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Mozambique: Globalization and Domestic Policy Choices

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1. Introduction

The global economy presents important and interesting challenges for Mozambique's businesses and policymakers alike. Mozambique has a strong interest in regional and global policy processes such as those taking place in the WTO, in negotiations with the EU concerning new Economic Partnership Agreements (EPAs), and in amendments to and extensions of SADC and SACU agreements. But its influence in these international and regional arenas is very limited. Fortunately, the most important policy issues that globalization presents are domestic. And it is here that Mozambique is sovereign. While international and regional treaties and agreements place some limitations on that sovereignty, most of them limit actions that would be against Mozambique's best economic interests.

The name of the conference at which this paper is being presented— *Mozambican Business Opportunities in a Global Economy and Business Strategy and Local Economic Development* — alludes primarily to private business, but the government plays an important role in shaping the framework in which business decisions are made and in which Mozambique's dreams of economic development will or will not be realized. This paper focuses on the interface between business and policy, drawing conclusions about international trade policy especially and making observations about a wide range of complementary domestic policies.

Section 2 presents general lessons about globalization drawn from international experience. Section 3 discusses two dimensions of trade policy: international trade diplomacy, which involves negotiating and implementing international trade agreements, and the formulation of unilateral trade policies. Section 4 describes five sets of issues that arise in formulating unilateral trade policies: protection of infant industries, the value of tax incentives, the effects of and best responses to "dumping" and subsidies, the reasons for and best responses to market and policy failures, and how best to handle resources and resource rents with regard to the general economy and domestic processing industries. Section 5 suggests a domestic reform agenda for Mozambique's further integration into the global economy.

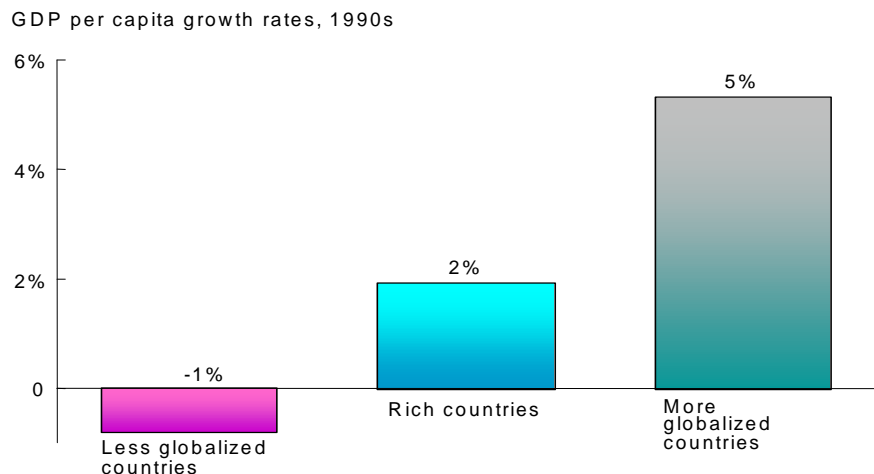
2. Lessons of Globalization

OPENNESS AND GROWTH

The goal of economic development policies is to increase incomes and reduce poverty. Growth is essential to poverty reduction—and openness is essential to growth. Low and middle-income countries that have integrated into the global economy through trade and investment have generally grown faster than richer countries; those that have not integrated have grown more slowly (Figure 2-1).¹ Isolation, especially for small economies such as Mozambique's, is not a viable policy option.

Figure 2-1

Global Convergence and Openness



Source: The World Bank

Openness has many dimensions—the level and complexity of import tariff structures, ease of customs procedures, transparency of rules for quality and safety, and efficiency of transport and logistical networks. But good trade policies are essential to any national development policy. Furthermore, good trade policy depends largely on what a country does independently, not what it negotiates with other countries.

¹ See Sachs and Warner (1995) and Secretary of State for International Development (2000). While the work of Sachs and Warner has been much debated and criticized, often justifiably, the importance of global integration to growth remains very difficult to challenge.

To ensure satisfactory developmental performance, a wide range of other policies and institutions must complement trade policy. Among these are

- Effective legal institutions for the protection of property rights and the enforcement of contracts,
- Stable fiscal institutions and macroeconomic policies,
- An effective and non-burdensome regulatory regime,
- Competitive markets,
- Efficient infrastructure and basic services (e.g., finance, utilities, telecommunications, transport), and
- Effective institutions and markets for human capital, especially in the form of education and flexible labor markets.

The multidimensionality of openness and the wide range of complementary policies that make it possible mean that no single set of policy and institutional prescriptions applies to all countries in all circumstances. Differences in political, economic, and institutional contexts mean that each country must find a path that works best for itself.

The private sector—and the decisions of investors, producers, and workers—drive a country’s economic development, but the government plays a critical role. It creates an environment in which incentives accord with market forces and in which fiscal, legal, and other institutions do not distort or impede private actors but facilitate competitiveness.

GLOBAL PRODUCTION CHAINS AND IMPORT-LED GROWTH

Global production chains provide a wide variety of development opportunities. Much freer international trade and vast improvements in information technology, transportation, and logistics have made it possible to allocate production tasks for goods and services on the basis of a location’s comparative costs of production.

Countries that facilitate such truly globalized trade are part of a process that has relentlessly driven down the costs of internationally traded goods and services and benefited consumers everywhere. Most important, countries that have participated successfully in global production networks have reduced poverty rapidly.

In the context of global production networks, the “export-led” growth of east and southeast Asia is more accurately described as *import-led growth*. This region’s export industries were supported by trade liberalization and trade facilitation policies that cut the cost of importing raw material and intermediate inputs. In many cases, these policy regimes applied special measures to further improve access to inputs in world markets. For example, southeast Asia’s electronics exporters did not build on previously protected import-substitution industries but on new investments attracted by institutions that insulated them from the effects of protection and permitted them to import and export as freely as possible. In the 1980s, Indonesia replaced customs with a Swiss preshipment inspection service that cut the cost of importing by at least 20 percent in a matter of months. Indonesia also established an export facilitation program that freed exporters from import

duties on imported raw inputs, from local content requirements, and from all import licensing schemes on industrial raw materials. Those exporters could then compete with international producers on a level playing field. And Malaysia and Thailand relied heavily on customs arrangements that permitted exporters to trade both imports and exports freely.

Institutional innovations such as these were like magnets for investment in electronics, garments, footwear, and other labor-intensive sectors. They resulted in average economic growth rates of 7 to 9 percent for more than 15 years, and reduced the incidence of poverty by massive amounts—in Indonesia from 40 percent in 1976 to 11 percent in 1995. The same lessons of innovation learned in Asia are borne out by the experience of Mauritius, one of the clearest post-colonial success stories in southern Africa (See Exhibit 2-1).

Small, poor countries such as Mozambique can gain much from participating in global value chains and production networks. Small and limited domestic markets provide little opportunity for achieving the scale of operation necessary to compete internationally. Participation in global networks overcomes this constraint by allowing producers to achieve economies of scale for a segment of production. National economic development need not be constrained by small or underdeveloped domestic markets.

Policy barriers—especially those that affect logistics and trade facilitation—can limit the ability of investors and producers to thrive in these networks. At all stages of production in global networks, international trade is a substitute for self-sufficiency. Indeed, logistics and trade facilitation are far more critical to a country's industrial competitiveness than the development of integrated local or regional value chains. Local content rules can impose a similar burden. For a variety of reasons, investors will always prefer local rather than international sourcing, all things being equal—and they will buy locally when it is cost-efficient and appropriate to do so. But policies that force local purchasing when it is inappropriate hinder the development of competitive downstream industries that are the only sustainable source of demand for upstream producers. This is especially relevant for countries such as Mozambique in the context of rules of origin in regional and other preferential trading arrangements.

Exhibit 2-1

Mauritius Gains from Globalization

When the island of Mauritius gained independence, its economic prospects were bleak (Meade 1964). It was among the poorest countries in the world; its population was too high for its limited land and natural resources; and any wage sufficient for landowners to hire laborers would be too low for even a subsistence standard of living. It appeared that the only hope was large increases in sugar yields or significant increases in world sugar prices. Neither of these was very likely. Mauritius appeared to be stuck in a Malthusian trap, condemned to grinding poverty, inevitable ethnic strife, and political and economic instability. Thirty years later Mauritius would be unrecognizable to those who participated in British-commissioned studies at independence. Per capita income (PPP adjusted) is more than five times higher than the average for sub-Saharan Africa and more than two and a half times that of all developing countries. Rates of growth and other human development indicators outperform these other countries by a wide margin.

This achievement was built on (1) recognition of special opportunities in world markets, and (2) trade-promoting policy reforms—facilitation of the import of raw materials and the export of processed products, with minimal regulation or other interference. Thus, outward-oriented investors in Mauritius were permitted to import what they wanted from any source, to engage in any processing of these materials that they could do economically in Mauritius, and to export to any market in the world.

Over the same period, Mauritius continued to have relatively high rates of protection for a wide range of import-substitution industries. The tariff structure was characterized by high and variable rates, and an escalating pattern that encouraged inefficient local

assembly industries. The myth about the importance and fragility of import-substitution industries prolonged the high-cost policy regime. Mauritius began to rationalize its import duty regime when it recognized that the protected industries employed few and imposed high prices on consumers. It introduced a VAT that reduces budgetary reliance on import duties (Flatters 2002b, Box 7).

That the export-oriented economy in textiles and other sectors developed so well in spite of persistent import-substitution measures is testimony to the effectiveness of the EPZ system and the market-friendliness of the rest of the investment and industrial policy regime. Mauritius now exports a wide range of manufactured products, including garments and textiles, sunglasses, watches and watch parts, medical equipment, and many other goods. In addition, it continues to earn considerable income from tourism, and has begun to export banking and information processing services.

Outward-oriented manufacturing also created a huge number of jobs. Mauritius now contend with labor shortages not surpluses, and its wages and skill levels have risen to the point that it is losing comparative advantage in labor-intensive manufacturing. Mauritius is graduating from producing low-skill manufactures to exporting skill-intensive products. It has become a regional growth engine, a hub for coordination and logistical support of production and exports of a wide range of services and manufactures, including textiles and garments.

Mauritius is an African example of the gains possible from joining global markets. The country's policy environment has made trade as easy as possible and has permitted investors, domestic and foreign, to engage in activities that can be done best in Mauritius.

3. Trade Negotiations and Trade Diplomacy

Most discussions of trade policy focus on “trade diplomacy” and trade negotiations among national governments. The most all-encompassing arrangements are those enshrined in the World Trade Organization (WTO), a successor to the General Agreement on Tariffs and Trade (GATT). The WTO is based on agreements among 149 member countries that set a framework of agreed rules governing trade in goods and services. It provides a forum for updating rules and a mechanism for dealing with disputes concerning their application. The Doha Round of negotiations, underway for several years, is still far from concluding because of disagreements about increasing benefits for developing countries.

The main function of the WTO is to provide a mechanism for countries to commit to and lock in “good” trade policies. One of the motives for its founding was fear of trade wars among major economic powers. In a trade war, one country imposes tariffs to protect certain domestic interests, other countries retaliate, and protectionist acts escalate to the point of mutual destruction.

Central to the WTO (and the GATT), but now honored almost exclusively in the breach, is the most favored nation (MFN) principle, or the nondiscrimination principle. Under this principle, members apply the same trade policies to all members. For example, a country may not apply a tariff to imports from one member any lower than tariffs it applies to others. The two main exceptions are as follows:

- Developed countries may give trade preferences to less developed countries, and
- Under certain conditions, members may enter into preferential trade agreements so long as preferences under the agreement apply to all trade among all parties to the agreement.²

The MFN principle, once one of the most important in the modern world trading system, has nearly disappeared among a proliferation of bilateral, regional and other preferential trade agreements (PTAs). Whether a cause or an effect, the rise of PTAs is a sign of fundamental change in the world trading order.

² There is an important exception to this condition for preferential agreements among developing countries.

PROBLEMS WITH TRADE DIPLOMACY

Especially for a small country that cannot influence world markets, the first lesson of trade policy is that protection hurts the protected while liberalization benefits the country's citizens. In contrast, trade negotiations, especially under the WTO, seem guided by the fiction that "concessions" through tariff reductions harm the country granting them while benefiting the trading partners. Granted, some developing countries would gain if developed countries reduced agricultural subsidies and protection and reduced tariffs on key labor-intensive products, such as garments. But these same developing countries would gain—and gain much more and more directly—by rationalizing their own tariff regimes.

At the beginning of the Doha Round, the World Bank estimated that gains in world income under modest global trade liberalization scenarios would be about \$355 billion by 2015. Of this, \$184 billion would accrue to developing countries, and two thirds of this amount would be due to liberalization of their own imports. Taking into account dynamic effects and the effects of liberalization and trade in services reform, these gains could be much more substantial. In fact, most of the gains possible from participating in the Doha Round could be had by staying home and focusing on unilateral trade reform. This is not to say that developing countries should not take WTO negotiations seriously. But there is little danger that any developing country will erode its influence in WTO negotiations on such weighty matters as trade liberalization in garments and agriculture by moving ahead with trade liberalization independently. And WTO negotiations might prove useful in countering opposition to reform by domestic vested interests. Trade negotiations should be used to promote and lock in good domestic trade policy, not to resist it.

Whatever is agreed as a result of WTO processes, these are only minimum requirements. Agreeing to bind a tariff at a particular level does not prevent a country from lowering it more. Accepting certain disciplines on the use of contingent protection measures, such as safeguards and antidumping duties, does not prevent a country from adopting more stringent requirements for use at home.

One of the great advances of the WTO relative to the GATT is that developing countries are full participating members. Members' voices and rights are not a function of size or income; however, developing countries have argued for and been generally successful at obtaining special rights on the basis of their low incomes. Some of these rights, such as the ability to acquire generic medicines under less stringent licensing conditions than allowed by intellectual property provisions of the WTO regime, are warranted and of great value. But others, such as the right to move more slowly in reducing import tariffs, and less stringent provisions for entering PTAs, should be exercised with caution. For example, delaying trade liberalization means foregoing gains from participating in the global trading system and is almost certain to impede growth and poverty reduction.

REGIONAL AND OTHER PREFERENTIAL TRADE AGREEMENTS

As observed earlier, regional and other preferential trade arrangements are increasingly dominating international trade diplomacy. For Mozambique alone, recent, actual, or prospective arrangements include bilaterals with South Africa, Malawi and Zimbabwe; regional agreements with SADC and SACU; nonreciprocal preferences granted under AGOA and the EU's Everything

but Arms (EBA) deal; Economic Partnership Agreements (EPAs) with the EU; and possible agreements with India and other configurations of partners in South Asia.

A fundamental and still unresolved issue is whether these arrangements contribute to or detract from trade policy—whether they promote global and unilateral trade liberalization or impede it. For a country like Mozambique the issue is whether participation in such arrangements can be used to promote useful and necessary domestic policy reforms without imposing hidden economic costs. This is the policy challenge; and there are some real dangers.

- ***Trade Diversion.*** The most significant economic danger of PTAs is that they distort economic incentives in a way that diverts trade. For example, tariff preferences cause Mozambique to switch from less to more expensive sources of imports, reduce tariff revenues, and provide little if any benefit to users of imports. This danger and its costs increase with the size of the tariff preferences. The simplest solution is narrow the gap between preferential tariff rates and the MFN rates applied to imports from non-partners. In other words, the dangers and costs of trade diversion can be minimized by using PTA negotiations to promote general domestic tariff reform.
- ***Regulatory Complexity.*** The proliferation of PTAs makes rules for importing and exporting increasingly complex because tariff rates are a function of a good's origin and destination. Complying with and enforcing rules imposes costs and acts as a hidden barrier to trade.
- ***Rules of Origin.*** A PTA without a common external tariff requires rules of origin to determine whether goods qualify for tariff and other preferences. These rules are among the greatest sources of regulatory complexity in PTAs. In addition, by increasing the cost of qualifying for preferences they often serve as instruments of protection. The solution? Make rules of origin as simple as possible, and reduce the gap between preferential and nonpreferential rates.³
- ***Policy Diversion.*** Concentration on preferential trade negotiations and arrangements can divert scarce policymaking capacity from the more valuable tasks of domestic regulatory reform and nonpreferential tariff reduction. As in any kind of trade diplomacy, mercantilist tendencies are encouraged.⁴ Finally, PTAs are often negotiated for the benefit of a few rent-seekers who want to gain access to or protection from particular markets. The proliferation of such negotiations encourages rent-seeking and policy diversion.

The most often discussed benefits of PTAs are the market access opportunities they provide for exporting to partner countries' markets. In assessing such benefits, however, one must take into account several mitigating factors. First, the benefits might be very small if partners' MFN tariff rates are already low, as is often the case in developed countries. In the few sectors that have high

³ See Flatters (2004) and Erasmus, Flatters and Kirk (2006).

⁴ Mozambique's insistence during the SADC negotiations on maximizing the speed of South African preferential tariff reductions and on backloading as much as possible its own tariff reductions exemplifies this tendency.

tariffs, such as textiles and agricultural products, restrictive rules of origin, quotas, and other nontariff barriers often make it difficult to take advantage of preferences. Second, in many south-south PTAs, markets are too small to offer much opportunity for developing the economies of scale necessary for international competitiveness. Furthermore, many south-south PTAs are burdened by restrictive rules of origin in key sectors.

Mozambique is a member of SADC and is considering joining SACU. Both of these groups illustrate some of the dangers associated with PTAs. Both groups are economically very small. SACU is smaller than Finland and all of SADC is still smaller than Turkey. Both are dominated in economic size by South Africa. Neither is large enough to serve as a strategic base from which Mozambique could pursue global economic integration. They are not, in themselves, viable routes to gaining international competitiveness either in the development of export markets or sourcing raw materials and intermediate inputs to supply potentially competitive domestic industries.

Because Mozambique imposes relatively high import duties, especially on final consumer goods, the danger of costly trade diversion of imports of basic goods from cheaper sources in Asia and elsewhere to South Africa is substantial. Joining SACU would require Mozambique to adopt the common SACU tariff. That tariff is higher than Mozambique's for important goods, such as garments and transport equipment, and more complex. While Mozambique would have a voice in further reform of the SACU tariff, the current revenue-sharing formula for customs duties provides incentives to the BLNS members to veto significant tariff rate reductions.⁵

If Mozambique used membership in SADC or SACU to promote domestic trade policy reforms some of these problems might be overcome. For example, to avoid trade diversion in SADC, Mozambique would have to reduce its MFN tariffs, especially on final consumption goods. SADC membership might be worthwhile if it were used to justify this kind of reform. Unfortunately, Mozambique's record in such endeavors is not promising. Rather than embracing SADC as a means to promote domestic tariff reform, Mozambique has taken every opportunity to backload tariff reductions even for trade with its SADC neighbors. In addition, it has lobbied for measures by which it would be free to impose temporary "contingent" protection in response to demands of domestic industries, with no disciplines such as those set out in the WTO. These actions exemplify the self-destructive mercantilist approach that characterizes nearly all trade negotiations.

Mozambique could also benefit economically if it used membership in SADC or SACU to justify improving trade facilitation at important border points, especially with South Africa. MFN-based tariffs should be reformed and trade facilitation improved, however, regardless of membership in any PTA, and regardless of what happens in WTO negotiations in Doha, Hong Kong, or Geneva. There is a real danger that participation in PTA negotiations pulls some of Mozambique's best trade policy decision-making skills away from key issues and reinforces protectionist tendencies and interests.

⁵ See Flatters and Stern (2005).

4. Unilateral Trade Policies: Some Issues

For a small country like Mozambique, the main value of trade diplomacy is that it motivates commitment to beneficial reforms. Trade negotiations, however, achieve indirectly what can be done better independently, and the dangers of the indirect route to reform are serious. Trade diplomacy can stall domestic reform, a situation with costly economic side effects. International experience is clear on the economic benefits of integrating into the global economy. Yet a number of myths persist about reasons for resisting integration.

INFANT INDUSTRIES

One of the commonest arguments for protection is the infant industry argument. The “infant” cannot compete without a “short period” of protection from established competitors. The industry is often described as “strategic.” A related and often simultaneously argued point is that the industry is heavily protected or otherwise subsidized in other countries, making it difficult if not impossible for local producers to compete.

First, consider the basic argument. Suppose that a new firm or industry cannot compete immediately because of start-up costs or a necessary learning curve. If assistance is justified, import protection is not usually the best form. Not only does it subsidize the industry, it imposes costs on downstream users or final consumers, or both. Employment gains are often small (Exhibit 4-1). In any case, negative initial net cash flows are a characteristic of nearly all investments. These costs should be taken into account when the decision to invest is made. Why should private costs be publicly subsidized for the sake of future private profits? Whose costs should be underwritten and whose should not?

Some kind of policy intervention may be justified only if short-term *external* benefits to the investments can be identified or if private start-up costs can be shown to exceed the social or economic costs of intervention. Otherwise, state subsidy or protectionist policy merely shifts costs from investors to consumers or taxpayers and distorts the price signals that investors need to make sound decisions. It encourages wasteful investments and, perhaps more significantly, encourages rent-seeking behavior. Resisting such pressures requires strong economic policy institutions.

In practice, most governments are poor at picking “winners.” And in countries where governments attempt to do so, investors become adept at picking government’s pockets. Infant

industries remain infants and impose long-term costs on domestic consumers, downstream users, and taxpayers. Others fail before or after the period of protection ends. And others make excess profits from unnecessary protection and policy-sanctioned domestic monopolies.

Exhibit 4-1

Infant Industry Protection: Pasta in Namibia

The SACU agreement includes a provision for the protection of domestic infant industries. Namibia chose to take advantage of this provision in the pasta sector.

The SACU MFN tariff on pasta was 25 percent. At the request of a local flour milling group that wished to build a pasta factory, the government agreed to impose an additional import duty of 40 percent for four years, then phase it out over another four years. Since the milling branch of the company gets wheat on a duty-free basis, its flour is also effectively duty-free, except for any excess of its milling costs over those of international mills.

The factory was completed in 2002 and operated immediately at nearly 100 percent of capacity—three shifts, seven days per week. It was a commercial success. This is not surprising given how protected it was: the effective rate of protection vis à vis South African producers was about 89 percent and vis à vis international competitors about 425 percent (based on cost data from the firm). Other than rents created for the (South African owned) firm, what are the benefits of this instance of protection for Namibia?

Small rises in demand for local wheat do not affect the price that farmers pay. They receive no more than the pre-tariff world market import parity price regardless of local demand (Erasmus and Flatters 2003).

What does the pasta factory provide for consumers?

Increased import duties ensure that consumers have much less choice in buying pasta. The factory employs a special high temperature process that allows the use of flour milled from inferior local wheat rather than durum wheat. This results in a product acceptable to some consumers, but unacceptable to many others. A tour of local supermarket shelves revealed only the local brand. “Specialty” pasta—normal pasta in most other markets—has to be bought at very high duty-inclusive prices in specialty shops. High prices and low sales volumes made this an unprofitable product for most supermarkets to stock.

What about employment? Operating at full capacity with three shifts, the factory employs 20 workers, 10 less than the minimum promised when the owners applied for protection. But this low number does not represent the net job creation from the factory.

Previously, another local pasta producer served the local market with pasta made from flour purchased from the milling company that now operates the pasta plant. Shortly after the new plant opened, the old producer’s line of credit was revoked and the factory was forced to close. Data on the number of jobs lost have not been obtained. But it can be said with certainty that the net number of jobs created by this instance of infant industry protection is less than 20.

Of course, problems in the investment environment might be discouraging new investment. But if weak capital markets, for example, make it difficult to borrow against future profits, the solution lies not in subsidizing production or instituting protection, but in improving the markets. Weak capital markets are often themselves a result of infant industry protection and poor regulation in the financial sector. If the investment environment is weak, strengthen it; don’t further weaken it by inviting rent seeking and engaging in costly and arbitrary protection. If the problem is too

much rent seeking, recognize that infant industry protection is more likely to aggravate than solve the problem.

Declining industries might be thought of as the opposite type of problem. In a growing and healthy economy, firms and industries rise, decline, and fall. Policies that entrench existing patterns of production interfere with this necessary process. As observed earlier, nearly all of the export industries that developed in southeast Asia in the latter decades of the 20th century were based on new investments, not small-scale manufacturers who had become dependent on small domestic markets. While some jobs in import-substitution activities were lost, many more jobs were created in export industries that became competitive as a result of trade policy reform. In Indonesia, for instance, export industries created on average four times as many jobs per dollar invested as protected import-substitution industries.

This is not to deny the social and economic virtue of policies and institutions that assist workers and vulnerable groups temporarily displaced as a result of these dynamic patterns. But helping workers adjust does not require long-term industrial support for firms and industries that can no longer compete. Adjustment assistance can be much more effective and less expensive if directed at workers rather than firms and industries.

In fact, the industries most vocal in demanding protection or assistance in the face of declining competitiveness are precisely those that have been shielded from competition (e.g., garment industries in developed countries). An unfortunate consequence of protecting infant and strategic industries is the political difficulty of reducing or ending protection when the protected firms or industries do not become—or claim not to be—competitive. Protection is easy to grant but difficult to withdraw.

TAX INCENTIVES

Taxes are necessary to raise revenue for public expenditure needs. Taxes are also costly, not only in transferring private income to the public sector, but also in distorting private decisions and imposing administrative and compliance costs on the government and the private sector. A good tax system minimizes indirect costs by being as neutral as possible in affecting investment, savings, and production. This can be achieved through low marginal rates of taxation, especially on activities that are elastic in supply or demand, a broad tax base, and simplicity and transparency in structure and administration. Granting a tax “incentive” to any activity, firm, or individual requires that others pay additional taxes to meet a given budget target.

Tax incentives are not necessary to promote investment and development and their economic costs are high. A recent report on 14 case studies in Brazil, China, India and Mexico concluded that “the incentives used to attract foreign direct investment ... are largely ineffective. Worse, they are frequently counterproductive, costing governments millions of dollars annually, protecting inefficient players, and lowering living standards and productivity” (McKinsey 2004). Countries that got “hooked” on investment incentives got drawn into costly incentive spirals, providing incentives that were often unnecessary and when they were necessary, promoted inefficient and noncompetitive investments. India continues to grant unnecessary tax holidays worth \$2,000 to \$6,000 per worker to business-processing and IT investments. In the mid-1980s

Brazil gave tax concessions that began at \$50,000 to \$94,000 per employee in the auto industry and quickly escalated to more than \$300,000 per worker. The main result was that Brazil was saddled with a costly industry with enormous surplus capacity.

In its surveys of investors, McKinsey confirmed the findings of other studies showing that incentives are not important to firms making strategic decisions. Yet investors are happy to accept incentives and many companies appear to have become skilled at pleading for them. A recent OECD study finds that the auto sector, for instance has become very effective at “incentive shopping” (Oman 2000). South Africa’s Motor Industry Development Program (MIDP) is giving a small number of European luxury carmakers subsidies of more than R5 billion (US\$830 million) per year. For typical investors, the subsidy has been 200 to more than 600 percent of the amounts they invested. This program was intended to run from 1995 to 2000. Extended several times, it will now run until 2012, and the industry is pressuring the government for further extensions.⁶

Recognizing these facts, some countries are reducing reliance on tax incentives, preferring instead to simplify tax systems and correct underlying problems in the investment environment. In the early 1980s, Indonesia abandoned tax incentives, simplified its tax system, and lowered marginal rates. Some feared that this would cause Indonesia to lose investment to neighboring countries still doling out incentives. Over the next decade Indonesia’s share of ASEAN’s foreign investment doubled.

The costs of incentives are high and nontransparent because of a variety of unintended effects. Costs include

- The necessity of charging higher rates on other taxpayers, thus raising indirect costs;
- Large subsidies that transfer money from taxpayers to beneficiaries with no impact on investment, or result in waste by distorting investment decisions;
- High costs to administer incentives and comply with increasingly complex tax systems (another source of pure waste); and
- Increased rent-seeking and reduced competition—the tax incentives game attracts particular interests and diverts attention from more important issues in the investment environment.

Furthermore, tax incentives do not influence most investors, who tend to give more weight to tax simplicity and stability. Given that the investment environment in many countries is plagued by problems not involving taxes, tax incentives should not divert attention from those problems or be seen as a substitute for dealing with them. The best tax incentive of all is a stable regime with low rates and minimal use of exemptions, special provisions, and other inducements. Simplicity and predictability are also the main requirements for the tax system to fulfill its primary function of raising revenue.

⁶ See Flatters (2005b) and Flatters and Netshitomboni (2006).

SUBSIDIES AND DUMPING

Two related arguments for protection are based on the claim that foreign competitors are subsidized or are dumping products, or both. Closer examination of either claim reveals that the real argument is often simply that competitors are producing at a lower cost. This is not a legitimate argument for protection, at least not in a country that wishes to integrate into the global economy. The purpose of engaging in international trade is to gain by producing and exporting goods and services that can be produced domestically at relatively low cost and importing those that can be obtained at a lower relative cost from foreign sources.

Effect of Subsidies

Differences in relative costs among countries arise for many reasons, one of which might be subsidies for particular products in some countries. The country using subsidies almost always bears their costs, while importing countries are not affected. In a few cases, subsidies are sufficiently large and widespread that they lower the world price of a good and have some effect on other countries. The lower world price hurts producers in other countries and benefits consumers. If the other country is a net exporter of the good, losses to domestic producers outweigh benefits to consumers. For net importers of the subsidized good, benefits to domestic consumers outweigh the costs to domestic producers.

For net importers of subsidized goods, therefore, the appropriate policy response is to thank the subsidizing countries for their generosity. For net exporters, is there any argument to be made for subsidizing or protecting domestic producers? No. In the face of the foreign subsidy policies, the world price is what it is, and any subsidy or domestic market protection imposes distortions on production and consumption decisions. The resulting costs are borne domestically and, unless the domestic market is large enough to affect world prices, foreign markets are not affected.

Effect of Dumping and Antidumping Actions

The argument that one should counter foreign protection with domestic protection is similarly flawed. The WTO's rules on export subsidies and dumping aim to discourage frivolous and harmful uses of protection and subsidies. Less stringent than economically desirable, these rules leave considerable scope for the use of such measures. As a result, antidumping actions have become a form of disguised protection sanctioned by inadequate WTO procedures. The rules, however, set only a minimum standard for antidumping actions; countries may use more stringent and economically justifiable procedures, including refraining from the use antidumping procedures altogether.

The only legitimate economic argument for instituting antidumping actions is when dumping by a foreign seller is predatory and will (1) destroy all domestic competition in the importing country, and (2) give the dumping exporter a monopoly in the importing market by which it can then command prices higher than those in international markets. In other words, the problem is not the low prices that result from dumping, but the higher prices that might result should the dumping exporter create a monopoly in the domestic market.

The simplest and best means for preventing predatory dumping is to maintain open international markets. When markets are open, a foreign producer of, say, steel or garlic, would be foolhardy to believe it could regain losses incurred by dumping by selling later at a monopolistic price higher than prices in the world market. When markets are open, monopolistic pricing is met by a surge of imports from other sources. In almost all cases imaginable, open markets are the simplest way to ensure that predatory dumping does not occur and that antidumping actions are not required.

The biggest problem with WTO-sanctioned antidumping procedures is that they do not *require* governments to take into account the interests of domestic consumers or downstream users of imported products. Imposing a temporary or permanent tariff to deal with “dumping” or any other problem without taking into account those interests is a recipe for bad trade policy. Fortunately, WTO procedures do not *prevent* governments from making those interests a part of their antidumping regimes. Otherwise, antidumping will continue to be just another form of harmful protection (Stegemann 1991).

MARKET AND POLICY FAILURES

A more general argument against trade liberalization and other types of market-oriented reforms is that markets are not perfect. Markets can fail by sending inaccurate signals about relative costs. Inaccurate signaling occurs when markets are incomplete or when some activities have significant “external effects.” This means that market prices do not always take into account the consequences of individual actions and certain goods or services—such as basic education or technological research and development—are under or over-provided.

Improving basic education is one of the most important and useful things any government can do to improve a country’s prospects for long-term development and to facilitate and maximize gains from integrating into the global economy. There is also little doubt that this is an area in which government action is needed. The design of institutions and incentives to provide high-quality basic education is a challenge for all developing country governments.

Claims for government action are also made for technological research and development. In rich countries such claims are advanced with regard to developing technologies, in poorer countries with regard to gaining access to existing ones—and the best way to obtain access is by creating an environment that attracts investment. The biggest challenge facing low and middle-income countries is to create an environment that encourages foreign and domestic investment that capitalizes on well-known technologies, not only for production, but also for logistics, design, and marketing. Market access is generally best achieved by attracting firms that know the markets being targeted and can assist with the design, production, marketing, input sourcing, and all the other requirements needed to succeed in these markets. Such investors are not just sources of capital and technical, design, and marketing expertise. They can also be a very effective in pulling down protectionist barriers in developed countries. African trade negotiators played a role in developing the African Growth and Opportunity Act (AGOA), but U.S. buyers and investors who saw some African countries as potential sources of supply in the face of quota scarcity and rising costs in Asia played a much larger role.

Market failures also arise from failures of government policy and institutions. Industrial policy interventions, for example, often seek to solve problems that are rooted in other policy failures. Protection, investment, and other incentives are then claimed to be needed because of the economy's "high cost" structure. Why are costs high? Causes vary from country to country and over time, but usually include some subset of the following complaints: ports and customs are inefficient; telecommunications infrastructure is bad and expensive; crime rates are high and law enforcement weak; labor markets are inflexible and minimum wages high; labor skills are low; financial markets are uncompetitive, with poor service and high prices; transport infrastructure is poor; electricity supply is unreliable and/or expensive; the court system is weak and contracts are difficult to enforce; financial regulation is weak with the result that foreclosure and bankruptcy processes are costly, time-consuming, uncertain and unreliable. Many, if not all, of these problems are rooted in weak government policies and institutions, and solving them provides a full agenda for most governments. Public support of market institutions is critical in creating an investment environment conducive to long-term economic development.

Finally, from the perspective of growth and equitable development, investment in human capital may be the most significant market failure. The almost complete absence of capital markets for the financing of human capital investment at all levels of education is compounded by the influence of family structure and income inequality on educational choices. Public support of investment in education and skill development should be a critical element in long-term development strategies.

RESOURCES, RENTS, AND DOMESTIC PROCESSING

Resources are a source of wealth, but resource rents can be dangerous if they are mishandled and especially if they lead to political or economic excesses. Large pools of resource rents can invite economic mismanagement. For example, state-run oil companies have brought a number of countries to the brink of fiscal collapse by spending oil revenues recklessly and accumulating large debts in expectation of future income. This behavior runs counter to the prudent rule of accumulating rents and spending only the current income from the fund. In Indonesia, tropical forests have been exploited far in excess of sustainable or economic rates in order for certain parties to profit. This has resulted in environmental damage and a substantial reduction in the present value of long-term rents generated by the forests (Exhibit 4-2). Gross mismanagement can turn resource rents from an asset into a curse. The economic problems that arise are sometimes compounded by political instability and conflict that arises from struggles over access to the rents.

The macroeconomic impact of resource exports on domestic costs and the real exchange rate is referred to as "Dutch disease." Resource booms, in causing appreciation in the real exchange rate and rising demand for nontradable goods, can raise costs for and reduce the competitiveness of producers of tradable goods. This, in turn, reduces the competitiveness of import-competing activities and other exports. This, of course, is the economic mechanism through which resource utilization adjusts to changing patterns of comparative advantage and is not necessarily bad. But

Exhibit 4-2

Indonesia: Costly Downstream Processing in the Forest Sector

Indonesia has one of the world's richest endowments of tropical forest. Until the late 1970s it exported almost all logs to Taiwan and Japan for conversion into veneers and plywood. Export earnings exceeded \$2 billion per year, but the government collected few royalties.

To encourage domestic processing, the government imposed an export tax on logs but not sawn timber or plywood. Investment in processing was already beginning to shift from high-wage Asia to Indonesia, but the export tax incentive did little to speed the shift. A year later the government enacted a much stronger incentive: a progressive ban on log exports, implemented through an export quota that would go to zero in five years. To get a share of the export quota and the corresponding high rents on log exports, investors had to set up plywood mills. Most mills were inefficient and lost money. But investors viewed them as a necessary cost of engaging in highly profitable log exporting.

The management of the export quota was highly corrupt and none of the log rents went to the government budget. Log export revenues plummeted and were only partially offset by plywood exports. Plywood mills were

highly inefficient; their purpose was not to produce plywood or produce it efficiently, but to secure log export rights. Log rents were thus wasted in inefficient plywood production.

Gradually, plywood exports replaced log exports, and plywood production became efficient. The incentives, however, led to excess plywood capacity, creating a long-term demand for logs well beyond the sustainable or economic capacity of Indonesia's forests.

The export restrictions did indeed increase domestic plywood capacity—but at great cost. If the government had simply continued the initial modest 10 percent export tax and implemented a better royalty system, it would have sped up the plywood investment program that was already underway, bolstered government revenues from a valuable resource, and avoided the economic costs of the drastic and ill-conceived program that was implemented. Despite the economic failure of that program, rent-seeking cronies that benefited from it persuaded the government to reapply the model in rattan and several other resource sectors, with even more harmful consequences for poor rural households that depended on harvesting and growing these products.

if the resource boom is a manifestation of too rapid exploitation of resource wealth the Dutch disease effect is cause for concern. The solution lies in correcting resource mismanagement. When managed at an economically optimal rate, resource rents can provide a basis for long-term development opportunities.⁷

If taxed, resource rents can be a valuable and relatively low-cost source of revenue for meeting long-term development needs, such as human capital investment. Otherwise, public funds are insufficient or depend on distorting taxes on trade, savings, and investment. Untaxed rents that accrue to foreign shareholders in the resource sector are a net loss to the economy—a transfer of rents from the domestic economy to foreigners.

⁷ Resource rents are not the only source of Dutch disease. Large inflows of foreign aid can have a similar effect. Recent research has suggested that real exchange rate appreciation due to aid flows has eroded the competitiveness of labor-intensive manufacturing industries in recipient countries and as such has blunted the effect of aid in promoting development in low-income countries (Rajan and Subramanian 2005).

In principle, resources are an ideal base for taxation, since taxation of true economic rents does not distort economic incentives. Designing a rent tax that does not distort incentives is a challenge, however, and many resource taxes are not economically neutral.⁸ Taxing resource rents only when the goods are exported, for instance, creates potentially very harmful incentives to squander the rents being targeted. This is especially so when the taxed commodities provide little economic rent in the first place (e.g., almost most agricultural products on which poor farmers depend for a living).

Governments commonly impose taxes and other restrictions on resource exports not to collect rents, but to encourage or force domestic processing. By restricting exports of resources, governments reduce the domestic price of the resource and give domestic processors a cost advantage over foreign processors, who must pay the prevailing world price. An abundant resource or primary product can provide a “natural” basis for competitive processing, primarily through an inherent transport cost advantage. Processed goods cost less to ship than raw materials because they are usually lighter or less bulky. The competitiveness of local processing also depends on complementary factors of production and technologies. Such factors, however, do not always accompany endowments of natural resources. If export sales at higher prices are foregone in order to force domestic processing and domestic use, the economic advantage of natural resources may be squandered. Furthermore, it is largely the poorest of the poor—the farmers whose livelihoods depend on exporting basic crops—who bear the cost of export restrictions. This has certainly been case with export restrictions on logs, rattan, spices, and fruits in Indonesia.

⁸ The costs of distortionary resource taxes can be high. Taxes on gross resource revenues do not discriminate between high- and low-cost rent sources and hence encourage “high grading” and considerable waste in the form of underutilization of economically valuable resources. Presumptive cost setting can have the opposite effect if costs are set too high. Uncertainty about the stability of resource tax regimes can create unnecessary risks and can lead to under- or overexploitation of resources. Export taxes can encourage high-cost domestic processing of resources and end up dissipating resource rents through pure economic waste. See Boadway and Flatters (1993).

5. Globalization Agenda for Mozambique

Mozambique has come a long way in a very short time in integrating into the global economy. Despite social upheavals and natural disasters, the country's economic performance of the past decade has been remarkable. Nevertheless, Mozambique is still a very poor country and much remains to be done to improve its economic health. What strategy should Mozambique follow to fulfill the promise of its recent performance? The following are the main elements of a globalization strategy for Mozambique.

FOCUS ON DOMESTIC REFORM

Mozambique's domestic policies are far more important in determining its economic future than are the policies of the United States, the European Union, or South Africa. While Mozambique has very little influence over the policies of other countries or the outcome of trade negotiations in the WTO and elsewhere, it has a clear comparative advantage precisely where it matters most—in managing its own domestic policies.

Good trade policies work best in a supportive domestic policy environment. Domestic policy reform has to cover the entire regulatory regime, at the border and behind it. The government cannot tackle all regulatory problems simultaneously. In choosing priorities, it should be guided by the goal of improving the global competitiveness of domestic producers. To do this it needs to listen to investors and producers to identify regulatory and other unnecessary constraints in the domestic market. But it also needs to identify and discount the pleas of noncompetitive rent-seekers—those that seek protection and other privileges to avoid competition. Overcoming political resistance to reforms that threaten some within and outside of government will require cultivating domestic constituencies of competitive and outward-oriented investors.

IMPORT POLICIES

Mozambique has undertaken substantial tariff reform and has one of the region's simplest tariff structures. Nevertheless, rates on consumer goods remain high, and the cascading of rates from primary to intermediate and final goods provides very high levels of protection to a wide range of noncompetitive import-substitution industries, at a high cost to consumers and providing very little sustainable employment. Of equal or even greater concern are problems with trade facilitation at the border. Import policy reform should focus on both problems.

Mozambique should continue with nonpreferential tariff reform and refrain from using external trade negotiations as an excuse for delay. Mozambique's insistence on its right as a poor member state to backload all tariff reductions in SADC is exactly the wrong model to follow. The nonpreferential tariff rate on final consumer goods should be reduced substantially. The number of rate bands should be reduced and the gap between them narrowed. To avoid costly trade diversion from PTAs into which Mozambique has entered, this process should proceed in tandem with the implementation of Mozambique's commitments in SADC that are finally coming into force.

Customs reform needs to continue, with more emphasis on trade facilitation and less on methods of direct control to protect revenues. The high transaction costs and unnecessary delays at the main border crossing into South Africa are of considerable concern to importers, exporters, and consumers. This border point will be key in developing Mozambique's regional and global competitiveness, and measures to increase competition and reduce costs should remain a part of Mozambique's import reform program.

EXPORT POLICIES

Mozambique must continue to develop labor-intensive exports. Import-led growth in Asia and elsewhere has shown that export incentive programs succeed when they make it easy for investors and producers to import. As long as hindrances to importing exist, special measures must be undertaken to free exporters from them. These include exemption from duties on imported raw materials, and a smooth crediting and refunding of VAT input taxes paid by exporters.

Behind-the-border barriers to investment and competitiveness—excessive and poorly enforced regulations, poor infrastructure, weak and noncompetitive service sectors—must also be dealt with. Domestic businesses tend not to view these barriers as big problems because they hold down domestic competition. But they are a burden on consumers and serious barriers to investment and international competitiveness and to global integration, job and income growth, and poverty reduction.

Though export processing zones can be used to bypass some regulatory impediments to the development of competitive export industries, they should be viewed as stopgaps only and should not interfere with fundamental reform. Taxes and other restrictions on exports of primary products, especially agricultural products that are important sources of income and employment for the rural poor, should not be used to promote downstream processing. Such taxes and restrictions merely hurt poor farm and plantation workers, with economic gains in processing outweighed by losses in foregone primary exports and incomes of farm workers.

INVESTMENT ENVIRONMENT

Investors widely and justifiably regard Mozambique as a high-cost economy because of well-known weaknesses in domestic regulations and other policies. Enabling investment will require solidifying macroeconomic and fiscal progress, instituting a transparent and fairly enforced legal and regulatory regime, and providing efficient public infrastructure and other services.

Macroeconomic and Fiscal Policies

Mozambique has been fairly successful in instituting sound macroeconomic and fiscal policies, and needs to continue doing so. Tax policy implementation needs improvement. Continued tariff reform will increase the burden on other taxes, especially the VAT. The VAT treatment of exports is a delicate matter. It offers a big loophole for tax fraud. But excessive policing of exporters' input tax credit claims can seriously impede export competitiveness. The use of tax incentives to attract investment is very tempting. But such incentives are not necessary or even important in attracting investors, seldom help small or medium businesses, and can destroy the integrity of the fiscal regime if used excessively.⁹

Legal and Regulatory Regime

Mozambique's problems with its legal and regulatory regime are highlighted in studies conducted by local consultants as well as the World Bank and other international organizations.¹⁰ Land and labor laws, financial regulations, business licensing, and general administration of the justice system, especially as it pertains to enforcement of private business rights and contracts, all need to be reformed. Though important, competition laws and policies that protect against the emergence of harmful and costly monopolies are difficult to design and administer well. A much more useful first step in this regard is to examine other elements of trade policy and the regulatory regime that unwittingly promote monopolies and restrict competition. A complex regulatory regime is in itself often a major barrier to market entry and to new competition, not to mention a source of high costs and lack of global competitiveness.

Public Services

Public infrastructure and other services involve roads, transport, telecommunications, and education. Once regarded as almost entirely within the public sector, such services can now be provided through a range of public-private institutions. The public sector needs to create a regulatory environment and other incentives to ensure that services are provided efficiently and at low cost, regardless of the ownership of the actual service providers.

CONCLUDING REMARKS

To reach its development goals, Mozambique must integrate into the global economy. It has made great progress in recent years, but much remains to be done. The current policy regime raises domestic costs, rewards rent seeking, and discourages competition. Solving these problems is within the grasp and the power of Mozambique. The private and public sectors need to work together to build an environment that encourages and facilitates productive investment, promotes trade, and creates jobs and incomes for the citizens of Mozambique.

⁹ See Boadway, Flatters and Wen (1996) and Flatters (2005).

¹⁰ For instance, see FIAS (2001) and World Bank (2005).

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