PRIVATE SECTOR DEVELOPMENT AND ECONOMIC DIVERSIFICATION:
EVIDENCE FROM WEST AFRICAN STATES

BY

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ABSTRACT

The likely gains from economic diversification in developing countries have been well discussed in the literature. The general consensus is that a diverse economy, based on a wide range of profitable sectors instead of one or a few, is key to building sustainable development and providing new opportunities for growth, employment and development. In fact, it is accepted that economic diversity and sustainable development are linked. Economic diversification is an integral part of economic development and also a consequence of economic development. In addition, economic volatility of a nation can be reduced with increased real sector performance through economic diversification, thereby improving economic stability and job creation. Most West African countries are mono-cultural and dependent on commodity exports with all its attendant vulnerabilities. Despite efforts towards achieving a more diversified economy, countries in the sub-region have been hampered by a sea of challenges, prominent among which include limited market access, insecurity and political instability, rent seeking behavior, inadequate technological capabilities, etc. This paper seeks to investigate empirically the link between private sector development and economic diversification. Panel Data analysis was employed with data drawn from West African countries over the period 1980 to 2012. The findings from this study showed that economic diversification depends on the level of private sector development, quality of infrastructure and other non-economic factors such as quality of governance and political stability.

Keywords: Diversification, Private Sector Development, Infrastructure, Panel Analysis, West Africa

JEL CLASSIFICATION: C23, R58, H54

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1.0 INTRODUCTION
The relative economic stability of a country or region is frequently linked to the extent of diversification of the sources of income and employment. A country or region that derive its economic sustenance from one or few industries is considered to be more exposed to the possibility of wider fluctuations while another or others with a wide variety of sources of income tend to be relatively sheltered from extreme vicissitudes of cyclical behaviour.

Although the economies of West African countries under the aegis of Economic Community of West African States (ECOWAS) have shown remarkable progress in the area of economic growth the past decade, this has not translated into sustainable improvement in the welfare of the people as unemployment, inadequate infrastructure and poverty issues remain major challenges confronting successive governments and policymakers in the sub-region. As a consequence, new wave of serious security challenge with international collaboration has arisen due to these debilitating factors confronting the people. As shown in table 1, West African Monetary Zone (WAMZ) countries like Nigeria, Ghana, Liberia, and Sierra Leone recorded impressive growth except The Gambia. On the other hand, West African Economic and Monetary Union (UEMOA) countries, with few cases of negative growth (Niger 2004 and 2007; Guinea 2009, Mali and Guinea-Bissau 2012), also showed some form of economic growth. As indicated in figure 1, African economic growth average was higher than ECOWAS average from 2004 to 2007 but remain tied in 2008 and 2009 at 5.4 percent and 3.1 percent respectively. Thereafter, ECOWAS average rose above African average except in 2012 when it was 5.75 percent compared to African average of 6.6 percent.

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1 It has been argued by some that part of the security challenges confronting the sub-region, for example, the Boko Haram insurgency in Northeast part of Nigeria, is traceable to extreme poverty in the region.
A major characteristic of these economies is that agriculture is their mainstay and most of them depend on primary products for export. Indeed, the prices of these primary commodities are exogenously determined by international price movements. Thus, these economies are vulnerable to happenings in the economies of their trading partners and quite often, they constitute the source of exogenous shocks through which adverse economic consequences are imported from outside with dire consequences for sustainable growth and development. Accordingly, within the context of resource-rich countries, particularly in the developing world, economic diversification may help tackle a number of economic issues. In the first instance, it is expected to counteract the “Dutch Disease” effects of natural resources. Secondly, efficient public finance management maybe hampered by dependence on few primary commodities especially minerals since they are price-volatile and exporting them, may transmit volatility into public finance and national income. It therefore implies that diversifying away from such dependence may help to stabilize public finance. Also, some resource-rich countries face depletion issue and economic diversification is one of few strategies available to ensure economic sustainability (Auty, 1988, 1993; Humphreys, Sachs and Stiglitz, 2007; Gelb, 2010).

However, a successful diversification of the economy would require the collaboration of the public and private sectors of the economy. In particular, the critical role of the private sector as the engine of growth presupposes that adequate infrastructure provision and investment should be provided for the private sector to actually perform its critical role of being the engine of growth and stability.

Following this introduction is section two which deals with a review of the evolution and diversity of the ECOWAS economy. Section three focuses on review of related literature on the
subject matter while the issue of data and methodology is discussed in section four. Empirical results and interpretation are presented in section five. The paper is concluded in section six.

2.0 OVERVIEW OF THE WEST AFRICAN ECONOMY

The level of diversification of the economies of ECOWAS countries is depicted in table 2. It is remarkable to observe that Nigeria, a key economy in the sub-region, is one of the least diversified economies. This is not unconnected with the fact that Nigeria is mainly dependent on oil, implying that there is urgent need for the country to diversify her economy away from a single commodity. Using diversification index (table 2) among the ECOWAS countries, it is obvious that Nigeria is not the only economy in the sub-region that is highly concentrated on one or few commodity export. Only Cape Verde and Senegal show high level of economic diversification in comparative terms. Other countries with moderate level of diversification are Cote d’Ivoire, Benin, Togo, The Gambia and Sierra Leone. There are also some countries whose diversification outlook is not stable. For instance Ghana’s diversification index was higher than African index in 2007, 2008 and 2011 while it fell below in 2009 and 2010. A similar trend was observed for Liberia. Her diversification index was below African index in 2007 and 2009 but higher in 2008, 2010 and 2011. In the case of Guinea, the diversification index was below African index in 2007-1009 but higher in 2010 and 2011. The other remaining countries namely Nigeria, Mali, Niger except in 2008, Burkina Faso, Guinea Bissau are considered least diversified based on the fact that they fall below the African index (see figure 2). The analysis has shown that less than 20 percent of the sub-regional economy is relatively diversified. Thus, there is urgent need for policy to focus on increasing the degree of diversification of the sub-region’s economy.
Figure 1: ECOWAS and Africa Real GDP Growth Rates

![Real GDP Growth Rates, 2004-2013](image)

Figure 2: Diversification Index of ECOWAS Countries and Africa, 2007-2011

![Diversification Index of ECOWAS Countries, Africa](image)
In both medium and the long run it is expected that the private sector would play a leading role in diversifying the economy of the sub-region. It is expected that the sub-region has the resilience to accommodate innovation and entrepreneurship. This can be attested to by the private sector driven evolution of the entertainment industry and the attendant success thus far in the sub-region especially in Nigeria. The entertainment industry in Nigeria is a vibrant and very vital sector of the economy. It is said to be the second highest employer of labour in the country, apart from the civil service. The industry is mainly made up of young and creative individuals and comprises mainly music and movie aspects. Also, the tourism sector which also has a strong private sector component is a major foreign exchange earner in The Gambia. Thus, hospitality sub-sector like hotels, recreational centres and event managements are also part of the private sector initiative in diversifying the economy of the sub-region. The impact of the entertainment industry in Nigeria, especially the film production component, is felt beyond the shores of the country extending to other African countries, Europe, America and other parts of the world. Thus, it has helped to broaden the revenue base for the economy as well as providing employment for a chunk of the populace. This is not to say that all is well with the entertainment industry in the country as it is confronted with myriads of problems and requires government support.

However, in the short-run, the role of government intervention is crucial. Thus, it is commendable that the federal government of Nigeria has intervened positively with a bailout donation of the sum of two hundred million US Dollars ($200m) to develop the entertainment subsector. It is, however, argued that government need to do more to help the industry develop
on a sustainable level by coming up with legislations to strengthen and regulate the entertainment industry; with a view to checking piracy, attracting foreign participation and investment in the industry, training and developing capacity, providing the necessary infrastructure like viewing centres and distribution outlets across the country. The success of the entertainment industry is one clear case of the ability of the economy to absorb a lot more innovation with the potential of being exported to other countries.

In view of the long term strategy of the diversification programme, the private sector is expected to take the centre stage in production activities with little or no government protection and support overtime. Investment in research and development, technological advancement would form the fulcrum of these activities. Empirical studies have shown that social rates of return to Research and development (R&D) are substantially above private rates of return and this provides the main justification for government subsidies to R&D. The decision of firms to undertake R&D are based on their private return to R&D which is lower than the social rate of return and thereby creating under-investment in R&D. Government has continued to play a leading role in R&D through innovative activity in firms by direct spending on education such as universities or business, investing in human capital formation, patent protection laws, and capacity building. Other indirect policies of R&D are competitive policy and regulation especially within high R&D industries like pharmaceuticals and telecommunications.

Thus, the broad approach to developing the private sector or the private sector development strategy revolves around the engagement of the government by the organized private sector (OPS). In addition to the organised private sector’s traditional role of advocacy and lobbying government to reduce the costs of doing business for the private sector, the OPS will also be
engaged in internal restructuring and capacity building to develop resource and manage projects that grow the private sector. Further, the OPS will implement its part of the diversification process of private sector objectives and citizens economic empowerment through sectoral development and business linkages where the strategic sector goals and results are clearly spelt out.

**Table 1: REAL GDP GROWTH RATES, 2004-2011**

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<tr>
<th></th>
<th>2004</th>
<th>2005</th>
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Table 2: Diversification Index for ECOWAS Countries and Africa, 2007-2011

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Source: African Economic Outlook, 2012
3.0 REVIEW OF LITERATURE

The debate on economic diversification is not a recent phenomenon in economic literature. It dates back to the work of MacLaughlin in the 1930s when he sought to explain the economic cycles in American cities by the degree of concentration of economic activities. Rapid development of these works occurred in the 1940s and 1950s and remained the dominant paradigm on growth and development up and until the end of the 1970s. These earlier works on diversification constituted the starting point for the theoretical reflection on the diversification of developing economies. Works on diversification have equally demonstrated that it plays an essential role in controlling economic vagaries, particularly fluctuation in prices of raw materials for developing countries. It would be recalled that Kuznets (1966) and Rostow (1960) made structural transformation of economies and their diversification an indispensable passage for growth and development. Early works on diversification placed emphasis on a series of elements considered as essential in strengthening the productive fabric of developing countries. The first element was linked to investment capacity or accumulation by countries (Lewis, 1954). A large consensus has been established by the literature on the need to release significant resources for investment in order to diversify economic structures and strengthen the transformation of traditional economies.

The first generation of works on diversification was also at the origin of an important debate on sectoral priorities. Indeed, if some quarters defended the idea of balanced growth, many more emphasized the structural nature of some sectors that could play a cumulative role for the rest of the economy (Hirschman, 1958). Similar to capital accumulation and sectoral policies, the first works on diversification had equally insisted on the role of industry. A consensus was
established around industrial development and on its place in the transformation of traditional economies and the modernization of productive structures of developing countries (Gerschenkron, 1962).

The notion of diversification was at the centre of early works on economic development in areas of development strategies, import-substitution strategies implemented by most developing countries in the 1960’s and 1970’s. Furthermore, these works generated a series of analytical work to define tools for measuring progress towards diversification such as input-output matrices.

Finally, these works sought to identify factors at the centre of the diversification process and put emphasis on investment, sectoral policies, and particularly industrial development. However, the crisis that began towards the end of the 1970’s and the failure of import-substitution strategies led to the marginalization of the debate on diversification. In its place, macroeconomic stabilization and international specialization became the major themes of reflection and development policies. Nonetheless, there has been a dramatic resurgence of the debate on diversification.

Many factors have been adduced for the resurgence of the debate on diversification. In the first instance, there is the issue of weak economic performance in a great number of regions and countries, particularly in Africa. Furthermore, African countries did not benefit much from the trade preferences accorded to them by a great number of developed countries, and various studies undertaken on the benefits likely to be derived by African countries from the Doha Round show that the benefits will be limited (ECA, 2004). Several studies emphasize supply
constraints and lack of diversification of African economies as reasons for Africa’s low benefits from international openings.

The resurgence of the debate on diversification in economic literature a few years ago is responsible for these concerns. This new literature sought to come into the historical continuity of the open tradition in the debate on diversification. The second direction taken by the theoretical renewal concerns the determination of conditions for success in the diversification of productive structures of economies. The new research has an undisputed advantage compared to studies carried out in the 1960’s and 1970’s as it can draw on the differentiated experiences of developing countries during the last three decades (Gutierrez de Pineres and Ferrantino, 1997).

Recent literature has identified several factors to explain the diversification process generally and in Africa in particular. The first series of factors is linked to the level of income in an economy. It has been shown by the works of Imbs and Waciarg (2003) that diversification has an inverted U-shaped relationship with the level of development. Thus, diversification increases with economic development, measured by per capita revenue, then decreases with a turning point. In particular, this study put the emphasis on macro-economic aspects. Barthélemy (2004) confirmed this argument and emphasized the importance of healthy macro-economic management in the success of diversification efforts.

Another major factor determining diversification is investment, which contributes highly to the growth dynamics and to increasing productivity of new economic sectors. From this perspective, the historical experience of developing countries show that a rise in investments always translates into increased diversification of the productive capacity.
Apart from investment, the role of industrial policy is crucial in the diversification effort with industrial development constituting a major renewal of sectoral policies in the debate. Today, undoubtedly, industrialization must be at the heart of new diversification strategies in order to improve international integration of developing countries. Historical experience shows the role of this sector in growth dynamics and in improving competition of national economies. Industrial development plays a major role in the diversification of developing countries’ economies and in improving international competition. Different studies have shown that other factors contribute in the diversification of the economic fabric including new technologies and opening up to foreign markets. These different works as well as historical experience emphasize the link at the origin of the diversification process and the improvement of international competition. Indeed, the countries which have succeeded in improving their position are those that maintained during the last three decades a high investment rate particularly in the industrial sector. This investment enabled them to access new technologies and improve productivity and competitiveness of their economies. These links have enabled these countries to increase their exports and improve their international integration. In addition to industrial policy, trade policy also plays prominent role in the diversification of economies (ECA, 2004). However, trade policies in Africa lack dynamism and give constant and linear support to some industrial activities that are not favourable to the development of competition in African economies (Hammouda, et al 2006).

A number of authors have sought to explain the connection between diversification and growth. In particular, the recent works on endogenous growth stresses the importance of diversification. Thus, the Romer model introduced a beneficial effect of diversification which is expressed through the availability of inputs within an economy and can contribute to increasing labour productivity and human capital (Berthelémy and Söderling, 2001). It is also noted that
diversification can equally contribute to growth by increasing the number of sectors and accordingly, investment opportunities and reducing investors’ risks (Acemoglu and Zilibotti, 1997). Among different authors, diversification plays a major role in economic growth through the stabilization of export revenues. Indeed, specialization in only one product was always considered a source for volatility and great instability. Their works derived inspiration from research on financial portfolios and the different diversification strategies in order to reduce investors’ risks. At this stage, different works have shown the correlation between diversification and stability of export revenues and accordingly the sustainability of growth dynamics (Stanley and Bunnag, 2001).

Generally, the literature review has brought about the identification of a series of variables that influence the diversification process, which are grouped as five categories of variables. The first one pertains to the physical factors that are investment, growth and human capital. The second category is connected to policy decisions and particularly the impact of trade and industrial policies in strengthening the industrial fabric and in the diversification process. The third category deals with macro-economic variables such as exchange rates, inflation and big macro-economic imbalances. The fourth category touches upon institutional variables such as governance, conflicts and investment environment. Finally, the last variable concerns the issue of market access, which could play an important role in diversification policies especially through the elimination of tariff peaks and tariff escalation for developing economies’ exports to developed countries.

Hammouda, et al (2006) though limited by poor quality of data was a bold attempt to fully model the determination of economic diversification in the entire African continent. The result for West Africa was particularly worrisome. Apart from the coefficients of the physical variables such as
investment and per capita income appearing with wrong signs, most of the important variables
were not significant statistically. The policy variables such as trade openness and industrial
production were also with the wrong signs. Hence, serious policy implications could not be
drawn from this study. However, it should be noted that the study had serious limitation as only
four countries were used to generalize for West Africa.

4.0 DATA AND METHODOLOGY
As demonstrated in the literature review, economic diversification is an endogenous process.
Both the rate and level of economic diversification of a country is determined by both economic
and non-economic factors. The theoretical and empirical literature have identified some of the
determinants of economic diversification to include the level of gross investment, gross domestic
product per capita, industrial production index, level of openness to trade, exchange rate policy,
domestic fiscal balance, quality of governance, political stability among others. The objective of
the present study is to follow up on the pioneering effort of Hammouda, et al (2006) by assessing
the impact of the private sector development in particular on economic diversification of the
West African countries. Accordingly, we specify the following generic model:

\[ DIV = f(PRI, X_i) \]  \hspace{1cm} (1)

Where DIV = Diversification index
PR = Private Sector development
\( X_i \) = a set of control variables

There is a strong contention built around the Keynesian notion that government policies are more
effective in the short-run. In the long-run, the private sector must be a key player. Hence,
government should provide within the short-run the necessary environment for the private sector
to innovate, invent and generate sustainable economic growth and development. Diversification therefore requires both short-run and long-run policies. In the short-run, public investment in infrastructure is paramount to encourage accumulation of private capital through private investment. Thus, in this study, private investment turns out as the proxy for private sector development. The volume of private investment serves as a rough measure of the level of private sector development. It is expected that increase in private investment would positively influence the rate of diversification of the economy.

Other determinants of economic diversification captured by $X_i$ include the level of public infrastructural development, the quality of governance, political instability measured as number of conflicts. Public infrastructure is required for economic diversification; hence the two variables are expected to be positively related. We also expect good governance to enhance the rate of economic growth and diversification. However, political instability and conflicts are detrimental to economic diversification and sustainable development in general. Thus, a negative coefficient is expected for conflict.

The estimable equation of economic diversification is therefore specified as follows:

$$DIV = \alpha_i + \beta_1 PRI + \beta_2 INFR + \beta_3 GOV + \beta_4 CONFLICT + \epsilon_{it} \ldots \ldots \ldots (2)$$

$$\beta_1 > 0, \quad \beta_2 > 0, \quad \beta_3 > 0 \text{ and } \beta_4 < 0$$

Where $DIV$, $PRI$ are as earlier defined. $GOV$ is governance quality using the Corruption Perception Index (CPI) as proxy, $CONFLICT$ is measured as the number of violent protest. $\alpha_i$ are the fixed effects for countries and $\epsilon_{it}$ are random error terms.

The model is estimated using the panel least squares method and cross-sectional regression given the fact that the number of cross section item is greater than the period.
All the variables are from the African Economic Outlook 2012 database and covered the period 2007-2012.

4.1 CROSS-SECTIONAL REGRESSION RESULTS AND INTERPRETATION

The results of the analysis are presented in tables A1 and A2 in appendix. Table A1 presents the results of the cross-sectional regression for the 15 countries of ECOWAS, using data for the period of 2011. This year was chosen because private sector investment data were not available for all countries in other years covered in the study. Inspite of this limitation, it was possible to derive strong and economically plausible results for the West African sub-region. First, the coefficient of the variable of paramount interest, private sector development was both positive and statistically significant at 5% level. This is consistent with the theoretical prediction. Other things held constant when private sector investment rises by 10%, index of economic diversification rises by 2.1 unit. Second, the effect of infrastructure is positive and significant at 5% level of statistical significance. If infrastructure improves by 10%, the index of economic diversification will rise by 1.1 unit. This confirms the theoretical prediction that improvement in the state of infrastructure can enhance the level of economic diversity.

The conflict variable is associated with a negative coefficient though not statistically significant at 5% level. This result also is in accordance with the theoretical prediction that political conflict retards the opportunity for economic diversification.

The variable representing the quality of governance appears with a negative coefficient. This is a very intriguing result as one would have expected high quality of governance to generate conducive environment for economic diversification to occur. However, this variable is not statistically significant at 5% level.
4.2 PANEL RESULTS WITH CONTROL VARIABLES:

The results of the panel least squares estimation for the control variables is presented in table A2. As shown in the table, the political conflict coefficient is still negative but statistically significant at 10% level. Political conflict is likely to hamper economic diversification. In specific terms, a 10% rise in the number of conflict is likely to cause a decline in economic diversification index equivalent to 1.6 units. The most fascinating results relates to the coefficient of the quality of governance. The variable appears with a positive and significant coefficient. From the value of the coefficient, a unit increase in the corruption perception index increase the economic diversification index by 1.45 units. So, the quality of governance has strong positive impact on the level of economic diversity. Lastly, the physical variable, the economic growth, did not have positive nor statistically significant impact on the level of economic diversity. The implication of this is that economic growth leads to more specialization rather than economic diversification in West Africa. This maybe the possible reason why the economic growth recorded in the past decade has not been able to sufficiently impact on employment and poverty reduction. Diversification would increase the employment space and create jobs as well as reduce the poverty level.

5.0 POLICY RECOMMENDATIONS AND CONCLUSION

Reliance on a single or few commodity exports, as seen among most African countries, is not a healthy development. Most economies in West Africa are highly concentrated on a single commodity export, often primary product. In this study, we have examined factors determining economic diversification in West Africa using most recent data with the intention of discovering key policy implications that can help diversify the economy of these countries. In congruent
with our ex ante expectations, the results of the econometric analysis provide some useful policy lessons for those West African countries wishing to overcome the single-commodity export syndrome and increase their level of economic diversity.

The findings show that economic diversification depends on the level of private sector development. Private sector innovation and investment are essential element of economic progress. Without strong entrepreneurial skill, innovation and efficient investment it would be difficult to make inventions and discoveries which will create jobs and enhance sustainable economic development. Providing incentive for private sector investment, therefore, becomes the major policy challenge for the government and policy-makers. Antagonistic macroeconomic policy (monetary and fiscal) could hurt economic diversification through its adverse impact on private sector development.

The findings from this study further points to the importance of non-economic factors in economic development. Apart from the economic variables, non-economic factors such as political stability and good governance appear to have strong influence on economic diversification. The marginal benefit of good governance in West Africa is quite high relative to the developed world. Reduction in the level of corruption will seriously improve the conduct of government activities and the quality of government expenditures. Policy makers should not treat the issue of corruption with levity. The campaign against corruption, lack of transparency and accountability should be intensified.

Political stability is essential to grow strong, sustainable and diversified economy. No serious investment can take place in an environment characterized by violence and anarchy. Economic diversification requires stable planning and coordination of policies to achieve. No price is too
high to purchase peace except peace itself. The impact of political instability in Mali, Cote D'Ivoire, Liberia, Sierra Leone and insecurity in Nigeria speaks volumes on the need to ensure peace and security at any cost.

Lastly, the findings support the proposition that efficient provision of infrastructural services is the basis for economic growth and diversification. Economic diversification has been hampered in most African countries by lack of infrastructure (both hard and soft). Policy makers should note that without adequate provision of basic infrastructure, the drive toward economic diversification will remain a fantasy. With the present state of weak, outdated and inefficient infrastructure, policy is needed to provide public infrastructure otherwise the quest for economic diversity will remain but a delusion.
Reference


