional economic and employment stimulation tool for Ghana.

There have been a range of critiques by a great variety of professional economists and policymakers of (what many consider) the anti-developmentalism that is inherent in the IMF's financial programming framework. William Easterly's is, perhaps, one of the more cogent and comprehensive of these critiques. We summarize his views here under four broad themes:

- (1) FP is based on identities that, in practice, tend to have large and variable measurement errors that make it a near-impossibility to identify and achieve precise targets;
- (2) Policies issuing from FP are often based on the assumption of constant, even one-for-one, economic relationships that may either not exist, or (as is more likely) are neither particularly stable nor strictly one-for-one;
- (3) Apart from changes in money stocks, other, often equally important, channels of monetary policy are completely elided. (Changes in) credit and asset prices, for example, do affect economic activity at large.
- (4) Some important variables are assumed to be exogenous to monetary variables when, in fact, they are often measurably affected by monetary policy, a good example being the level of employment.

This last critique is obviously germane to our consideration of the output and employment effects of Ghana's current monetary-policy regime. From our analyses of both the theoretical bases of FP and its application in Ghana's monetary stance, FP is clearly based on a "New Classical" approach to macroeconomic policy that assumes that output growth is not sensitive to (changes in) monetary policy; that is why proponents argue that restrictive monetary policy will reduce inflation without any noticeable negative impacts on

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William Easterly, *An Identity Crisis? Testing IMF Financial Programming*, CGD Working Paper No. 2 (Washington, DC: Center for Global Development, August 2002).

long-term growth. *Experience (and less dogmatic theory) tells us, however, that excessive restrictions on money and credit, coupled with high rates of interest do, indeed, affect growth adversely.*

There are other problems with FP, especially in instances when “structural” goals are included as policy targets or performance requirements, which we will not examine in detail here. Such is the case, for instance, with financial liberalization, which in Ghana’s case, was introduced through the Economic Recovery Programmes of the 1980s, and the PRSP and HIPC initiatives in the 1990s and 2000s. Financial liberalization was, in effect, implicitly made a requirement for poverty reduction.

The answer to the crucial question asked at the beginning of this section--namely, whether or not, at this stage of Ghana’s development, and given its stated long-term development goals, the current monetary policy regime would best serve the country’s interests--is clearly contained either in the preceding analyses and discussion of Ghana’s monetary policy regime, or in the critical review of the IMF’s financial planning framework on which it is based. *Ghana’s current monetary policy practices undermine growth and employment without necessarily curing inflation. It is therefore not optimal for Ghana’s stated developmental goals of growth with quality jobs, and poverty reduction.*

In the last section of this chapter, possible elements of an alternative monetary policy, designed to be in greater consonance with the country’s long-term developmental aspirations, have been spelt out. To distinguish it from the existing policy regime, and to emphasize what its primary intent is, it is described as a “developmental monetary policy”.

### *B. Understanding the Inflation-Growth Trade-off*

Keeping inflation low has, of course, its benefits; but there are also costly trade-offs. No serious economist or policymaker disagrees that high inflation is not a desirable goal for any economy. For policymakers across the world, if the choice is between high inflation and strong economic growth and low inflation with equally strong growth, they will, with perhaps near unanimity, rightly opt for the latter. But that is a different issue altogether than the underlying premise of the IMF-inspired, African countries’ obsession with low-inflation monetary policies, which is that low inflation rates are, by themselves, conducive to economic growth.

In point of fact, a less restrictive monetary stance—which would result from the relaxation of the low-inflation policies—would be more appropriate for faster economic growth in Africa. The tight-money regime that has been in place since the mid-1980s in Ghana has led to sky-high real rates of interest which

have proved almost impossible to dislodge. It is highly likely that, over the past three decades, this has cost the country a few percentage-points of economic growth and, possibly, decent employment opportunities in the formal sector as well. (We return to a discussion of this in Chapter V). Maintaining low inflation rates with tight monetary policies, therefore, may be normatively desirable; but it is not costless in 'real' economic terms. It comes with a high sacrifice ratio more often than not.

Besides, low inflation is only a means to other, more desirable, real-economy ends; it is not an end in itself. As Stiglitz has argued in a critique of the IMF's obsession with low inflation (even when and where it creates a high 'sacrifice ratio'), "...there are other dimensions to good macroeconomic policy besides low inflation. The term *macro* [after all] refers to the *aggregate* behavior, the overall levels of growth, unemployment, and inflation, and a country can have low inflation but no growth and high unemployment. To most economists, such a country would rate as having a disastrous macroeconomic framework". He continues: "To most economists, inflation is not so much an end in itself as a means to an end: it is because *excessively* high inflation often leads to low growth, and low growth leads to high unemployment, that inflation is so frowned upon. But the IMF often seems to confuse means with ends, thereby losing sight of what is ultimately of concern"<sup>43</sup>.

Although the relationship between inflation and economic growth has been studied extensively by economists over the years, there is still no agreement on the true nature of the relationship. Perhaps the most influential of the studies were the ones done by Bill Easterly and Michael Bruno in the mid-1990s. Bruno, in 1995, studied the relationship between inflation and growth in 127 countries between the years 1960 and 1992. He found that average growth rates declined only slightly as inflation crept up to the 20-25% range.

His most interesting finding, for the purposes of this paper, however, was that, in the period 1960-1972, economic growth actually increased as inflation rose from negative rates to the 15-20% range. His explanation for this was that "in the 1950s and 1960s, low-to-moderate inflation went hand-in-hand with very rapid growth because of investment demand pressures in an expanding economy"<sup>44</sup>. In other words, *inflation that results directly from expansionary economic policy will not create any significant barriers to further growth.*

Other, subsequent research showed, in direct challenge to Bruno, that high rates of inflation *do* lead to lower economic growth. In response, Bruno and Easterly published new findings that showed that the negative relationship between inflation and growth that the critics had highlighted only existed at very

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<sup>43</sup> Quotations are from J. Stiglitz, *Globalization and Its Discontents* (N.Y.: W.W. Norton, 2002), p. 27.

<sup>44</sup> M. Bruno, *Does Inflation Really Lower Growth?*, *Finance and Development* (Sept. 1995), pp. 35-38.

high rates of inflation, generally in the 40+% range. When inflation was more moderate than that, no clear relationship existed between inflation and economic growth<sup>45</sup>.

Other researchers have since joined the fray: for example, in 1998, the IMF economists, Atish Ghosh and Steven Phillips, studying a sample of IMF member-countries over the period 1960-1996, found evidence that the relationship between growth and inflation could turn negative at as low a rate of inflation as 2.5%, in direct contradiction of the Bruno-Easterly position. But Ghosh and Phillips also reported obtaining a similar statistical result at inflation rates in the 5-10% range<sup>46</sup>.

Much of this research uses nonlinear econometric methods to try to capture the differential effects of low and high rates of inflation on growth, but, ultimately, to attempt to pinpoint the thresholds at which inflation begins to have a deleterious effect on economic growth. And while there is no consensus as to which exact inflation rate does that, the most recent research suggests that the growth/inflation relationship differs for the developing countries and the rich ones. A 2001 study by M.S. Khan and A.S. Senhadji, for instance, concluded that growth turns negative for industrialized countries when their inflation is in the 1%-3% range; but for developing countries, it happens between 11% and 12%<sup>47</sup>. On the other hand, a more recent (2004) study by Burdekin, Denzau, Keil, Sitthiyot, and Willett, also using non-linear techniques, came to the direct opposite conclusion—that the threshold was higher for the rich countries, at 8%, than for the poor ones at 3%<sup>48</sup>.

An even more comprehensive recent (2006) study by Robert Pollin and Andong Zhu came to the conclusion, among other things, that inflation and growth are more likely to have a strong positive correlation if macroeconomic policy is focused on stimulating demand—which would be a confirmation of Bruno's 1995 findings that triggered much of this research in the first place<sup>49</sup>.

Clearly, the increased use of ever-more-sophisticated econometric techniques does not appear to have succeeded in settling this important question of precisely when inflation undermines growth. Still, there are one or two lessons that can be gleaned from this literature for policy guidance in Ghana.

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<sup>45</sup> Bruno, M. and W. Easterly, *Inflation Crises and Long-Run Growth*, Journal of Monetary Economics, Vol. 41 (1998), pp. 3-26.

<sup>46</sup> A. Ghosh and S. Phillips, *Warning: Inflation May be Harmful to Your Growth*, IMF Staff Papers Vol. 4 (1998), pp. 672-86.

<sup>47</sup> M.S. Khan and A.S. Senhadji, *Threshold Effects in the Relationship Between Inflation and Growth*, IMF Staff Papers Vol. 1 (2001), pp. 1-21.

<sup>48</sup> R. Burdekin et al, *When Does Inflation Hurt Economic Growth? Different Non-Linearities for Different Economies*, Journal of Macroeconomics, Vol. 3 (2004), pp. 519-32.

<sup>49</sup> R. Pollin and A. Zhu, *Inflation and Economic Growth: A Cross-Country Non-Linear Analysis*, Journal of Post-Keynesian Economics, Vol. 4 (2006), pp. 593-614.

Firstly, even though there was no consensus on the threshold, out of all these studies only one found evidence of a negative relationship between growth and single-digit inflation levels for developing countries. *This suggests that low or single-digit inflation targets are unlikely to contribute positively to Ghana's economic performance in the medium term; indeed, if it is accompanied by high real interest rates, the impact on growth is likely to be strongly negative.*

Secondly, none of the researchers could challenge one of the central conclusions of Bruno's seminal 1995 study, which is that the relationship between inflation and growth will be fundamentally different depending on what the source of the inflation is. As he argued, demand-pull inflation resulting from economic expansion will have a positive effect on growth, as long as the inflation rate remains moderate (i.e. does not exceed 20%). On the other hand, inflation caused by excessive business mark-ups over costs, or by supply shocks (an oil shortage or significant input-price hike, say), or exchange rate volatility, will be negatively correlated with growth.

*But the negative effects on growth will not be due to inflation as such; rather, it is the monopolistic pricing power of businesses, the economy's capacity and ability to adjust to supply shocks, or erratic swings in the exchange rate that will be primarily responsible.*

In short, there is little credible evidence that maintaining low rates of inflation will, by itself, contribute positively to economic growth. And if the monetary interventions required to keep inflation low also result in high real interest rates, economic growth may actually be significantly compromised. Indeed, macro-econometric studies of Ghana by Heintz and Epstein, using vector auto-regression or VAR models<sup>50</sup>, and of South Africa by Pollin et. al. using vector error correction or VER models<sup>51</sup>, show that increases in the interest rate have a sustained negative impact on economic growth. And if slower growth serves to undermine supply-side productive capacity, the high-interest rates that have resulted from Ghana's anti-inflation, restrictive monetary stance may reinforce capacity constraints that have long-run implications for both growth and inflation.

### C. Inflation Dynamics in Africa

Since the Bank of Ghana and other African central banks seem to be so preoccupied with inflation, it should be instructive to ascertain—especially in light of the preceding discussion—whether the remedy they are implementing (i.e. restrictive monetary policy) is warranted by the causes of the pathology. To do

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<sup>50</sup> G. Epstein and J. Heintz, Monetary Policy and Financial Sector Reform for Employment Creation and Poverty Reduction in Ghana, IPC Country Study #2, (UNDP: International Poverty Center, Brasilia), 2006.

<sup>51</sup> Robert Pollin et.al, An Employment-Targeted Economic Programme for South Africa (Cheltenham: Edward Elgar, 2007).

this, we present below (Table 13) econometric estimates of the relative importance of various contributing factors to the rate of inflation in sub-Saharan Africa. They come from pooled data covering Ghana and 18 other countries over the period 1975-2005. The factors expected to be the primary determinants of inflation on the continent, and which are therefore included in the estimates, are: past inflation rates, the GDP growth rate, the growth rate of the money supply, the percent change in the nominal exchange rate, and the growth rate of an index of food production. The coefficients listed on the table indicate the impact of the change in each of these factors on the rate of inflation in these 19 countries.

TABLE 13

*Coefficient Estimates of the determinants of inflation* (Dependent variable=the annual CPI)

Variable	Coefficient
Lagged inflation	0.43**
GDP growth	-0.21**
Money supply (M2) growth	<0.01
% change in the nominal exchange rate	0.12**
% change in index of food production	0.08*

*\*Statistically significant at the 10% level.*

*\*\*Statistically significant at the 5% level.*

The estimates give us a number of insights into inflation and its causes in Ghana. Firstly, inflationary shocks tend to persist over time: a shock in one year, therefore, is very likely to persist far into the future, though the impact weakens over time. Secondly, economic growth tends to not get compromised by low rates of inflation. This would suggest that growth tends to be accompanied by expansion of productive capacity, which then puts downward pressure on inflation. This is an important result, because if demand-pull inflation *were* the primary characteristic of Ghana's inflation, the coefficient would be positive. In other words, higher rates of growth would put upward pressure on prices as growth bumps up against constraints in production capacity.

Thirdly, the growth rate of the money supply does not have a significant impact on inflation—which begs the question as to why a tight monetary policy should be the preferred inflation-fighting technique, especially when it is almost inevitably associated with a high sacrifice ratio.

Fourth, depreciation of the currency's value (i.e. an increase in the nominal exchange rate) leads to inflationary pressures, which suggests that there is significant pass-through between the exchange rate and the price level. In Ghana, one explanation for this is the fact that the overwhelming bulk of imports are production inputs. An exchange-rate depreciation therefore tends to show up as an increase in production (hence output) costs, with very little induced 'expenditure switching' since the inputs often have no close domestic substitutes.

And, finally, the estimates highlight the immense importance of food prices in the determination of the overall price level in Ghana: positive shocks to food production (say, a bumper harvest) tend to reduce inflationary pressures; negative shocks (droughts, etc.) push them up.

There are several important conclusions that can be drawn from this picture concerning price dynamics in Ghana. First: inflation is driven primarily by supply-side factors, not demand-side ones. Therefore negative supply-side shocks will tend to raise inflation rates even as the growth rate of the economy decreases. *This by no means implies that high inflation compromises growth, but rather that inflation and growth respond to the same factors.* Second: monetary aggregates have a limited impact on inflation, but predictably adverse ones on the signaling prices (real interest rates, the nominal exchange rate) that affect the 'real' economy (growth, jobs creation, etc.). And, third: depreciation of the nominal exchange rate inevitably contributes to inflation, given Ghana's imports profile. These last two observations have serious implications for the conduct of monetary and exchange-rate policies for the country.

#### *D. Monetary Policy Instruments and Targets*

To reiterate: in seeking to fulfill (what they and the IMF consider) their primary mission of taming inflation, Ghanaian and other African central bankers deploy instruments and targets adopted from the IMF's financial programming (FP) framework. In this approach, changes in the domestic money supply are assumed to affect the supply of credit, the inflation rate, and the level of foreign reserves. So, often, a ceiling on domestic credit is imposed, and a low inflation-rate target is included as an objective in the policy regime. This means that, effectively, the desired growth rate of the money supply is determined by the inflation, credit, and/or foreign reserve targets<sup>52</sup>.

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<sup>52</sup> See William Easterly, *An Identity Crisis? Testing IMF Financial Programming*, CGD Working Paper No. 2 (Washington, DC: Center for Global Development, August 2002).

If credit ceilings and low inflation targets are the mainstays of monetary policy within FP then--as Epstein and Heintz have shown in their empirical research work on Ghana, South Africa and Kenya, and in confirmation of Easterly's theoretical critique of FP--there clearly will be little room for meaningful *expansionary* monetary policy in African central bankers' toolkit<sup>53</sup>. In other words, there is an inherent contractionary bias in FP-inspired monetary policy regimes, which explains why and how interest rates in countries in which they are being practiced are uniformly higher, and growth rates consistently lower, than in countries with different monetary policies. High interest rates and low growth, of course, are both inimical to employment creation.

But worse yet is the possibility that the FP-based monetary-policy regime is actually the wrong one for the illness it purports to treat. It has just been shown that, in Ghana and the 18 other countries in the sample, inflation is generally a supply-side phenomenon. If a restrictive monetary policy is deployed to tackle a supply-side shock that has inflationary consequences (say, an unexpected and significant increase in food and oil prices), the impact would be *pro-cyclical*. In other words, tightening monetary policy in response to an inflation-inducing shock only exacerbates the inflationary pressure.

There is thus a two-fold risk for Ghana in this policy regime: (1) the current policy has a contractionary bias, which has adverse impacts on job creation; and (2) the policy, intended to be anti-inflationary, is more likely to have the opposite effect in the medium term, which confirms the results of BoG's own studies on the impacts of its policies.

These risks should underscore an important axiom of development policy: *monetary policy, like all economic policies, must be dictated by the actual causes of the issue being addressed, not some theoretical ideal.*

### *E. Implications for Policy*

For Ghana to successfully pursue a jobs-intensive growth path to middle-income status in ten years, it will do well to take seriously the implications for its monetary policy of the lessons and issues arising from the preceding analyses, the main ones of which are that:

1. maintaining inflation in the single-digits does not, by itself, enhance economic growth. And if low levels of inflation are achieved and maintained through the regime of tight money that the Bank of Ghana has ostensibly implemented for the past three decades, the rate of economic growth over the long run will be measurably lower than it would otherwise be, and jobs creation would be commensurately compromised.

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<sup>53</sup> See Epstein and Heintz, *op.cit.*

What the empirical studies revealed is that the direction of causality appears to be *not* from low inflation to rapid growth but, rather, from high growth through the expansion of production capacity to low inflation.

2. a monetary policy focused almost entirely on maintaining single-digit inflation and limiting the expansion of domestic credit is inherently contractionary, in the sense that there are no foreseeable circumstances in which an expansionary policy may be pursued as the optimal policy.
3. given the structure of employment discussed earlier in Chapter II, and the structure of imports mentioned above, an anti-inflation monetary policy may well be pro-cyclical, since inflationary pressure in the economy results from supply-side shocks.
4. in the light of the foregoing, it must be stressed (by way of caveat) that nothing highlighted here suggests that monetary policy should be designed irrespective of the inflationary dynamics extant. Excessive growth of the money supply *will*, eventually, cause financial and price instability. However, there would always exist a prudent range of monetary *expansion* in which an alternative policy-regime that is more deliberately pro-employment and pro-development can be found. We may call such a policy a “developmental monetary policy”, and it should have the *dual focus* of stabilizing inflation at some moderate levels that will, *at the same time*, enhance the growth of the economy and of jobs.

#### *F. Towards A Pro-Development Macropolicy Regime*

Generations of development economists have been taught that the dominant focus of macroeconomic policy is the maintenance of low inflation (“price stability”) and a favourable external balance.

Important as these are, the focus is clearly too narrow for the complexity of macroeconomic problems that developing countries like Ghana face in this globalizing world economy<sup>54</sup>. Other options are both necessary and possible; indeed, what is needed *in general* is a policy framework that allows for the use of multiple policy instruments for attaining multiple intermediate goals that support the country’s long-term development objectives.

It should not be difficult, in this regard, to find consensus on the following items as viable and desirable long-term, macro-development objectives for Ghana:

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<sup>54</sup> See Nikoi Kote-Nikoi, *Optimal Development Policies for the Age of Globalization*, IEA Occasional Paper No. 29 (Accra: Institute for Economic Affairs, July 2001).

1. Maintaining a competitive real exchange rate;
2. Limiting or eliminating exchange-rate or macroeconomic volatility caused by the liberalized flows of, especially, short-term capital;
3. Sustaining real interest rates in a range consistent with (specified rates of) long-run economic and employment growth.

Nor would it be particularly difficult to find agreement on the following as necessary and important intermediate policy instruments for achieving these long-term objectives:

1. Interventions in the foreign-exchange markets to maintain real exchange rates at a competitive (though not fixed) level;
2. The deployment of capital controls or other capital management techniques to smooth capital flows so as to reduce the economic and exchange-rate volatility they are associated with;
3. The setting of short-run, real interest rate targets to enable the balancing of (the twin macroeconomic goals of) inflation control and growth enhancement.

Arguably, a policy regime premised on such an approach would be significantly more pro-development than the dominant macro model that informs the incumbent, FP-based, monetary-policy regime<sup>55</sup>. It certainly would address the two principal concerns of policy, namely, macroeconomic stability and inflation control; and since multiple instruments are available to policy makers, targets could be pursued simultaneously. Long-run objectives, such as employment targets, could be incorporated into this framework, and macroeconomic policies would then be coordinated with other policy areas to enhance the chances of attaining the goals.

As far as monetary policy, specifically, goes, an alternative to the current BoG regime can be easily crafted which will complement the broad approach to development policy described immediately above, an alternative which would be more conducive to the attainment of Ghana's long-term development goals as described all through this paper. Indeed, now that inflation is largely stabilized, and the prospects for keeping the external debt at sustainable levels improving, monetary policy should focus more on generating employment and a faster rate of economic growth than on seeking to push inflation even lower when the real-economy benefits appear to be so dubious. As argued earlier, the emphasis on reducing inflation only serves to exacerbate an already-constraining monetary,

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<sup>55</sup> The *monetarist* basis of the FP framework—i.e. the Quantity Theory of Money—is only very thinly disguised, in fact.

debt and reserve targets; and those targets themselves, and the tools used to achieve them—e.g. ceilings on domestic credit (or reserve money) and floors on international reserves—are of uncertain benefit to the Ghanaian economy. Their contractionary bias, however, is certain.

What could be elements of such an alternative, developmental monetary policy for Ghana?

*It would be a monetary policy regime that has, and keeps, as its focus the generation of quality employment across the economy as well as the control of inflationary pressures, the country's debt exposure, and its reserve accumulation. Aiming for these objectives would, in practice, entail the following:*

- (1) As long as other targets are being met, the BoG should aim to be as expansionary as possible, rather than display the excessive caution and conservatism on monetary aggregates that it currently does;
- (2) *The focus on reducing inflation to low single digits has an excessively high sacrifice ratio (i.e. costs to the real economy per unit trend movement in the inflation rate), and should therefore be abandoned altogether.* Instead, BoG should aim at stabilizing inflation at the current rate, and keeping it from accelerating beyond some normatively defined "moderate" range—say, between 10% and 20%;
- (3) The BoG has already developed in-house tools for evaluating monetary policy and its impact on the real economy. Two of these are the Composite Index of Economic Activity (CIEA), and the Business Confidence Index (BCI). The CIEA contains a variety of indicators, regularly available, which provide a sense of where the real economy is headed at any given time, and therefore can provide guidance as to how policy may be adjusted. It also incorporates some notional estimate of the level of (formal) employment, obtained from SSNIT, which could easily be developed into a robust instrument for employment targeting. The BCI also provides useful indications of prevailing business sentiment concerning the economy, which could then become additional guidance for policy adjustment.
- (4) The BoG should loosen its credit ceilings to support the expansion of credit for employment-generating financial intermediation. This would allow for a more rapid increase in money and credit to the business sector which, as was shown earlier, does increase the pace of real economic growth. Such a policy, however, would

need to be accompanied by complementary changes in the very structure of the financial sector if it is to have the desired effect on employment and poverty reduction. This is necessary because banks in Ghana have been traditionally unwilling to invest the effort in finding worthy borrowers, as attested to by the high levels of excess reserves in the banking system, the preference for financing short-term loans, the large interest-rate spread (around 20%, on average) in the system, and therefore the limited access to affordable credit by, especially, small firms (the real lending rate averages about 18%). A more active approach through looser credit policies by the central bank, especially to support lending by small and rural banks, would create a greater employment-centred, developmental boost.

As it is currently structured, however, the financial intermediation system in Ghana, dominated as it is by the formal banking system, is not really operating to promote economic and employment growth. Bank credit to the private sector as a proportion of GDP is only 14.7%--as compared to 82.7% in South Africa, 56% in Mauritius, 51.6% in Namibia, 24.3% in Ethiopia, 21.1% in Senegal, 20% in Gambia, 19% in Mali, and 16% in Nigeria. In non-African comparator countries, even larger shares of available credit go to the private business sector: e.g. Malaysia (97.4%), Thailand (82%), Chile (62.7%), Hungary (46.9%), and Sri Lanka (32%). An examination of the asset portfolio of Ghanaian commercial banks indicates that their preference is to hold large amounts of excess liquidity (Table 14 below), and invest in low-risk assets with strong real returns such as short-term government securities, rather than extend credit to a private business sector (especially the SMEs that dominate the sector) that they perceive to be of excessively high-risk. Under these circumstances, the use of monetary policy to stimulate economic expansion--say, a reduction in the reserve requirement--is easily dampened by the banks since they will not extend the additional excess reserves as new loans to the productive sector (again, see Table 14).

TABLE 14

Ghana: Actual and Required Reserve Ratios in the Commercial Banking System,  
2003-2006

	Dec. '03	Dec. '04	Dec. '05	Dec. '06
Required Reserve Ratio	44.0	44.0	24.0	24.0
Actual Reserve Ratio	82.9	57.0	56.9	47.4

*Source:* Bank of Ghana, Statistical Bulletin (various years).

## **CHAPTER V**

### ***Beyond the Labour Market: Improving Informal Employment Opportunities***

As has been stressed throughout this study, a variety of different constraints operate to limit the quality and quantity of employment opportunities in Ghana. Regulatory distortions emanating from the regulation of wage-labour may be one of the binding constraints on the formal economy, as economic orthodoxy likes to argue, but it is only one of several constraints of equal importance and, in any case, may be binding only on a small segment of the labour market. The various surveys of Ghanaian business analyzed in Chapter III, the Growth Diagnostics exercise, and the analyses of Ghana's monetary and anti-inflation policies conducted in Chapter IV helped identify and evaluate other factors that might be preventing the robust creation of high-productivity jobs in the country.

Many of the constraining factors identified have a greater bearing on formal economic activity than on the informal, even though, as has been stressed throughout, it is the informal economy that creates the overwhelming preponderance of job opportunities in the country (see Chapter II). It so happens that these are time-intensive, low-productivity, low remuneration jobs, which renders the informal sector at once the biggest producer of jobs but also the biggest repository of poverty and labour inertia in the economy.

If, as previously argued, labour-market rigidities are not preponderantly responsible for the persistence of low quality and insufficient employment options in the non-public formal sector, it should be clear they are even less responsible for the poor quality of jobs in the informal economy. Yet it is important to identify the peculiar operating constraints on the informal sector so as to find ways to enhance, by deliberate policy intervention, its role as the long-standing producer of employment opportunities but, this time, with the view to improving the *quality* of jobs being created, and thereby the sector-specific returns to labour.

The problem of employment in Africa is complex and multifaceted, involving numerous factors and stakeholders. To provide sound solutions, a jobs-policy needs to be equally comprehensive and multi-pronged, and must involve both formal and informal sectors of the economy. But to not place the emphasis of the policy on the sectors of the economy where most people are, and have historically been, employed—i.e. the informal sector—would be economically and ethically unjustifiable.

With regard to this proposed emphasis on informal employment, we have argued previously that the path to the improvement of the quality of jobs in the

sector lies *outside* the labour-market proper. In what follows, we buttress this proposition by examining constraints emanating from three areas of economy and society that are particularly important for informal employment, namely, the financial sector, market access, and urban policy. The focus here is on non-agricultural employment, specifically urban informal non-agricultural employment, but the analysis and recommendations are equally applicable to the self-employed in the agriculture sector as well, as most of their activities belong, strictly speaking, to the informal sector.

#### *A. The Financial Sector*

Even though the formal banking system does not quite blanket the economic landscape with services for all, banks still remain the dominant financial institutions in Ghana. But, as we saw in the previous chapter, in Ghana (as in most countries in Africa) the intermediation functions that financial systems should offer in order to promote the economic-development process at large have largely atrophied. Firms are offered, at inordinately high cost, inadequate access to the appropriate financial services that enable job-creating investment, the banking system itself being hamstrung by many structural problems and central-bank policies that are not necessarily conducive to enterprise or national development.

The consequence of this is that small- and medium-sized enterprises (SMEs)—which happen to be the overwhelming majority of formal-sector, private firms in Ghana; informal-sector enterprises—which account for the greatest number of the self-employed, both agricultural and non-agricultural; and agricultural producers, in particular, face very high barriers in accessing credit facilities and financial markets. Not only is access to operating credit severely limited, but the cost of *all* types of credit is typically usuriously high. This is the sense in which financial market rigidities frequently have a more profound negative impact on the quantity and quality of employment, formal and informal, in Ghana, than labour-market rigidities.

The high cost of credit in the formal Ghanaian banking system is attributable to a number of factors, some of which were broached in the preceding chapter. Firstly, the risk premium that borrowers pay in credit markets is extremely steep. This is due not to objectively identifiable or measurable considerations of risk or creditworthiness, but to perceptions, often incorrect or wildly exaggerated, that have it that most SME borrowers are high-risk or not particularly bankable<sup>56</sup>. This reliance on perceptions is important, and perhaps inevitable, as many commercial banking systems in Africa never quite

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<sup>56</sup> See, for instance, R. Atieno, Formal and Informal Institutions' Lending Policies and Access to Credit by Small-Scale Enterprises in Kenya: An Empirical Assessment (Nairobi: AERC Research Paper No. 111, 2001).

develop the capacity to collect information on the creditworthiness of potential borrowers outside of a narrow, select clientèle (often government or substantial export companies)<sup>57</sup>. For small-scale and rural borrowers—who are decidedly not members of this set of privileged borrowers—high transactions costs may also raise the cost of commercial-bank credit, as many banks are not geared towards the efficient management of small loans to numerous small producers.

Secondly, the sizeable interest-rate spread found in Ghana, and replicated across Africa, is largely an artifact of the very structure of the banking system, in that banking on the continent as a whole tends to be highly concentrated, often oligopolistic, with a few large banks effectively dominating the entire commercial-bank space. In Ghana, the banking system has, over the last few years, become relatively less concentrated than it has historically been. It currently consists of some 23 major banks and 120 rural or community banks, representing a wide range of institutional types. The 'major banks', for instance, are made up of 11 commercial banks, 3 development banks, 2 merchant banks, 6 universal banks, and 1 apex bank. But the degree of *effective* concentration remains high, as the top 6 banks hold about 75% of all deposits and banking assets, and there is documented evidence of interest-rate coordination and other collusive behaviour among them<sup>58</sup>.

Thirdly, as we saw in the preceding chapter, Ghana's central-bank policies have become more-and-more beholden to the concept of 'inflation targeting' or not-too-different anti-inflation policies. The BoG has a low inflation target ("single-digit" inflation) set over a specified policy horizon, and the challenge is to manipulate money or credit availability with policy instruments (short-term interest rates) to attempt to hit the target, and keep the inflation rate more-or-less there. But, as the BoG's own studies that we examined in the previous chapter indicated, low inflation levels aggressively maintained by discretionary policy inevitably yield excessively high real interest rates, with a consequent rise in the 'sacrifice ratio' for the economy at large<sup>59</sup>.

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<sup>57</sup> For more comprehensive descriptions and analyses of the African banking scene, see P. Kimuyu and J. Omiti, Institutional Impediments to Access to Credit by Micro and Small-Scale Enterprises in Kenya (Nairobi: Institute of Policy Analysis and Research Discussion Paper No. 26, 2000); M. Nissanke and E. Aryeetey, Financial Integration and Development: Liberalization and Reform in sub-Saharan Africa (London: Routledge, 1998); and W. Steele et.al., Informal Financial Markets Under Liberalization in Four African Countries, World Development, Vol. 25, No. 5 (1997), pp. 817-30.

<sup>58</sup> See Thierry Buchs and Johan Mathisen, Competition and Efficiency in Banking: Behavioral Evidence from Ghana. IMF Working Paper WP/05/17 (2005); and M. Bawumia et.al, The Determination of Bank Interest Spreads in Ghana: An Empirical Analysis of Panel Data. Bank of Ghana Working Paper WP/BoG-05/01 (2005).

<sup>59</sup> See Heintz and Pollin, *op. cit.*; also Nikoi Kote-Nikoi, Central Banking for Development: Making African Monetary Policy Genuinely 'Pro-Poor' (Accra: Centre for Policy Priorities *Occasional Paper* No. 07/002, January 2007).

And, lastly, there's a shortage of credit and related financial services to the private sector because banks in Ghana tend to hold excess liquidity: they prefer to hold short-term government securities because they are seen as less risky than loans made to small commercial borrowers<sup>60</sup> (Table 14). Credit to the private sector is thus effectively being rationed, and this rationing is likely to be most severe on rural and small-scale urban borrowers for much the same reason that interest rates are extremely high—lack of credit information systems, and perceptions of risk, however unfair or unsubstantiated.

In sum, institutional barriers in the banking system tend to limit the availability of credit to small-scale producers and the informal self-employed--a segment of the business sector often with little capital assets of their own, and who could therefore use credit, if available, to overcome their debilitating capital constraint to create the types of job opportunities an aspiring middle-income country cannot do without. The informal self-employed, in particular, are effectively shut out of the formal credit and financial markets; or, when credit is available to them, it is on particularly onerous terms. This limits the ability of the informal sector to improve the quality (and quantity) of employment opportunities by, for example, investing in capital equipment to raise the sector's productivity and its workers' remuneration.

### *B. Market Access*

For the informal self-employed--and even for the mass of small, formal enterprises that dominate the Ghanaian business scene--the domestic market is the primary (if not sole) source of demand for the goods and services they produce. In Ghana, Kenya and elsewhere, informal enterprises and workers rely almost exclusively on domestic demand<sup>61</sup> (see Chapter III); therefore barriers to market access, specifically, and insufficient local demand, generally, limit the ability of these firms or individuals to realize income from their efforts. Enhancing market access, therefore, would be an important jobs or employment-enhancing policy.

Measures such as public investments in roads, storage facilities, communications and information infrastructure, marketing outlets, a pragmatic commercial or imports policy... all these will help improve access to markets. Sound general macroeconomic policies also impact the level of domestic demand and help deepen local markets. Substandard infrastructure and restrictive macro

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<sup>60</sup> See E. Sacerdoti, *Access to Bank Credit in Sub-Saharan Africa: Key Issues and Reform Strategies*, (Washington, DC: IMF Working Paper No. 166, 2005); Steele et.al., op. cit.; and T. Mkandawire, *The Political Economy of Financial Reform in Africa*, *Journal of International Development*, Vol. 11 (1999), pp.321-42.

<sup>61</sup> See Pollin, Githinji and Heintz, op. cit., and S.D. Barwa, *Structural Adjustment Programmes and the Urban Informal Sector in Ghana*, *Issues in Development Discussion Paper No. 3*, ILO, Geneva.

policies (such as the BoG's anti-inflation monetary regime) would work in the opposite direction to the desired, by constraining the development of domestic demand.

Institutional barriers to direct market access can affect earnings in other ways. In some cases, informal workers must go through various intermediaries in order to access markets. This worsens their terms-of-trade, since the intermediaries capture a significant share of the value produced along the supply chain. Often, 'purpose-built' interventions can increase direct market access and improve the terms-of-trade. For example in Durban, South Africa, the municipal government established buy-back centers to facilitate the direct purchasing of recyclable materials from self-employed waste collectors<sup>62</sup>. Prior to that, waste collectors had to rely almost completely on intermediaries for market access. Thus the municipality's intervention served to increase market access, by creating a type of market exchange that did not exist before.

In many countries, the majority of the informally self-employed outside of agriculture are engaged in the provision of some sort of service. This has implications for how policies are crafted to improve productivity and earnings in the sector, for the simple reason that productivity in services is rather distinct from productivity in manufacturing and other industrial-production activities. Productivity in services and, by extension, earnings from service activities, is strongly influenced by the level of demand and the degree of development of markets. For example, a street vendor's productivity will be largely determined by the quantity of goods s/he sells within a defined period of time. In manufacturing, productivity is essentially a 'supply-side' issue, linked directly to the nature of the production technologies in use. In services, the boundary between the supply-side and the demand-side is blurred in the determination of overall productivity; this is why the issues of domestic demand and market access mentioned above are crucially important for improving productivity and earnings in informal non-agricultural employment in Ghana.

### *C. Urban Space-Use Policies*

The quality of governance of urban space, in general, and public space, in particular, is central to the livelihood strategies of many of the informal self-employed, and its importance can only increase in coming years given the projected rates of growth of urbanization—partly fuelled by continuing rural-to-urban migration—for Ghana and much of sub-Saharan Africa.

The informal self-employed need physical space from which to operate their businesses. But because most of them are asset-poor, they lack private

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<sup>62</sup> See M. Chen et. al., *Progress of the World's Women 2005: Women, Work and Poverty* (N.Y.: UNIFEM, 2005).

property rights over such space. And even when the businesses are operated from a residential structure—as ubiquitously happens in urban Ghana—the security of tenure may be uncertain. In many other cases, the enterprise cannot even be restricted to private homes or spaces: street hawkers in Accra, for instance, need to go to their markets; their markets may not come to them.

For the purposes of the revitalization of informal employment being advocated here, it would be analytically useful to see urban public space as a type of public asset, with all the major attributes of a public good, but with peculiar characteristics, too. For example, it may not be entirely or always desirable or (even possible) to have unrestricted access or no monitoring; in other words, some degree of exclusion is possible, and may even be deemed desirable. Moreover, the use of a public urban space by an individual does not necessarily preclude its use by another or others (e.g. the mobile roadside vending that is ubiquitous in major cities like Accra), but issues of congestion and diminishing returns can become serious problems. One approach to addressing problems of congestion, insecure tenancy, and ‘tragedy-of-the-commons’ effects is to increase the excludability of such spaces by defining enforceable private-property rights, as advocated famously by Hernan de Soto in 1989.

On the other hand, privatizing public spaces may not produce welfare improvements when the current informal use of public space generates synergies among informal activities (e.g. clustering of informal activities have been known to lead to the development of markets and higher levels of demand); when economies of scale exist (e.g. when multiple uses of public space are possible without significantly raising the costs or lowering the productivity of other users); or when there are concerns over equity (e.g. if the poor are unable to secure access to privatized property rights).

Therefore, a more sensible regulatory framework is needed for the urban environment, one that (in this context) improves the security of access to public assets for the informal self-employed. Most of the approaches to the management of multiply used urban spaces currently deployed in Ghana (and across Africa) aim, rather, to “clean up the streets”; i.e. to remove the taint of ‘backwardness’ and ‘indiscipline’ that informal economic activities ostensibly visit upon the modern urban setting. (The current mayor of Accra’s on-going campaign to rid the city of hawkers is a case in point, as was the immediate past Ghanaian Vice-President’s constant broadsides against “indiscipline” in the city).

Implicit in these regulatory approaches, of course, is the belief that informal commerce is wholly incompatible with “world-class” cities. If they become successful, the inevitable end-result would be the undermining of the livelihoods of the informal self-employed, a sabotaging of efforts to improve

employment opportunities for the poor, and a threat to efforts aimed at bringing down the incidence of poverty.

## CHAPTER VI

### ***CONCLUSION: AN OPTIMAL JOBS STRATEGY WHEN INFORMALITY RULES***

We now return whence we started: in the light of the preceding discussion, what should the appropriate employment-enhancing strategy for Ghana be, when informal employment is already the rule rather than the exception, and when the formal sector is hamstrung by a huge variety of seemingly insurmountable structural and other difficulties?

Much as policymakers and the urban sophisticates in Accra may frown upon it, there is no escaping the fact that informal employment represents an important source of livelihood for the great majority of the Ghanaian labour force, in both the urban and rural economies. Given the low level of current and prospective private industrial, and other such formal, development in the country, there is little reason to expect that formal employment opportunities, even though desired and aspired to, will replace the informal economy as the main source of livelihood for the majority of the work force in the medium term. Even if, for some unexpected reason, formal employment opportunities should expand rapidly against past trends, informal employment will remain a critical earnings path for the majority for decades to come.

But because in policy circles informal employment is seen as a marker of underdevelopment, the sector has been effectively overlooked in policy discussions and official anti-poverty development strategies—except, perhaps, to ‘formalize’ it. Labour-market rigidities continue to be held responsible for the poor quality of jobs or employment prospects, the paucity of supporting evidence notwithstanding. Financial and industrial policies, geared as they are to the needs of the formal economy, typically cater to larger firms. The Ghanaian banking sector, in particular, will seek to resist any change in policy orientation that departs from the current, since the status quo remains immensely profitable for it. As would exporters: the current policy regime in Ghana, being the legacy of the structural adjustment policies of the 1980s and ‘90s, has a decidedly mercantilist orientation, and tends to promote exports disproportionately over most other kinds of economic activity, even though in principle a dollar of export earnings adds no more (and no less) to national income than a dollar from any other productive activity. An emphasis on exports, however, is the *de facto* exclusion of informal enterprises from policy prominence, as informal activities cater completely to domestic markets. Indeed, as was shown in previous analyses, the majority of Ghanaian enterprises, including private formal-sector

firms, rely almost completely on domestic demand. For a balanced, high productivity, employment-intensive growth, therefore, policies that narrowly benefit the formal economy *must* be balanced by purpose-designed policies that privilege the informal sector.

Besides, comparatively speaking, bankers and exporters have a bigger and readier access to policymakers than do those in informal employment; that employment policies remain disconnected from the reality of most people's livelihoods—think of the National Youth Employment Programme—is therefore hardly surprising. The constraints outlined above as hampering the (qualitative and quantitative) improvement of the work experience for the majority—in terms of finance, market access and the use of public space—will continue to limit earnings and productivity among informal workers if there is no deliberate switch in policy in the near future.

So...what is to be done? What is sorely needed is a reorientation of both thinking and policy towards the elimination of these constraints that limit productivity and economic mobility in Ghana's informal employment. This will not resolve all the substantive issues surrounding sub-optimal employment in the country, admittedly, as it is, at best, a narrowly-targeted and therefore partial answer. Informal employment would still be concentrated in services, where the prospect of major gains in productivity is severely limited. Even outside of service activities, own-account workers in informal manufacturing are unable to capture the benefits of scale economies due to the very nature of informal enterprise. There thus exist real and substantial limits to productivity improvements in informal activities that go beyond the institutional and policy constraints highlighted above. Still, as informal employment continues to absorb the majority of the work force four decades after the seminal studies of Hart, Streeten and the ILO, and will arguably do so for the foreseeable future, any move to shore up its contribution to the country's development and economic transformation effort cannot but be a positive one.

But any such efforts aimed at improving working conditions in the informal sector should be seen as complementary to, not a substitute for, a broader economic development agenda that emphasizes agrarian livelihoods and an expansion of formal-sector employment opportunities. The policy playing-field is far from level, however, and systematic biases against informal employment continue apace, ably aided by the differential access to power that formal- and informal-sector enterprises enjoy, and also by the bias in orthodox economic theory and analysis against informality on productivity grounds.

Given their proven track-record of labour absorption, however, employment strategies that are not inclusive of informal activities, or that do not aim to align the sector more closely with the broader development agenda, will be myopic in the extreme. The optimal policy, as detailed above, would entail,

essentially, a process that appears like the “formalization” of informal employment; but it, in fact, is a policy that goes considerably beyond the formalization exercises of old that merely sought to officially register the unregistered enterprises. The “formalization” envisaged here is achieved by deliberately extending to informal-sector enterprises economic services (such as finance), appropriate regulation (such as urban space-use policies), and stronger linkages with the domestic economy (by enhancing market access). It is important, in this regard, to note that the kinds of barriers to intra-sectoral mobility discussed earlier are impediments not only to the development of the informal sector narrowly construed, but to the fuller integration of the formal and informal spheres of the economy. Identifying and removing these barriers becomes a process, at the same time, of economic inclusion, deepening and widening.

To return to an earlier observation, by way of wrapping up the argument: improving employment opportunities in Ghana and across Africa is a development challenge, one that requires a variety of specific policy interventions the precise nature of which depends on the structure of employment extant in each country, and the particulars of the institutional setting. Informal employment must be included in a broad-based strategy for economic development and poverty reduction, but with the ultimate objective of transforming these employment arrangements from their marginalized state into the core arrangements that characterize formal, high-productivity, employment. It is only with such an inclusive, employment-centred approach to economic development, we believe, that Ghana can lay the foundation for an egalitarian, employment-centred economic growth and transformation strategy, and for the chance to make real headway in the fight against mass poverty.

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***APPENDIX A***