



Towards Addressing the **Economic and Public Finance** Challenges to AfCFTA Implementation

Policy Brief

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This policy brief seeks to highlight some salient ideas of mitigating key economic and public finance challenges and threats to the implementation of the AfCFTA. Its production is part of the EU-OACPS TradeCom II Capacity Building Project implementation in COMESA through the Enhancing COMESA Capacity in Trade Policy Analysis, Research and Training for Deeper Regional Integration and Participating in the Global Economy Project.

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Introduction

The African Continental Free Trade Area (AfCFTA) is a flagship initiative of the African Union's Agenda 2063. It is part of the blueprint for attaining inclusive and sustainable development across the African continent over the next five decades. The Agreement establishing the AfCFTA covers trade in goods, trade in services, investment, intellectual property rights and competition policy (AUC, 2018). As efforts to scale up the implementation of the AfCFTA have gained momentum, many key stakeholders and independent observers have raised some concerns. For instance, the 12th General Assembly of the Union of African Shipper' Council (UASC)¹ international conference of 20-21 April 2021 in DR Congo sought insights and ideas on: (i) advantages and opportunities of the implementation of the AfCFTA; (ii) challenges and threats raised by the implementation of the AfCFTA on the economies and public finances of African countries; (iii) African transport systems facing the imperative of satisfactory implementation of the AfCFTA; and (iv) role and contribution of the African Shippers' Councils in the implementation of the AfCFTA.

Drawing from the issues identified at the UASC conference, this policy brief seeks to highlight some salient ideas of mitigating key economic and public finance challenges and threats to the implementation of the AfCFTA. The policy brief therefore sought to:

- a) Review the key trade performance, productive capacity, and public finance challenges to AfCFTA implementation.
- b) Explore the interface/nexus between the AfCFTA trade liberalization activities and the wider continental economic policy issues.
- c) Propose policy measures for mitigating the key challenges and risk to AfCFTA implementation.

Economic and Public Finance Challenges and Threats for the AfCFTA

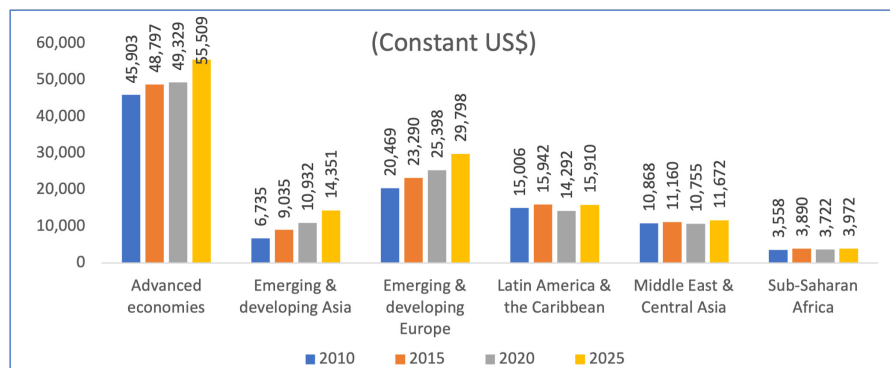
It is worthwhile to review the key economic and public finance challenges and threats for African economies as they seek to implement the AfCFTA. This is critical towards establishing the appropriate mitigation measures for the AfCFTA implementation challenges and threats.

Economic Size Challenges

Taking sub-Saharan Africa as a proxy for the African continent, the size of sub-Saharan Africa's population-adjusted economic activity – measured in real (or constant) Gross Domestic Product (GDP) per capita terms – offers insights into the growth-related economic challenges for Africa's implementation of the AfCFTA.

Sub-Saharan Africa has the smallest real per capita GDP of any developmental regional configuration in the world. Per capita real GDP increased marginally from US\$3,558 per person per year in 2010 to US\$3,722 per capita per annum in 2020, and was projects to increase slightly to US\$3,972 per capita per year by 2025 (Figure 1). On the other side of the spectrum, real per capita incomes in advanced economies were US\$45,903 per person per year in 2010 (13 times larger than in sub-Saharan Africa) and increased to US\$49,329 per capita per year in 2020 and were expected to increase to US\$55.509 per capita by 2025.

Figure 1: Real per capita GDP



Source: Constructed from IMF (2021)² database

From the forgoing, a potential challenge that sub-Saharan African and by extension, Africa may face in implementing the AfCFTA relates to the relatively low robustness of the continental market in terms of buying power or average incomes. That is, the large continental market of about 1.3 billion people currently will, other things being equal, most likely result in low effective demand for goods and services within the AfCFTA, constrained by the relatively lower per capita incomes.

The silver lining is that sub-Saharan Africa is projected to experience the second

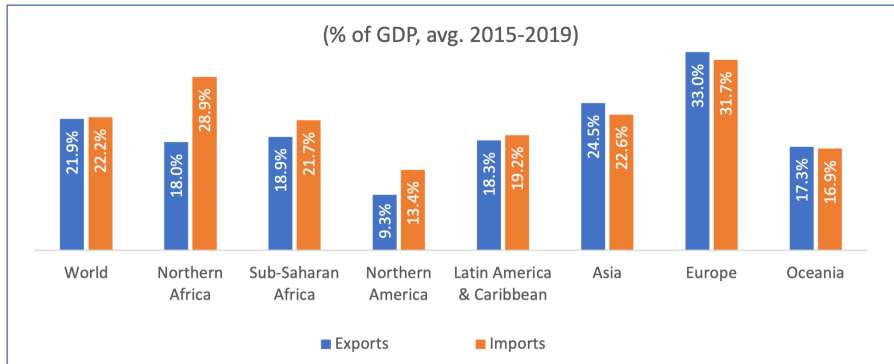
highest real GDP growth recovery after the Asia emerging and developing economies; albeit from the lowest real GDP base in the world. It is expected that the sub-region's GDP growth rate will have rebounded to 4.2 percent by 2025 (IMF, 2021).

Trade Openness and Global Trade Shares

Implementation of the AfCFTA will also depend on Africa's receptiveness or openness to trade (measured base on two indicators: (i) exports as a percentage of GDP; and (ii) imports as a percentage of GDP) and its performance in terms of its trade (exports and imports separately) as a share (or percentage) of total global trade (exports and imports separately) particularly compared to the trade shares of other territories or regions.

Taking a recent historical perspective, generally, sub-Saharan Africa and Northern Africa's *trade openness* are somewhat comparable to world averages. The ratios of export openness in sub-Saharan Africa and Northern Africa were 18.9 percent of GDP and 18.0 percent of GDP respectively, over 2015-2019 compared to a world average export openness of 21.9 percent of GDP over the same period (Figure 2). On the other hand, over the same period, the ratios of import openness were 21.7 percent of GDP and 28.9 percent of GDP for sub-Saharan Africa and Northern Africa, respectively; in contrast, the world average import openness ratio was 22.2 percent of GDP.

Figure 2: Trade openness globally



Source: Constructed from UNCATD (2021)³ database

In terms of trade performance measured as trade shares, Northern Africa and sub-Saharan Africa's trade (exports + imports) shares were tiny parts of world trade over

2015-2019. Northern Africa's export and import shares of world exports and imports were 0.7 and 1.1 percent per year on average, respectively (UNCTAD, 2021). Sub-Saharan Africa, being larger economically, demographically, and geographically, fared slightly better, with export and import shares accounting for 1.7 and 2.0 percent of world exports and imports per annum on average, respectively during 2015-2019. Across the board, all export and import shares in Northern Africa and sub-Saharan Africa declined marginally during COVID-19 in 2020.

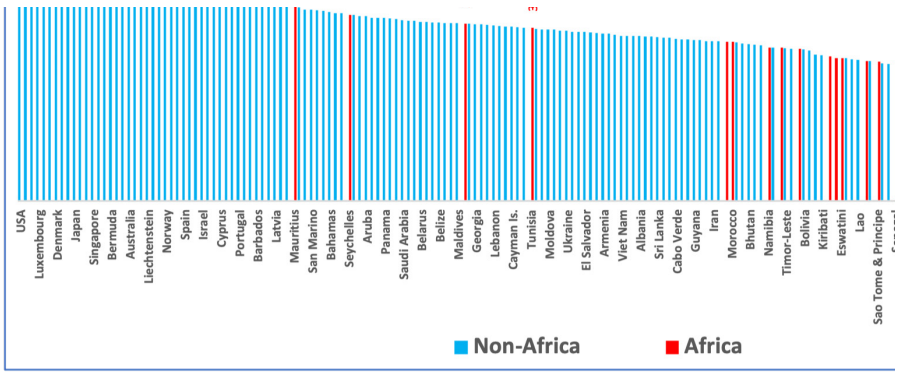
Africa remains quite marginalized in terms of both its export contribution to world exports and import demand out of global imports. Notwithstanding any underlying historical root causes (such as colonialism), the main contemporary sources of Africa's current state of significant trade marginalization in the world are twofold, namely: low domestic productive capacities, and, resultantly, low export sophistication. These two issues are elaborated in the ensuing sub-sections.

Domestic Productive Capacity and Export Sophistication

Domestic productive capacity is the capacity to produce goods and services efficiently and effectively, for domestic consumption and/or exports, based a combination of the availability of the right factor endowments (human, natural and formed capital), techniques and technologies. The United Nations Conference on Trade and Development (UNCTAD) has developed and publishes an overall Productive Capacity Index (PCI) (UNCTAD, 2021) for 195 world economies. The PCI is formulated as a composite of eight sub-indexes measuring capacities in the following areas: private sector; institutions; human capital; natural capital; energy; structural change; transport; and ITC. The overall PCI and the sub-indexes all range from a conceptual minimum of 0 (theoretically depicting zero productive capacity in the respective economy) and a maximum of 100 (highest productive capacity feasible).

Figure 3 presents the overall PCI for 2018 for all 195 economies of the world, which are captured by UNCTAD. The main message in Figure 5 is that compared to non-African economies, Africa has relatively low overall productive capacities, with only Mauritius – with an index score of 37.4 and ranked 46th out of 195 countries - making it onto the list of top-50 highest productive capacity economies in the world. The vast majority of African countries were at the tail-end of the PCI. In fact, 17 out of the bottom 20 economies in terms of productive capacities were African countries.

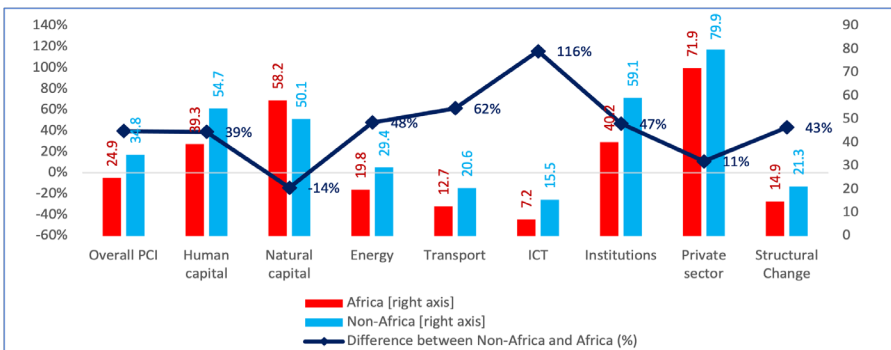
Figure 3: Productive capacities index (PCI): overall



Source: Constructed from UNCATD (2021) database

The overall PCI was decomposed into its eight constituent sub-indexes and the simple (unweighted) average sub-index was computed for Africa and Non-Africa. Figure 4 presents the results, which underscores the relatively low productive capacities in Africa compared to the rest of the world. In 2018, Africa was only ahead of non-Africa in terms of natural capital productive capacities; on all other productive capacity counts Africa was behind the rest of the world. The largest gaps between non-Africa and Africa in sub-index score was in ICT where the non-Africa score was 116 percent larger than that of Africa. This was followed by transport (62 percent higher in non-Africa), energy (48 percent) and institutions (47 percent).

Figure 4: Decomposition of PCI by broad region



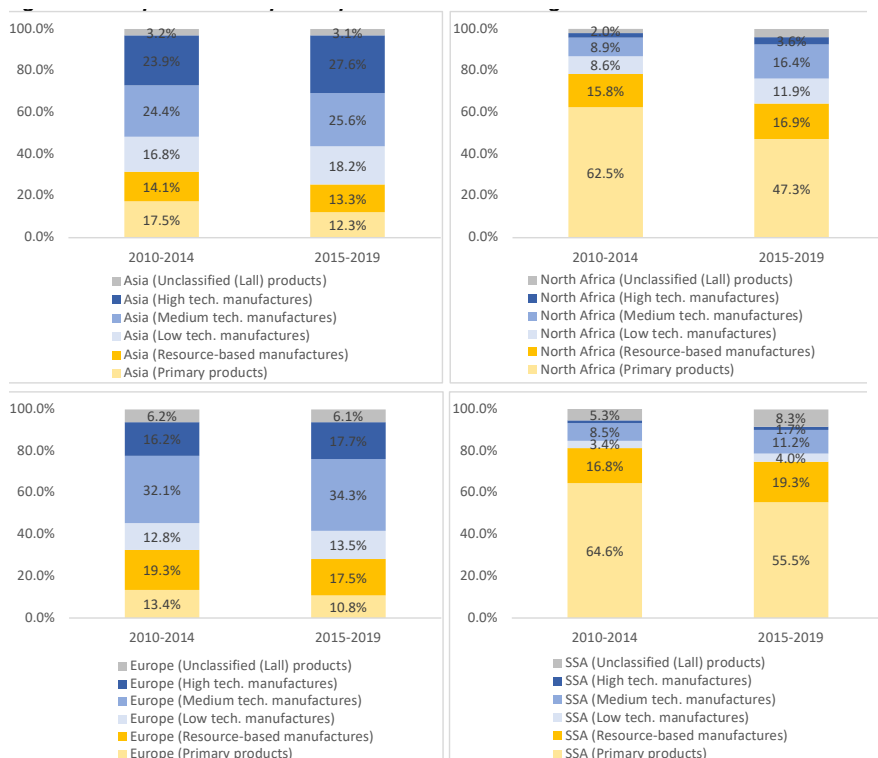
Source: Constructed from UNCATD (2021) database

Arguably, productive capacities are important in explaining the export technological content and therefore sophistication of any country or region. The Lall classification categorizes commodity trade (exports and imports) into 11 groups⁴ according to the amount of technological content infused into them during production. In a sense, the Lall classification reflect the technological sophistication of exports (and imports) based on the underlying state of productive capacity; broadly the higher level of technological content in a commodity, the higher its value added and the greater its global appeal and demand.

“Productive capacities are important in explaining the export technological content and therefore sophistication of any country or region”

For analytical tractability, this policy brief aggregated the Lall classification into six groups of exports, namely: (i) Primary products; (ii) Resource-based manufactures; (iii) Low tech. manufactures; (iv) Medium tech. manufactures; (v) High tech. manufactures; and (vi) Unclassified (Lall) products. This was done for all regions designated in the UNCTADStats database, for the period 2010-2019, which was further split into 2010-2014 and 2015-2019 to allow for comparative static analysis. The results for four regions – Asia, Europe, North Africa and sub-Saharan Africa (SSA) – are presented in Figure 5.

Figure 5: Comparison of export sophistication in four regions



Source: Constructed from UNCTAD (2021) database

In summary, during 2010-2014, 65.2 percent of total Asia's exports per year on average comprised of low tech., medium tech. and high tech. manufactures combined, a proportion which increased to 71.3 percent of total exports per year over 2015-2019. Similarly, the composition of European exports changed, with the proportion of low tech., medium tech. and high tech. manufactures combined in total exports increasing from 61.1 percent over 2010-2014 to 65.6 percent over 2015-2019. The proportion of primary products and resource-based manufactures combined was relatively low (less than 35 percent of total exports) in both Asia and Europe and in both time periods.

In striking contrast, in both North African and sub-Saharan Africa, the combination of low tech., medium tech. and high tech. manufactures was, respectively, 31.9 and 16.8 percent of total exports per year on average during 2015-2019. Granted, some

improvements were observed during the later period compared to the 2010-2014 period. Nonetheless, the Africa's low export sophistication was significantly lower than in Asia and Europe. Although the association between export sophistication and domestic productive capacities is an empirical issue (that could be an important area of further study), from the forgoing, it is quite plausible that the lower export sophistication in North Africa and especially sub-Saharan Africa was due to relatively weaker productive capacity in those regions.

From the forgoing, Africa will need to significantly upgrade and build its productive capacity if it is to enhance its export sophistication. The continent will need an industrialization and sophistication strategy *behind the border* that effectively complements the trade facilitation efforts *at the border* and market consolidation and market access efforts *beyond the border*. The design and implementation of the AfCFTA now must determine to what extent these *behind the border*, *at the border* and *beyond the border* issues have been paid attention to and balanced. Neglecting the *behind the border* issue of a robust industrialization strategy may prove challenging or even detrimental to the implementation of the AfCFTA.

Challenges and Threats to Public Finances in Africa

The World Bank (2019) study on The African Continental Free Trade Area: Economic and Distributional Effects found that AfCFTA's short-term impact on tax revenues is small for most countries. For instance, tariff revenues would decline by less than 1.5 percent for most countries except for the Democratic Republic of Congo (3.4 percent), The Gambia (2.7 percent), the Republic of Congo (2.1 percent), and Zambia (1.6 percent)⁵. The limited tax revenue impacts were explained by two factors, namely: the fact that imports from African countries account for a small share of tariff revenues for most countries (less than 10 percent on average). This was complimented by the shielding from liberalization with exclusion lists because these revenues are highly concentrated in a few tariff lines (1 percent of tariff lines account for more than three-quarters of intra-Africa tariff revenues in almost all African countries) (ibid). However, the study did not proceed to discuss the potential policy actions that African countries might take to deal with the fiscal policy challenges emanating from the implementation of the AfCFTA.

So far, two fundamental issues have been raised, namely: the need to devise job strategies that foster high-earner employment avenues; and the need to establish

industrialization and sophistication strategies that build Africa's domestic productive capacities. Both aspects will require considerable investments. Most proponents of Developmental State theory in practice argue that African government should play the most critical role in nudging their economies to make the right investments in industrialization and job creation strategies. In this regard, the role of the public sector in resource mobilization and public investment expenditure will be crucial during the implementation of the AfCFTA, to ultimately ensure the generation of effective African demand for African goods and services as well as commensurate responses in terms of increased production, supply and intra-African exports.

Inherently, constraints on resource mobilization exist in Africa, with a huge bearing on government expenditures, including on strategic aspects like job creation, building productive capacity and industrialization. In 2020, total government spending as a proportion of GDP was lowest in sub-Saharan Africa among all the regions in the world, at 23 percent (IMF, 2021). This was projected to decline even further to 20 percent of GDP by 2025, further widening the African gap with other regions. The COVID-19 pandemic, which emerged in March 2020, has raised considerable new financing needs for supporting health, socio-economic, trade and trade facilitation response measures. This has exacerbated the already dire public finance challenges faced by most economies in Africa. These economies must now think of innovative ways for financing the fight against the new scourge amidst a plethora of competing demands for financial resources.

Going forward, unaddressed, the expenditure constraints for Africa could restrict the continent's ability to spur structural transformation as an avenue for enhancing AfCFTA implementation. "Massive funds are needed to support sustainable development across the world, and in African countries in particular. To raise such amounts, Africa countries will have to step up the mobilization and efficiency of both standard and innovative financing sources. Specifically, domestic resource mobilization, i.e., increasing government revenues through taxation and other non-debt income sources is essential in allowing countries to own and flexibly chart policies that address their specific development challenges while mitigating the risks of debt distress" (Boly, 2020, p.1⁶). In other words, robust and innovative resource mobilization strategies coupled with rational public expenditure frameworks will be required. However, this should be done in such a way that taxation efforts do not increase inequality in the economies but promote a fair distribution of incomes.

Mitigating Challenges and Threats to AfCFTA Implementation

The foregoing narrative basically unravels the structural weaknesses of African economies, which have the potential to limit achievement of the good aspirations and intentions of the AfCFTA. Thus, this calls for urgent practical policy actions to deal with the diverse challenges associated with AfCFTA implementation.

In the case of economic size, African economies need to seriously consider formulating and implementing effective strategies for creating high-earning jobs that put increasingly more money, in real terms, in people's pockets and enable them to increase their effective demand, thus ultimately prompting increased production and intra-Africa trade.

With respect to trade, while the levels of trade openness in Africa are generally comparable with and often higher than trade openness outcomes elsewhere in the globe, most economies on the continent exhibit low levels of domestic productive capacity and export sophistication.

To address the low domestic productive capacities among most economies, African countries will have to increase investment in enhancing and expanding ICT services, transport and logistics, energy supply, and the performance of public institutions. As Africa upgrades and builds these specific elements of productive capacity, it will also do well to pursue deliberate measures that enhance its export sophistication. The continent should aim to industrialize and also set in motion market access strategies and measures through which the *behind the border* export sophistication measures can be realized. These will include trade facilitation efforts *at the border* and market penetration measures that effectively and efficiently take products *beyond the border* to regional and international markets. As earlier alluded, to design and implementation of the AfCFTA will be decisive in determining the extent and quality of these *behind the border*, *at the border* and *beyond the border* measures and their ability to foster continental free trade.

In dealing with challenges and threats to public finances in Africa, particularly those related to budgetary and expenditure constraints on public investments for building productive capacities, enhancing export sophistication, creating job and industrializing, economies on the continent should seek to enhance resource mobilization through harnessing both traditional and innovative development financing options.

On the domestic front, resource mobilization through increased government tax and non-tax revenue measures will be critical in offering countries with much needed flexibility in setting public expenditure priorities, including those for mitigating adverse effects of the COVID-19 pandemic on health, socio-economic and trade.

Conclusion and Policy Implications

As Africa gains momentum in the implementation of the AfCFTA, the continent can expect a number of economic, public finances, and other challenges. These challenges are by no means insurmountable. Solutions for harnessing the potential benefits of the AfCFTA as well as those for coping with the anticipated AfCFTA implementation challenges and the mitigation of its threats have been identified in this policy brief. On that basis, the following policy suggestion could be considered by African countries:

- Establish high-income-earner job creation strategies as a key behind-the-border demand-side stimulus components to foster productivity and growth in African economies;
- Establish industrialization and sophistication strategies as a complementary behind-the-border supply constraint alleviator, to improve the productive capacity, production and export competitiveness and sophistication among African economies;
- Establish domestic resource mobilization strategies and public expenditure frameworks, to harness and rationalize public finances in African economies;
- Speedily conclude the design aspects and negotiations of regulations and instruments for the AfCFTA, establishing a firm basis for the successful implementation of the continental arrangement; and
- Scale up efforts to explore and establish African homegrown trade and trade facilitation (including digital trade) solutions to mitigate the COVID-19 pandemic.

References and Notes:

¹The organization started in May 1975, Abidjan (Côte d'Ivoire), as Ministerial Conference of West and Central African States on Maritime Transport (MINCONMAR), and has over the years transformed itself till 1999 when it became a Union of African Shipper' Council (UASC). It seeks to provide an effective inter-governmental sub-regional platform for sectoral cooperation in the field of maritime/transit transport in a maritime region where countries share common problems of demand and supply for shipping services and associated safety and environmental protection threats.

²IMF (2021) "World Economic Outlook (WEO) Database", International Monetary Fund (IMF), April, www.imf.org [accessed July 2021]

³UNCTAD (2021) "UNCTADStat database", the United Nations Commission for Trade and Development (UNCTAD), <https://unctadstat.unctad.org/EN/> [Accessed August 2021]

⁴The Lall Classification product groups are: (i) Primary products; (ii) Resource-based manufactures: agro-based; (iii) Resource-based manufactures: other; (iv) Low technology manufactures: textile, garment and footwear; (v) Low technology manufactures: other products; (vi) Medium technology manufactures: automotive; (vii) Medium technology manufactures: process; (viii) Medium technology manufactures: engineering; (ix) High technology manufactures: electronic and electrical; (x) High technology manufactures: other; and (xi) Unclassified products. UNCTADStats website: <https://unstats.un.org/unsd/tradekb/Knowledgebase/50658/Technological-classification-of-exports-by-SITC>

⁵In fact, the analysis found that for some countries, total tax revenues would seldom decline by more than 0.3 percent, except for Djibouti (0.5 percent), the Republic of Congo (0.6 percent), The Gambia (0.9 percent), and the Democratic Republic of Congo (0.9 percent).

⁶Boly, A., M.W. Nandelenga and J. Oduor (2020) "Mobilizing Domestic Resource in Africa for Inclusive Growth"; *Africa Economic Brief, Volume 11, Issue 3*; African Development Bank (AfDB); June. World Bank. 2020. The African Continental Free Trade Area: Economic and Distributional Effects. Washington, DC: World Bank. doi:10.1596/978-1-4648-1559-1. License: Creative Commons Attribution CC BY 3.0 IGO.



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