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EXPORT EXPANSION AND INVESTMENT PROMOTION IN SUBSAHARAN AFRICA:
Implementation Constraints to Getting the Policies Right

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The debate over export expansion versus import substitution as the appropriate basis for industrial and economic development in developing countries has been won. Empirical evidence clearly demonstrates the link between export expansion and increased prosperity, while countries that have followed policies of import substitution have experienced low or even negative growth. The most striking examples of rapid and, apparently, sustainable development can be seen in East Asia, where several countries' export booms have been matched by dramatic increases in overall economic performance.

As a result, virtually all countries now have some policies in place that are explicitly intended to encourage export growth. Although many of these policies have been enacted as a result of pressure from donors, policy-makers in developing countries generally agree that increasing exports is a good thing. It is a far cry, however, from standing on the sidelines vaguely trying to encourage exports and inward investment to enacting and implementing the policy reforms needed to make it happen. While few, if any, interest groups oppose exports *per se* , many interest groups, in various alliances and configurations, are arrayed in force against almost all of the policy measures that a successful export drive requires. This paper seeks to identify these policy measures and to identify the sources and motives of resistance to them, without, however, addressing specific steps line managers might take to overcome them. The relative strengths of the different stakeholder groups opposed to reform will vary from one country to the next, depending on the composition of the economy, political and/or colonial heritage, natural resource endowment, human resource base, and existing legal, regulatory and policy framework. For this reason, overcoming these constraints does not lend itself to a uniform approach applicable in all situations, but must instead be tailored to specific national or even local circumstances. For the most part, however, these steps are likely to involve a combination of incentives, sanctions, enforcement, and redesign of procedures, all of which are aimed at reducing the opportunities and potential rewards from activities that run counter to the goals of export and investment expansion.

For most countries in Sub-Saharan Africa, and indeed for most developing countries throughout the world, there are few meaningful distinctions between policies designed to encourage direct investment and those aimed at expanding exports. Some developing countries such as India, China, or Russia, have such large populations that foreign investors may be attracted to mainly by the prospect of gaining access to their domestic markets, just as companies invest in North America or Western Europe to increase their penetration of domestic or regional markets. Most developing countries, however, particularly those in Sub-Saharan Africa, lack the population size, wealth, and regional integration to attract investors in search of domestic or regional market opportunities. Uganda, for example, which has the same population as Australia but a GNP less than two per cent as great, offers a far less enticing domestic market than Australia, which has attracted major investments aimed mainly at serving the domestic market. Similarly, the Netherlands, which also has roughly the same population as Uganda, has attracted far more investment not only because of its vastly greater wealth but because of its membership in the EEC, which allows investors in the Netherlands free access to a market of more than 300 million consumers. For countries lacking a large domestic market or access to a large regional market, to attract investment is to develop export-oriented industries. The policy reforms required, therefore, are precisely those needed to develop a business climate that is conducive to expansion of exports, particularly in non-traditional sectors.

There is a temptation on the part of both donors and developing country governments to assume that all of the key policy elements must be in place before serious efforts at export and investment promotion can begin. While the importance of creating an enabling environment for export expansion and investment stimulation can hardly be overstated, empirical evidence suggests that many companies will develop export-oriented strategies and will invest under less than optimal conditions provided that: a) the conditions necessary for investment and export expansion in a particular industry have been met; and, b) that the prospects for overall improvement in the business climate are encouraging. As a recent World Bank study of export catalysts in developing countries points out, “Given initial conditions of large policy distortions and underdeveloped institutions, the developing countries...could rarely afford to wait until perfectly rational policy environments were achieved to promote development in an outward-oriented direction.” By the same token, “movement toward development can hardly be activated by all firms in an industry and all sectors in a country spontaneously, as the conventional view presumes, no matter how successful the country is in correcting the policy distortions” (Rhee and Belot 1990: ix-x).

The implications of this are twofold:

1) A country seeking to expand exports and attract investment must identify those priority policy constraints whose reform is a necessary condition for any significant investment and export growth to occur; and,

2) It is not sufficient merely to create an enabling environment for investment and export expansion to occur.

Empirical evidence strongly supports both of these conclusions. The danger of waiting for all the policy reforms to be in place before trying to develop export-based industries through mobilization of both domestic and foreign investment may mean that valuable opportunities are lost, which could have been developed with a less than perfect policy framework. The experience of China in the late 1970s and early 1980s is clear evidence that a country can attract investment even where the policy and institutional environment is fairly primitive. The experience of Bangladesh, which increased its garment and textile exports from less than $4 million in 1980/81 to nearly $300 million in 1986/87, shows that dramatic expansions of non-traditional exports can occur even where the policy framework and other business conditions are not terribly conducive to industrial development. Even allowing for the possibility that China, with over a billion potential consumers, and Bangladesh, with exceptionally low wage rates and unimpeded access to key markets, are special cases, the more recent experience of other countries, such as Thailand, Vietnam, Burma, Mauritius, Lesotho, Swaziland, Jamaica, Dominican Republic, indicates that by capitalizing on one or two advantages in market access or factor cost and availability on the one hand, and by making a few critical policy reforms, a country can attract a small number of investors which, as their success becomes apparent, may serve as the core of a large, export-oriented industrial expansion. The experience of these countries strongly suggests that a small core of outward-oriented companies can serve as a major catalyst to accelerated development of a better business environment, both by pushing for necessary policy reforms and by creating substantial pressure for their effective implementation.

Conversely, countries which have instituted far-reaching policy reforms and have created a policy environment that may even be superior to that which is found in investors' home countries, will not necessarily attract investment or expand exports of the kind or in the amount expected. A case in point is Botswana, which has what may be the most liberal business environment in Africa, abundant financial resources, and a generous package of investment incentives, yet which has attracted far fewer foreign investors than expected, and which remains almost wholly dependent on mineral and beef exports. There are many reasons for this, including institutional constraints and a tendency to promote investment in industries in which it has little competitive advantage.

Rhee and Belot (1990) identify several key policy elements that anecdotal evidence suggests are the most important in attracting investment and expanding exports. They are:

- unrestricted access to inputs at world market prices
- access to financing at appropriate costs
- ease of investment licensing
- realistic exchange rates.

Additional elements that appear equally important are:

- a stable, fair and transparent legal system
- an absence of excessive exchange controls and the ability to repatriate earnings
- a rational and not excessively burdensome tax regime
- an absence of government interference in, or restrictions on, hiring and firing of workers or other operational aspects of business activity.

This is not to suggest that exports cannot grow unless all or most of these conditions are met, nor does it suggest that investment will automatically flow once they are met. Evidence does strongly suggest, however, that countries in Sub-Saharan Africa, few of which have such commanding advantages in domestic market size, the cost of inputs, or access to export markets that companies are willing to put up with major inconveniences in order to operate there, must move as quickly as possible towards the establishment of an attractive business and investment climate.

This paper concentrates on the policy reforms required to establish a business environment conducive to increased investment, expanded exports, and the development of non-traditional export-oriented industries. It is based on a presentation delivered to the Uganda National Forum on Strategic Management for Private Investment and Export Growth. This was an IPC activity aimed at introducing strategic management practices into the development and implementation of export and investment promotion policies. The paper also draws many of its examples from other, successful IPC activities, including support to trade liberalization in the Philippines, assistance in development of private sector industry associations in Ghana, help in introducing strategic management practices into policy planning and implementation in Jamaica and Zambia, and support for market-oriented economic reforms in Zimbabwe.

I. SEQUENCING OF REFORMS

It is possible to distinguish between those policy reforms that are "necessary conditions" for export and investment expansion, and those that, although they are important to ensure sustainable export growth and investment, do not need to be fully implemented before a country can begin to implement its promotion strategies. In his study of economic policy reform in Africa, Ravi Gulhati (1990) cites the example of Mauritius, which has had one of the greatest successes of any developing country in developing non-traditional exports. The Mauritius government embarked on a reform program in 1980, supported by an IMF Macro Policy agreement and a World Bank structural adjustment program. It was not until 1983, however, that the government even began to analyze possible trade policy reforms, and it was not until mid-1984 that the first quantitative restrictions on imports were removed. True import liberalization did not begin until 1987, after the economy had been stabilized and the export and investment boom was well underway. Unemployment had fallen from over 20 per cent in 1982 to 4 per cent in 1987, while the country's balance of payments, which had averaged -11.6 per cent from 1979 to 1982, showed a surplus in 1986. In Gulhati's view, "perhaps the most successful reform was the restoration of the EPZs international competitiveness through a package combining a flexible exchange rate with wage restraint...realistic exchange rate valuation is a necessary condition for expanding exports and restraining imports, particularly when quantitative restrictions are being removed and import tariffs are being rationalized" (Gulhati 1990: 68 and 90).

The lesson here is that Mauritius recognized the conditions that had to be in place before it could hope to attract the investment its export boom would depend on. Because of political constraints in the wider economy (e.g., political resistance to IMF programs calling for reduced government spending; government and trade union resistance to reform of the sugar sector; resistance of import substituting industries to trade policy reform), these reforms were initially quarantined in the EPZs. Ultimately, the success of the EPZs proved so persuasive that most of the EPZ incentives, such as low taxation and access to inputs, were made available nationwide. In the Mauritian example, the EPZs served as a mechanism to introduce essential reforms before the political environment would support their widespread implementation. In this example, the proper sequencing of reforms, and the evident success of initial reforms, created an environment conducive to the implementation of further, sustainable reforms.

This does not suggest, however, that there is a blueprint for reform that is universally applicable, nor does it imply that even those policies identified as necessary conditions be fully in place before other policy and practical measures can be undertaken. Indeed, empirical evidence, from Mauritius and many other countries, strongly suggests that policy reform and export expansion can create a "virtuous circle" in which policy reforms lead to expanded exports, which in turn provides the impetus for further policy reforms. Martin Bornstein identifies four principal elements of economic reform: adjustment, marketization, privatization, and integration with the world economy, and concludes that, "because the four dimensions of economic reform can be mutually supporting, and because the outcome of reform measures in any one dimension is uncertain, a country may pursue all four dimensions of economic reform at the same time, rather than searching for and trying to follow some ideal progression of reform components and measures" (Bornstein 1990: 42).

II. FOREIGN EXCHANGE

a. Realistic Exchange Rate

Investment in developing countries has often been impeded by overvalued currencies. For most African countries, which lack large domestic markets, investors are attracted mainly by the potential to export to industrialized countries in Europe and North America. Overvalued exchange rates undermine what is often the major advantage African countries seek to exploit: namely, low wage rates. If foreign currency earnings only buy a fraction of the local currency units that a realistic exchange rate would suggest, local wages suddenly become uncompetitive.

Overvalued exchange rates can also, paradoxically, inflate the cost of imported inputs. When the exchange rate is overvalued, access to foreign exchange at the official rate must be strictly rationed. Delays in obtaining official foreign exchange impose a significant cost on companies even apart from the costs associated with failure to obtain foreign exchange in sufficient quantity. The solution that many companies turn to is to purchase foreign exchange on the parallel market. However, even in countries where the government allows the parallel market to operate, the purchaser of foreign currency must pay a premium over the rate that would be in effect if a more liberalized official exchange regime were in place. In countries where the government prohibits all parallel foreign exchange transactions companies engaging in such transactions, apart from the risk of punishment and fines, will also pay a risk premium in the exchange rate they obtain.

Overvalued exchange rates are, furthermore, subject to precipitous and unforeseen devaluations as governments respond to donor pressures for economic restructuring. Such devaluations can, overnight, change the cost structure for a company or an entire industry, rendering inputs more expensive. While moves of this kind towards a realistic exchange rate cannot, over the long term, be disadvantageous, their abrupt character makes it exceedingly difficult for companies to develop business plans, particularly for companies that sell in both domestic and export markets and which have a cost structure comprising local and foreign costs. These risks are especially acute for foreign investors, which are likely to have a capital structure that includes foreign, hard-currency obligations, which suddenly become far more expensive in local-currency terms as the currency is devalued. This foreign exchange risk alone is sufficient to cause many companies to avoid countries that otherwise would represent attractive investment possibilities.

An example of the problems created by overvalued exchange rates is offered by Zimbabwe which has, as a consequence of its exchange rate policies and restrictions on access to foreign exchange, seen many of its industries operating at a fraction of capacity, since they have been starved of equipment, spare parts, and raw materials. Zimbabwean companies with the resources to do so have moved many of their operations across the border to Botswana, which has a realistic (or somewhat undervalued) exchange rate. Foreign affiliates of Zimbabwean companies have, in many cases, undertaken expansions in Botswana rather than in Zimbabwe. Many, if not most, of these cross-border investments were aimed principally at the Zimbabwe market, which had the effect of further worsening Zimbabwe's foreign exchange position as it began to run substantial trade deficits with Botswana. In 1991 the Zimbabwe dollar was devalued by more than 60 per cent, which abruptly halted most of Botswana's exports to Zimbabwe as suddenly their prices were more than doubled. Although this development may have lessened Zimbabwe's trade deficit with Botswana as Botswana goods were priced out of the market, it also reduced Zimbabwe's own exports, as Zimbabwean companies supplying intermediate goods to their sister companies in Botswana saw that market vanish.

As the case of Zimbabwe demonstrates, a restrictive and overvalued exchange regime followed by abrupt devaluations can have profound effects on investor confidence that it may take years to remedy.

b. Liberal Foreign Exchange Controls

Related to a realistic exchange rate and equally important from the point of view of exporters and potential investors is the ease with which companies and individuals can obtain foreign exchange and transfer funds abroad. Companies seeking investment opportunities overseas generally have a minimum required rate of return, which is normally calculated in the currency of their home country or in a major currency such as the U.S. dollar or the Deutschmark. Without the guaranteed ability to convert local currency earnings into foreign exchange or to retain foreign currency earnings few companies will choose to invest. Companies also require the freedom to repatriate the proceeds should they decide to liquidate their investment, and will hesitate to invest without explicit guarantees of this right.

Some countries that are reluctant to liberalize or remove their exchange controls across the board will nonetheless grant special exemptions to certain companies or investments considered to be of strategic importance to the national economy. Such arrangements are especially common in the mining and petroleum sectors.

Adopting this kind of approach is inherently risky and is likely to turn away a significant number of potential investments and to attract others that may not be in the country's best interests. Investors, whether they are engaging in direct or portfolio investment, demand a premium for the level of perceived risk. If a country has not established a firm legal commitment to the rights of companies to repatriate earnings but instead grants exemptions on a case-by-case basis, investors will perceive, accurately, that a special exemption, arbitrarily granted, can also be arbitrarily revoked. Companies investing on this basis, rather than committing themselves to a long-term participation in the country's economic future, will seek to repay their initial investment as quickly as possible, rather than continuing to invest in increased capacity and productivity. Adopting a system of case-by-case exemptions also is an invitation to corrupt behavior on the part of officials responsible for evaluating and granting exemptions.

Exchange controls can have important adverse effects on exporters, particularly those which depend on imported inputs. Companies with high inventory turnover must constantly order new raw materials, something that becomes difficult if they must apply each time for the necessary foreign exchange, in a process subject to delays and arbitrary controls. Exporters supplying major markets in industrialized countries are often subject to stringent delivery deadlines. Even small delays in obtaining the foreign exchange needed to buy inputs may cause an entire order to be rejected by the customer as the production and shipment schedules slip.

The presence or absence of exchange controls also affects a company's ability to hire expatriate technical and managerial staff necessary for an investment project to succeed. Without the freedom to repatriate most of their earnings in a convertible currency, few expatriates will willingly accept a position with the company. Stringent exchange controls also can reduce the availability of local managerial and technical staff as they seek opportunities in other countries which grant them the freedom to transfer their earnings offshore. Again, the example of Zimbabwe illustrates this point: large numbers of Zimbabwean technicians and managers have left to take up positions in Botswana or South Africa, thus depriving Zimbabwe of essential talent.

Implementation Issues

An overvalued exchange rate, generally accompanied by exchange restrictions, has powerful constituents in many African countries. In the CFA zone, of course, exchange rate policy is beyond the control of any single national government. However, most governments in the CFA zone would resist pressure to devalue the CFA franc. Apart from Côte d'Ivoire, Cameroon, and the oil-exporting countries Congo and Gabon, most CFA countries import up to five times as much as they export (World Bank 1993). In these countries trading in imported goods is a mainstay of the economy. For most of the CFA countries, already heavily indebted, a devaluation would increase their debt service burden in local currency terms. In addition, the overvalued exchange rate acts as an effective subsidy for consumer goods and helps reduce the chances of the urban unrest that often accompanies rises in consumer prices. In many CFA countries, even manufacturers are hesitant for this reason to support devaluation. One Malian industrialist is reported as saying that his factory was burnt down once in the uprising that overthrew the Moussa Traoré regime; although a devaluation would render his business more competitive, he opposed it because it would almost certainly cause his factory to be burnt down a second time (Hardy 1993). Finally, even if the 14 CFA countries were to agree to a devaluation, the final decision rests with France. Although France would undoubtedly prefer a devaluation, many powerful and well-connected French companies holding lucrative government contracts in Africa would lobby hard to maintain the current value of the CFA.

In non-CFA countries, overvaluation is invariably accompanied by strict exchange controls. In these countries, access to scarce foreign exchange becomes an important tool of political patronage, since the ability to import goods at the overvalued exchange rate is an immediate path to riches. One solution governments often pursue is to allow the parallel market to function, although it remains technically illegal. This, too, is a politically useful tool, since selective enforcement of the law can be used to control political challenges while pandering to popular resentment of ethnic minorities. Periodic crackdowns on Indian businessmen in East Africa or Lebanese in West Africa, on the pretext of black market currency dealings demonstrate the extent to which enforcement of exchange controls and exchange rates can be manipulated for political effect. It matters little that the effect on exports and inward investment is almost wholly negative. Often these negative effects do not become apparent for a long time, while the "positive" effects of personal enrichment by elites, increased political control, and the appeasement of popular resistance to the government are felt immediately.

Despite the difficulty of enacting currency reforms, there is no real alternative for countries seeking to develop export markets and attract inward investment. For most prospective investors, the ability to repatriate earnings is one of the most critical elements of a decision to invest. African countries must realize that the Asian and East European countries with which they are competing for investment already have open foreign exchange regimes and realistic exchange rates. Although some countries have operated a system of rule by exception, under which desirable investment projects have been granted one-off concessions, even the most generous such concessions often fail to motivate foreign companies to invest, since they reason that whatever can be granted on an individual basis can just as easily be revoked. Even in Botswana, which has always had a convertible currency and minimal exchange controls, potential investors frequently have expressed concern that these policies may be altered.

Although IMF and World Bank adjustment programs have sparked unrest in many countries, external pressure from donors is often the only way for governments to enact necessary but unpopular currency reforms. Skilled politicians often are able to deflect criticism away from the government and onto the donors as a means of staying the course of reform without suffering its negative consequences, as the anti-donor rhetoric often employed by the Rawlings government in Ghana demonstrates. In the short run, this may be the only workable approach to the problem. In the long run, as the benefits from a realistic exchange rate become apparent, as has occurred in most Asian and several African countries, public resistance to the new policies will diminish or disappear altogether.

III. FISCAL POLICY

Appropriate fiscal policies and management of public finances are critical to development of exports and inward investment. There is, of course, the obvious fact that foreign investment is unlikely to flow to those countries which impose too heavy a fiscal burden on companies or individuals. This is true even in those countries which grant tax holidays or other exemptions to investors, since investors tend to fear that favors granted on an exceptional basis or as part of a package of special incentives are more easily revoked than those that are part of a uniform code, universally applied.

There is, however, another, more damaging effect of inappropriate fiscal policies on foreign investment, which occurs when a heavy tax burden causes enterprises to move from the formal to the informal sector, and prevents enterprises, as they grow, from moving into the formal sector. This contributes to a shrinking tax base, to which governments tend to respond by increasing the fiscal burden on those companies remaining in the formal sector. It is a problem analogous to that faced by the New York subway system, in which deteriorating services and higher fares cause people to abandon the subway for other modes of transportation, in response to which fares rise even higher, causing the user base to shrink still further.

In most African countries that have failed to reform their fiscal policies the formal sector may account for as little as 10% of economic activity, while constituting by far the largest source of government revenue (apart from foreign aid). In Madagascar, for example, reliable estimates place 80 to 90 per cent of all economic activity in the informal sector, a classification covering everything from subsistence farmers and street vendors to some fairly sizeable trading, service or artisanal enterprises that may perform some activities in the formal sector, but which keep a substantial portion of their activities undeclared. In such an environment, which is hardly unique to Madagascar, it is surprising that even 10% of companies remain in the formal sector.

Another example is provided by Mali, where the tax code includes a 45% tax on profits; a tax on business revenue that can go as high as 20%; a value-added tax; a 7.5% payroll tax; a 30% tax on real estate revenues; an 18% tax on dividends; and a 50% personal income tax, as well as various licensing and registration fees that raise the cost of doing business still higher. It is unlikely that any company pays all the tax the law requires; however, the willingness of the authorities to allow some flexibility creates a sort of client relationship in which the State depends on businesses for its revenue, but businesses in turn require substantial protection in order to survive. As a 1989 study of the Malian economy indicated, that, “the modern private sector only exists today on sufferance...Malian traders were authorized to return to Mali in 1968 but they were obliged to prove their loyalty and, in certain cases, to invest in industry, limit their profits and endure an extremely heavy tax burden that made them the primary source of revenue for the Malian budget. In exchange, they enjoyed the privilege of becoming part of the government’s clientele and were granted tax exemption and other...favors” (Courcelle and de Lattre 1989: 9). These favors in general include a high degree of protection from both foreign and domestic competition, largely through a combination of high import tariffs and barriers to investment. As Courcelle and de Lattre point out, “the foreign private sector has to accept the same unwritten rules, but, as it does not have the same reasons to do so as the Malian traders, it finds it more difficult and is tending simply to pack up and leave the country. The foreign private sector is ill-adapted to the Malian context...it is powerless to escape the predatory action of the State because it finds it too difficult to conceal its activities. Consequently it has only an extremely limited chance of development in either the industrial sector or trade sector.”

In many African countries the consequences of these policies have been disastrous. The shrinking tax base has starved the public investment budget, so that the physical and educational infrastructure a country needs to compete have been allowed to deteriorate. The domestic private sector has been rendered uncompetitive, often operating with a bloated work force, again at the State’s instigation, and surviving only because of the State protection it receives in return. The cost structure of exports, even in the absence of exchange rate distortions, is rarely competitive. A few foreign companies, mostly those with a long colonial experience, survive with the same kinds of protection afforded to formal sector domestic companies. Other foreign investors, however, faced with declining markets and a worsening environment, leave, while almost no new foreign investment occurs.

Many African countries, faced with the unpleasant consequences of their fiscal policies, yet recognizing the need for foreign investment, respond, not with an overall reform of fiscal policies, but with a set of exemptions and incentives designed to circumvent the policy obstacles to investment.

Many countries, in Africa and elsewhere, seeking to attract investment have recognized a need to offer some incentives to investors and exporters. They key question, however, is the extent to which incentives should take the form of economy-wide reforms applicable to all companies, or benefits restricted to certain classes of investors or exporters. Most countries, at least in their earlier stages of opening to investment, seem to favor the latter approach. A variety of tax holidays, grants and subsidies are made available to investors and exporters, based on the number of people employed, export volume, capital invested, and other factors. While these incentives have attracted investors to many countries, the net benefit to those countries is far from clear, for several reasons, including:

a. The Temporary Nature of Benefits

Few countries are prepared to offer incentives that continue indefinitely, and so develop a package of incentives meant to help companies to achieve levels of productivity and efficiency that will allow them to compete without subsidies within a specified period. In Botswana, for example, one of the critical problems in attracting investment is the exceedingly low level of labor productivity, combined with wages that are high relative to those in many other countries. Botswana in the early 1980s developed a Financial Assistance Policy (FAP) that offered a range of subsidies that included a labor grant that would reimburse 80 per cent of the wages paid to unskilled or semi-skilled workers in the first two years of operation, 60 per cent in the third year, 40 per cent in the fourth and 20 per cent in the fifth. It was assumed that the combination of on-the-job and formal training combined with five years of production experience would raise productivity to internationally competitive levels by the time the subsidies expired. Evidence from scores of companies benefiting from FAP has demonstrated that productivity has not reached competitive levels within the five-year period, and that their cost structure without the subsidies remains uncompetitive. Particularly in industries where the initial capital investment is low, companies can and do leave upon expiry of the incentives and move to other countries where the cycle is repeated. The alternative, which is to prolong the incentives indefinitely amounts simply to subsidizing inefficient industries which generate few real benefits for the nation.

b. Negative Economic Rates of Return

Countries offering incentives accept that, while the period during which the incentives are in effect can be exceptionally profitable to the investor, it generates a negative economic rate of return (ERR) for the country. The rationale is that once the incentives expire the company will begin to generate a positive ERR. However, if companies move on once the incentives expire, then each successive project will generate a negative return for the country while the incentives are in place and nothing thereafter. The country will continually have to offer new incentives to other companies promising to come in and re-employ the workers who have lost their jobs when their previous employer went out of business. In some cases it is enough for a company to threaten to pull out for incentives to be extended or, at the very least, renegotiated.

c. Lack of Investor Confidence

As long as investment incentives remain a privilege accorded to certain investors having met certain criteria and applied for various benefits, there exists the risk that benefits, having been granted, can be rescinded. There is a natural suspicion on the part of investors that a government, having made promises and attracted the desired investment, will fail to live up to its obligations. Although there are relatively few instances of this having occurred, prospective investors tend to be much more wary of special deals than they are of rules that apply uniformly throughout the economy. The exception to this occurs where a company will have paid sufficiently large bribes to ensure the continued compliance of the officials in charge of the approval process. Many multinational companies will automatically seek to offer bribes even where none is requested, as a means of ensuring their continued favorable treatment. The adverse effects of such practices on a host country can be devastating; although many Asian countries, such as Indonesia and Thailand, have managed rapid growth even though corruption is rife, in Africa the price of corruption has been economic stagnation, stifling of competition, and price distortions that impair competitiveness.

Also, in efforts to overcome investor suspicion, or to overcome other competitive disadvantages in an economy, countries begin to offer ever more generous incentives in a sort of bidding war where the country that “wins” actually loses by incurring costs that are disproportionate to the benefits received.

Although there is evidence that investment incentives, if properly structured, can attract initial investment that can play a critical role in stimulating industrial development, the evidence is also clear that in order to prevent those investors from moving on once the incentives expire, and to establish a truly sustainable progress towards industrialization, wide-ranging economic reforms are also necessary. Also, for both economic and political reasons, countries should avoid giving preferential treatment to investors while denying domestic companies, many of which could also become exporters in their own right, access to the same benefits. Evidence also suggests that tax benefits and other incentives should not be confined to exporters but should apply equally to all companies. In countries where the domestic market is small, anything that permits companies to increase their profitability and improve their product quality, production technologies and management ability is also likely to lead those companies to begin exporting.

Mauritius, which through its EPZ programs and other incentives has had tremendous success in attracting investment, has recently revised its tax code and other policies affecting businesses in recognition of these facts. Mauritius has moved from a system of tax holidays for export-oriented firms to a uniformly low tax rate (15 per cent), which is applicable to all companies and individuals. Hong Kong, which in a generation has moved from poverty to wealth through an explosion in manufacturing and service industries, owes much of its success to an absence of regulation, free port status, and a maximum 17 per cent marginal corporate and personal income tax (a maximum 15 per cent average rate). Hong Kong, which has maintained a realistic (or undervalued) exchange rate, has combined all those elements that are of critical importance to investors: unrestricted access to inputs at world market prices; access to financing at appropriate costs; ease of entry and of investment licensing; and a stable, fair and transparent legal system.

Implementation Issues

The issues discussed above are, essentially, those of implementation. Additional implementation concerns arise from the tension between companies already present in a country and the new investors the incentives seek to attract. Existing entrepreneurs feel, rightly, that the incentive regime gives an unfair advantage to new entrants into the market. While incentives tend to be applied mainly or exclusively to export-oriented companies, thus avoiding anti-competitive effects in the domestic market, there is no question that companies benefiting from special investment incentives may be able to compete more effectively on export markets than those companies that do not receive them. Apart from the cost of extending benefits retroactively to earlier investors, it can be argued that, since incentives should be designed so as to attract only those companies that otherwise would not invest, then earlier investors should, by definition, be excluded.

Investment incentives tend to become a game in which prospective investors seek to exact the maximum possible concessions from the host country. This game is played, not only in the pre-investment stage, but often after the investment has been made and the host country's stake in preserving the investment has become much greater. This is seen particularly where countries have sought to promote development in a disadvantaged, often remote area, where the potential loss of jobs can be disastrous. This has occurred several times in Botswana, where the government has developed a special incentive package for the Selebi-Phikwe, a town heretofore wholly dependent on the declining copper industry. A number of companies have successfully negotiated arrangements even more generous than the standard package, and then have been able to obtain even more generous concessions when they have encountered problems that could result in closure of their plant and dismissal of hundreds of workers. Few governments can resist pressures of that kind. Prospective investors also have become adept at playing off one potential investment site against another, in a bidding war in which the country that wins the investment may ultimately lose because of the costs it incurs.

The lesson appears to be that, wherever a country develops an investment regime that requires companies to qualify for benefits and which involves some discretion on the part of government officials as to which companies and which kinds of investment do qualify, it will invariably attract less investment of the kind desired, and will incur unacceptably high costs. For this reason, EPZs, although they have fallen into some disfavor, may be the optimal interim choice. EPZs, by establishing a uniform, impartial framework, remove much of the negotiation from investment promotion and investment decisions. At the same time, the benefits of the EPZ regime can become so readily apparent that EPZs become simply an interim step on the way to turning the entire country into an EPZ. This has occurred already in Mauritius, perhaps the clearest example of a successful EPZ policy. The rapid proliferation of Special Economic Zones in China, and their success in attracting investment and contributing to economic growth, may be a precursor to wider reform throughout China.

IV. ACCESS TO INPUTS AT WORLD MARKET PRICES

Companies whose production is targeted at export markets require access to equipment, spare parts and raw materials or intermediate goods at world market prices in order to compete internationally. While most countries have recognized this need, a variety of mechanisms to respond to it have been devised, not all of which respond equally well to investors' needs. IPC worked extensively in the Philippines, helping the government to develop and implement a system to facilitate the access of export-oriented companies to inputs at world market prices. As this IPC activity demonstrated, trade policy is one of the most bitterly contested areas of economic policy, since it brings two equally important government objectives into direct conflict: the need to maximize government revenue in the immediate term, as opposed to the need to attract investment and increase exports in the medium and long term. When added to the widespread rent-seeking that is a feature of customs organizations in many countries, this causes import policies to be among the most difficult to resolve. As a result, as the IPC experience in the Philippines confirmed, a variety of less than optimal solutions may be put into place. Although the stated rationale may be that the methods chosen are the fairest and easiest to administer, their selection owes as much to the need to find a compromise among the various competing interests. In the Philippines, a duty drawback system was chosen, which enabled the different agencies involved in the process (the Bureau of Internal Revenue, the Bureau of Customs, and the Board of Investments being the most important) to achieve a cooperative working arrangement without which no workable system could be devised. Although, as discussed below, a duty drawback system involves the greatest cost to the companies involved, the system devised was better than that which had preceded it, and may have been the only mechanism with any chance to succeed.

a. Duty Drawback Systems

A duty drawback system is among the most commonly used mechanisms for allowing exporters to obtain inputs at world market prices. Typically, the importer pays duty on the goods it imports and then, once it has exported the finished product, applies to the government for reimbursement of the duty it has paid. This is a fairly costly and inefficient system. It requires that standard formulas of manufacture be calculated for each product so that the value of imported materials and the duty paid can be calculated. The system for processing duty drawback claims is often slow and subject to corrupt practices. It is one that Customs Departments and Finance Ministries typically resist, since objective measures of their performance decline if they must pay back revenues they have collected. Most critically, a duty drawback system imposes a high cost on the manufacturer, especially for products where imported materials may constitute more than half the value of the finished product, as is the case with garment manufacturing. No matter how efficient the system for reimbursement of drawback claims, the manufacturer will always have a substantial amount of material in inventory or in work in process, for which duty has been paid but not yet reimbursed. This increases the required working capital in an amount equivalent to the duty paid on average stocks, and increases overall costs by an amount equivalent to the interest charges on the incremental working capital. In countries such as Uganda, which may be quite distant from the sources of raw material supply, a company may have to maintain three to four months worth of raw materials in inventory. For a company importing, say, $10 million in raw materials each year, at an average duty of 30 per cent, this could increase working capital requirements by $1 million, and interest charges by $100,000. In an industry as highly sensitive to cost as the garment industry, this can render a company uncompetitive.

b. Bonded Warehouses

Under a bonded warehouse system, a manufacturer imports its materials in bond and keeps it in a special warehouse which may periodically be inspected by Customs officials. For finished product that is re-exported, no duty is paid. For finished product sold in the domestic market, import duty is paid at the time of domestic sale in an amount equivalent to the duty on the imported components. This is an effective and fairly inexpensive system; however, the cost of building and maintaining a dedicated bonded warehouse can make it impracticable for smaller manufacturers. Also, since the manufacturer must typically bear the cost to the Customs Department of supervising the warehouse, this tends to exclude smaller manufacturers from participating in such a system. An alternative system that has been devised for smaller manufacturers is a bonded Customs warehouse, operated by the Customs department, in which a number of manufacturers may store their raw materials in bond.

c. Waivers and Exemptions

Exporters may be granted duty exemptions for raw materials. Generally the exporter will post a bond to guarantee re-export; however, it can be difficult for Customs to verify the actual re-exportation of finished goods containing the raw materials specified. In addition, the case-by-case nature of waivers and exemptions makes them particularly susceptible to corruption and other abuses.

d. Export Processing Zones

Export Processing Zones (EPZs) are yet another method of ensuring that exporters can obtain inputs at world market prices. Two basic forms of EPZ exist: the first, which is a self-contained industrial park in which only 100% export-oriented firms are allowed to establish themselves; and the second, which is a tax, regulatory and customs regime applicable to all companies meeting certain defined criteria, regardless of location. The first, unless it is built by private sector companies, can be very costly to the government. The second, while it avoids significant costs to government apart from administration, a portion of which may be borne by the EPZ companies themselves, is more difficult to control. With a physical EPZ, movement of goods into and out of the zone can easily be monitored, something much more difficult if EPZ companies are geographically dispersed.

The effectiveness of EPZs has yet to be demonstrated conclusively. Although Mauritius has been highly successful in attracting investment by EPZ companies, this success may have as much to do with the country's overall investment climate as with incentives or special privileges granted only in the EPZs. Also, since Mauritius is a small island with a single port, administration of the EPZ regime is easier and less costly than it would be for a larger, landlocked country. In a country larger than Mauritius a decentralized EPZ regime would be costly and difficult to administer, while a centralized EPZ might concentrate investment in areas of the country that are less than optimal from a purely economic viewpoint, absent the EPZ incentives.

There are concerns that EPZs may contribute little in the way of skills and technology to the rest of the economy. A World Bank study of EPZs in 27 developing countries (World Bank 1991) concluded that "there is general agreement that the transfer of product and process technologies through EPZs is small, except perhaps in simple industries such as garments. The most important technology transfer effects are in management and technical skills... Skill transfer to the rest of the economy occurs mainly through the movement of people who have received training in the zones... If the business environment outside the zones is not attractive, however, these skill transfer effects tend to be unfruitful." There are related concerns, as highlighted in the World Bank report, that EPZs may delay essential economy-wide trade and economic reforms. While the direct effects of EPZs on trade policy appear to have been positive in Malaysia, Sri Lanka, and Taiwan, evidence suggests that in the Dominican Republic and other countries the effects have been negative or unclear. Also, the physical segregation of most EPZs and their operation as self-contained enclaves prevents development of the kind of backward linkages that non-EPZ industrial development often fosters.

Some investors may hesitate to establish themselves in an EPZ for fear that this will rob them of the flexibility to sell their products in the domestic market. This was of particular concern to many prospective investors in Botswana, which in 1990 established an EPZ regime in the Selebi-Phikwe region, for which only companies exporting their entire output outside the Southern African region could qualify. Since one major attraction of Botswana as an investment location was its access to the Southern African Customs Union (SACU) market and to the Zimbabwe market, the scheme received less interest than it might otherwise have done, in spite of the very generous investment incentives on offer. In the event, the first major investment to participate in the scheme applied for, and received, permission to sell a portion of its output in the SACU and Zimbabwe markets for which it would not receive the incentives applicable to exports outside the region. EPZ regimes that do not offer this flexibility may find it hard to attract investors.

A study of the relative costs of different import schemes for exporters in the Philippines (Manasan, 1990) concluded that, from the point of view of the exporter, EPZs were the least costly of all import schemes, involving negligible costs. Bonded manufacturing warehouses involved slightly higher costs, averaging 1.74 per cent of the value of imports, followed by common customs warehouses (ranging from 2.0 to 6.4 per cent of import value), duty exemption schemes (5.2 to 7.7 per cent), and duty drawback schemes (9.5 to 21.4 per cent). Variations within these ranges depended on service fees, interest costs, and the cost of re-export bonds.

Because of the high cost and delays associated with duty drawback schemes, many manufacturers will refuse to consider investing in a country that will not grant them a bonded warehouse facility, a duty exemption, or EPZ status. Domestic companies will have few incentives to export if their cost structure will be uncompetitive internationally because there are no duty drawback or exemption schemes in place. Few companies, moreover, will consider investing in a country that will not allow them an exemption from import duties and surcharges on imported plant and equipment.

Implementation Issues

Trade policy is one of the most complicated issues faced by governments that wish to encourage investment and exports at the same time as they seek to protect existing industries and provide effective subsidies to consumers. The result in most countries has been a patchwork system of contradictory policies that manages to alienate almost everyone at least part of the time. The duty-exemption, rebate, and EPZ measures described above are a product of such a system, efforts to alleviate the effects of various restrictions on favored interest groups when the preferred solution would be to abolish the restrictions altogether and to move towards broad-based reductions in import tariffs.

In most of sub-Saharan Africa, however, import duties are one of government's chief sources of revenue. Since few individuals earn enough to be subject to an income tax, and since collection of income taxes is difficult, if not impossible, maintaining relatively high customs duties is one of the few means available to governments to generate revenues. Such duties are hard to maintain, however, since they increase the incentive to smuggle. Furthermore, high import tariffs raise consumer prices and the potential for unrest, particularly in countries where trade provides the sole livelihood for large segments of the population. An immediate solution favored by many governments is to subsidize various consumer goods to offset the effect of high tariffs. In these days of structural adjustment, however, subsidies are even less acceptable than excessive import tariffs. The response of many governments is to relax their efforts to ban smuggling. This has happened in Mali, turning Bamako into what the magazine *Jeune Afrique* describe as the world's largest duty-free shop (*Jeune Afrique Economique* , May 1993). This has certainly eased the burden on Malian consumers. It has, however, also made it virtually impossible for Malian manufacturers to compete; Malian-made textiles are being crowded out by a flood of cheap fabric from China and Pakistan. This patchwork system of regulations and lax enforcement increases the burden on the formal sector and drives many entrepreneurs into the informal sector. The burden falls most heavily on manufacturing enterprises which, unlike traders, cannot easily move from the formal to the informal sector.

V. THE INVESTMENT CODE

a. Openness to Foreign Ownership

While a great many companies, especially in the mining and petroleum sectors, are content to operate and invest in developing countries as minority partners of a local private or parastatal company, many will refuse even to consider investing in a country that does not allow them a majority share or sole ownership. This is especially true for companies in industries which require substantial flexibility and responsiveness to market conditions and in which a partner with veto power could prevent the company from taking vital strategic decisions.

Many countries restrict or prohibit foreign participation in certain sectors of the economy, justifying these restrictions on grounds of national security (particularly for mineral exploitation) or the need to reserve certain economic activities and employment opportunities for citizens (i.e., in retail trade, manufacture of school uniforms, or agriculture). These restrictions carry with them definite costs to the national economy. Blocking investment in any sector, while it may be intended to preserve the jobs of citizens, often reduces employment opportunities by preventing the development of forward and backward linkages that create additional employment. For example, prohibiting investment by large retailing companies may be seen as protecting the interests of small traders; however, apart from the direct employment such retailers may bring, their investment can have important multiplier effects on employment in construction, transport, horticulture, meat and dairy production, and other industries which experience an increase in demand for their products and economies of scale in delivering large orders to a small number of customers rather than a large number of very small orders.

Blocking investment in certain sectors prevents the introduction of new efficiencies, which may result in lower prices to consumers, and the diffusion of managerial and technical know-how. The transfer of knowledge by the foreign investor often results in increased entrepreneurial activity as some local citizens, trained by the foreign investor, eventually start their own, competing businesses, which in turn contribute to lower prices and increased employment.

b. Ease of Entry

Many developing countries, as a relic of colonial bureaucracy, have retained complicated systems for industrial and commercial licensing. Botswana, which is in the process of reforming its licensing procedures, until recently required that Ministry of Commerce staff conduct detailed economic analyses of prospective investments to determine whether they should be granted a license. Applications for licenses also had to be published in the Government Gazette, inviting any interested individual or Botswana-registered company to register an objection to the granting of a license. If an objection was filed, the license was withheld pending formal hearings at which each side was allowed to present its case. Other countries have even more restrictive practices. In India, for example, for a company to increase its level of production or to change the mix of products it produces, it must apply for a new industrial license, a procedure that can take years.

All of these procedures constitute a barrier to investment. The Botswana Government, recognizing them as such, is in the process of eliminating its licensing requirements and India has begun to liberalize some of them. Malawi has just introduced a new Investment Code which eliminates the licensing requirement and requires only that companies go through the normal company formation and business registration procedures and provide only the most basic information on proposed business activities.

These are positive and essential steps. It is unclear why government officials would have any greater ability to judge the soundness of a project than the individual or company preparing to invest money in it. The underlying assumption, which is that companies would make uneconomic investments if government did not prevent them, is impossible to credit. The procedure by which existing companies can block or delay new investments has no justification, either in theory or in practice. The initial justification may have been to protect existing investments and jobs from “unfair” foreign competition. It is clear, however, that not only do such restrictions prevent domestic industry from becoming competitive in international markets, they also prevent new domestic job creation and impose higher costs on domestic consumers.

Implementation Issues

Investment controls, even more than foreign exchange controls, have strong constituencies in the business community and government. As a rule, although they pay lip service to the ideal of competition, most established businesses would prefer a minimum of competition. Wherever possible, they will lobby hard in favor of erecting and reinforcing barriers to entry, particularly with respect to foreign companies that may be larger, more cost-competitive, better managed, and more established in the market. Even in wholly export-oriented industry, established companies may seek to limit new entrants. Especially in such industries as textiles and garments, which often are among the first to take root in developing countries, established companies, seeking to preserve their share of the country’s existing or future export quotas, will resist any efforts to open the industry to new investors.

Cumbersome licensing and approval procedures are a way for governments to dispense political patronage, both in terms of granting rapid approvals or waivers to favored clients, and in terms of allowing bureaucrats to extract rents at numerous points in the approval process. Obviously, the more numerous the signatures required, the larger the number of people who benefit. Even when a government, genuinely desiring to encourage inward investment, decides to streamline the process, the bureaucratic rent-seekers will resist. A process that on paper appears completely straightforward can take on new levels of complexity in its implementation.

The classic response is to establish a "one-stop-shop" for investment approvals that limits the points of contact between an investor and the bureaucracy. Although an improvement, it does not guarantee the transparency and simplicity an investor might expect. A one-stop-shop can reduce the number of bribes an investor might have to pay, and it may provide a single convenient location for paying them, but it cannot of itself guarantee fairness. In research they conducted on mechanisms to facilitate foreign investment, Wells and Wint found that, while the "one-stop-shop" label is used to signal to potential investors that a country is serious about attracting investment, in practice, "with rare exceptions, what these so-called one-stop-shops have in common, apart from the administrative task, is a lack of decision-making power" (Wells and Wint 1991: 37). While one-stop-shops may reduce the number of government agencies a prospective investor must visit, the one-stop-shop system does not guarantee any improvement in the efficiency with which applications are processed. They cite a number of examples in which the one-stop-shop, in addition to lacking its own administrative authority, has very little ability to influence those government units that do make the decisions. However, as they point out, it is often difficult to create an agency that combines decision-making authority with the administrative function: "Given the political implications of centralized decision-making, such an agency is not created by a simple decree or legislative act. There are usually strong interests in the country, and within the government itself, that attempt to ensure that many government units have a role in the decision-making after reform, even if a single agency for foreign investment is created" (*ibid* : 39).

It can be argued that the very existence of an investment code indicates deficiencies in the overall policy environment. Few industrialized countries have or need investment codes, since the laws governing property, contracts, labor, taxation and trade are, for the most part, applied uniformly to all companies, whether foreign or domestic. The long-term solution is, therefore, to work towards a policy environment that will render investment codes superfluous. In the short term, removing potential barriers to entry is critical. While government has a legitimate role to play in establishing and maintaining a framework in which private economic activity takes place, it should absent itself as much as possible from governing or otherwise influencing investment decisions. In particular, as a recent World Bank assessment of industrial development policy in Botswana has shown (Bell, et al: 1992), government should not get involved in the appraisal and approval of private investment projects, but should instead restrict itself to administering the framework within which the private sector operates, and to collecting information that may be useful to government and private sector decision-makers. Malawi's Investment Promotion Act of 1991 similarly abolished most industrial licensing requirements and streamlined the procedure for company registration. These measures reduce the opportunities for rent-seeking behavior by government bureaucrats and established private companies, and eliminates de facto protection for monopolistic and inefficient industries.

As long as specific investment regimes exist, prospective investors will seek ever greater concessions from government. As hard as these are to resist in the early stages, they become almost impossible to resist once a project has been started and the investor threatens closure of his factory unless additional concessions are granted. At that point, for political as well as economic reasons, such demands are hard to resist.

VI. THE LEGAL AND POLITICAL ENVIRONMENT

Companies evaluating overseas investment prospects pay close attention to the legal and political system out of concern that commitments made by the host country government can abruptly and arbitrarily be reversed. Although lack of a fair and transparent legal system will not necessarily prevent companies from making an investment, it will affect the way those companies operate. The higher the perceived risk, the higher return investors will require. Perceived legal or political risk may also affect the capital structure of an investment, with investors committing smaller amounts of their own funds and relying more on local financial institutions. Finally, to the extent that a country's perceived level of risk is high, it will tend to attract relatively "footloose" industries which, because of low fixed investments and high returns, can earn an adequate return in a short period and then move on to another country should conditions change. These investments contribute little to long-term economic development although investments in those same industries (e.g., garments) can remain for the long term and make substantial positive contributions if political, legal and economic conditions allow it.

The legal and political environment also affects the ability and willingness of local companies to export. Legal and regulatory constraints do not necessarily impede a company's ability to thrive in the domestic market, since all other companies operating locally are subject to the same constraints. These constraints, however, and the higher costs and inefficiencies that ensue, can prevent companies from developing the cost structure and product quality required to compete internationally. The critical legal and political concerns of exporters and investors include:

a. Security of Investment

The economic history of most of Sub-Saharan Africa has caused prospective investors to fear arbitrary expropriation. Although most countries on the continent now have begun to encourage and promote private sector activity, it was not long ago that private holdings in many countries were nationalized. Although expropriation has conclusively demonstrated its failure on economic grounds, investors fear that political considerations may at some point override economic concerns and cause governments once again to expropriate private (and, especially, foreign) holdings. Although many countries have passed laws and investment codes that explicitly guarantee against expropriation, investors fear that a new government may renege on commitments made by its predecessor.

In order to provide assurances of the security of investors' assets many countries have joined the Multilateral Investment Guarantee Agency (MIGA) of the World Bank and have qualified for the U.S. Overseas Private Investment Corporation and Export-Import Bank investment guarantee programs, as well as similar investment insurance programs offered by other countries.

b. Political Stability

The history of non-democratic and often violent political change in Africa leads many investors to fear for the security of their investments, and to question whether an abrupt change in government may reverse economic policies and incentives that were critical to the success of their investment. Where disruptive or violent change occurs, it can affect a company's ability to operate as workers become unable to travel to work; road, rail or port transport services are disrupted; power or water supplies are interrupted; and inputs become unavailable. Companies also find it difficult to recruit managers and technicians to go to countries where the perceived risk to their own safety and that of their families is high.

More peaceful changes in countries where private economic activity and property rights have not been guaranteed by law and tradition, may bring about a complete reversal of economic and political conditions and policies essential for businesses to prosper. Recent changes in property laws in Swaziland and Zimbabwe, for example, allowing the government to force a landowner to sell to a buyer and at a price dictated by the government, can only be a powerful disincentive to new investment. Governments following structural adjustment programs may suddenly be succeeded by governments reversing structural adjustment policies or, in response to political pressure, may reverse their own adherence to structural adjustment, as has occurred several times in recent years in Zambia and Ghana. In either case, exchange rates, price controls, import tariffs, and a host of other factors may change overnight, to the detriment of existing and prospective investors.

c. Resolution of Business Disputes

In countries without a well-established tradition of rule of law and an independent judiciary investors justifiably fear that they will lose in any business or contractual dispute with a local individual or company. The investment codes of several countries, including Malawi, now provide for arbitration of business disputes, locally or internationally. Countries can, in addition, become members of the International Center for the Settlement of Investment Disputes (ICSID). In the event that arbitration fails, however, investors must have some confidence that their rights and interests are adequately protected in disputes, whether with local companies or individuals or with the government itself.

d. Labor Law/Minimum Wages

Many African countries have instituted labor laws more appropriate to an advanced industrial economy than to a developing country seeking investment. While workers have certain rights that should not be abrogated, restrictions on the hiring and firing of workers, or minimum wage requirements can place a country at a competitive disadvantage with respect to other, competing countries, particularly in Asia, that have no such restrictions. While the desire to protect workers from unfair dismissal is a worthy goal, it is an unfair restriction on businesses to require them to undergo lengthy arbitration proceedings each time they wish to dismiss a worker. Companies must also have the freedom to reduce their work force in response to changes in economic or market conditions; the alternative may be for the company to cease operation altogether. Minimum wage regulations, while they reflect an entirely appropriate aim to ensure that workers receive a living wage, can either prevent companies from investing or keep to a minimum the numbers of workers they do hire. In such circumstances, minimum wages serve as a subsidy for people who have employment, to the detriment of those who do not. A more equitable approach, which will increase employment and investment as well, would be to let wages be determined by the market and to apply whatever social welfare schemes may be appropriate and affordable to all low-income citizens, whether or not they are employed.

e. Customs Tariffs/Market Protection

The effects that high import tariffs on imported inputs can have on export competitiveness are discussed above, as are some of the measures countries can use to ease the tariff burden on exporters. High tariff barriers on items for domestic consumption can also have serious adverse effects on the ability of local companies to export and can, over the long term, even impair domestic companies' ability to compete in their home markets. The example of Kgalagadi Soap Industries (KSI) in Botswana is instructive. Government granted this company a seven-year, 100% tariff protection, intending to foster the development of a domestic soap industry and exploitation of a natural advantage from domestically-produced tallow, a major input. The intention was that, by being allowed to develop without pressure from imports, the company eventually would fortify its domestic market position and make significant inroads into export markets by the time its tariff protection expired. In fact, the opposite has occurred. Imported soap, mainly from South Africa, subjected to a 100% import duty, became far more expensive than the domestic product, although it was of higher quality. Retailers simply raised the price of domestic product to a level just below that of the imported product. Consumers ended up paying more for soap than they would have done in the absence of tariff protection. Since the price difference was slight, many of them chose to buy the higher-quality imported soap. KSI therefore gained no advantage from its tariff protection and may even have lost domestic market share as a result. The only group to gain from the protective tariff was the retailers.

Faced with such a situation, a government might seek to impose price controls or ban imports entirely. The experience from many countries has shown, however, that this merely leads to smuggling, since the windfall profits from evading the tariffs become very high.

The experience of KSI also demonstrates that, to the extent that tariff protection is effective, it prevents the protected company from developing a cost structure that will allow it to compete once tariff protection is removed. KSI management has stated that when tariff protection is removed in 1993, South African companies will have a better cost structure than KSI and will take additional domestic market share from KSI as well as preventing it from competing effectively in the South African market (John Rudd, Managing Director, Kgalagadi Soap Industries (Pty) Ltd., Personal communication, 1992).

f. Immigration Policy

Companies investing in developing countries require the ability to send managers and technicians, often for extended periods, to set up and supervise production, marketing and administration. Domestic companies trying to develop their export potential require access to foreign production technology and management skills. Although these are among the most important benefits accruing to the host country, as skills are transferred to local citizens, government policies often do not reflect this. Instead, there is a widespread suspicion of investors' motives for sending expatriate staff and a fear that expatriates are blocking locals from opportunities for employment and advancement. As a result, companies often face significant delays in obtaining work and residence permits for expatriate staff, or denial of authorization to send people who may be critical to the project's success.

These fears and suspicions, while understandable, are without justification. Although an individual expatriate may possibly seek to stay in his position even though there are locals with adequate experience and training to perform the job, from a company's point of view there is no reason at all to hire an expatriate to do a job that a local citizen can do equally well. The higher salaries paid to expatriates, together with the cost of transport, housing, schooling, medical care and home leave generally cause companies to hire only those expatriate staff whose presence is essential, and to replace them with citizens as soon as possible. to do otherwise would negatively affect the company's profitability, not to mention public attitudes towards its presence.

Governments, while they can and should continue to encourage the rapid transfer of skills to citizens, should realize that it is as much in a company's interest to do this as it is in the interest of local citizens to accelerate this transfer and the replacement of expatriates with locals. Consequently, procedures and requirements for expatriate work and residence permits should be eased.

Implementation Issues

The legal and political constraints to export and investment promotion are the subject of intense conflict among competing interest groups, each of which may be able to present compelling arguments against policy reform. These may include:

Manufacturers: As the case of Kgalagadi Soap demonstrates, tariff protection can, over the long run, erode a company's competitive advantage in the face of foreign competitors who must improve their operations in order to overcome cost disadvantages. This will not prevent most manufacturers from seeking protection and bitterly resisting attempts to remove it.

Laborers: Laborers, particularly in countries with strong unions, have the most to lose in the short run if protective tariffs are removed, both from loss of jobs and from downward pressure on real wages. The labor movement, and the politicians who must be responsive to the demands of such a large and influential group, also are in the forefront of resistance to changes in labor and immigration laws that may make it easier for companies to dismiss workers or to hire foreigners, as well as efforts to reduce or eliminate the minimum wage. Efforts to address these constraints must often employ less than optimal solutions. Botswana, for example, has dealt with the problem of high wages and low productivity by allowing the minimum wage to rise more slowly than the inflation rate, producing a gradual decline in the real wage.

Government Agencies: Different arms of government often have competing interests relative to export and investment policy. This competition can prevent any meaningful policy change or it can result in policies that often work at cross-purposes. An example of this is the IPC experience establishing a one-stop duty drawback center in the Philippines. The performance standards established for the Center, in particular the reduction in average processing time for rebate applications, ran directly counter to the Bureau of Customs performance measures based on revenue collection. In most countries the customs department presents significant opportunities for illegal rent-seeking by its employees. These opportunities may be severely curtailed by the establishment of an effective rebate system or an overall tariff rate reduction. In Botswana, the policy of allowing inflation to erode the real wage was partly offset by Central Bank policies allowing the Pula to grow stronger relative to the South African Rand and the Zimbabwe Dollar, raising Botswana's wages relative to those in South Africa and Zimbabwe. In many countries, policies to allow companies access to inputs at world market prices conflict directly with government's need to raise revenue.

IPC activities in Jamaica, Zambia and Uganda have shown that a high-level, integrated approach to policy formulation may be the best solution, allowing the multiple effects of various policy changes to be predicted and evaluated in light of overall national development priorities. In both Jamaica and Zambia, IPC has assisted in the development and/or strengthening of high-level policy units. In Jamaica, IPC has helped to develop a policy unit in the Ministry of Finance, which coordinates the formulation and implementation of economic policy. In Zambia, IPC has worked with the Cabinet to improve its decision-making capacity and to ensure more effective implementation of policy decisions. In Uganda, under the direction of the President, a National Forum on Strategic Management for Investment and Export Growth was convened with IPC assistance, bringing together representatives of government and the private sector to discuss the policy changes required for successful expansion of investment and exports and to address some of the more critical implementation constraints. While a one-time forum cannot hope to resolve all of the issues, it is a useful first step in the direction of developing broad agreement on what the issues are, if not on the optimal solutions to them. Botswana has used a similar mechanism under the auspices of the Botswana Confederation of Commerce, Industry and Manpower, an annual conference bringing together representatives of government and the private sector to discuss ways to improve the business environment. There is some evidence that this forum is taken seriously by both sides, and that in many instances issues explored at the conferences are translated into meaningful policy reforms.

VII. CONCLUSIONS

Successful promotion of investment and exports in Sub-Saharan African countries depends on four critical and mutually reinforcing elements:

- The establishment of a policy environment conducive to investment and exports
- Effective cooperation between government and the private sector on policy and practical issues in policy reform and investment promotion
- Development of an institutional structure and institutional capacity to carry out an investment promotion program and to provide the necessary support to investors
- Design and implementation of a focussed and sustained outward investment promotion strategy

As we have seen, the success of investment and export promotion efforts, while it does not require that all policy and institutional reforms be in place at the outset, depends to a large degree on successful sequencing of reforms, with those reforms that are close to being "necessary conditions" (e.g., the ability of companies to operate without excessive government interference; access to inputs at world market prices; and realistic exchange rate valuation) taking precedence over those that, while important, are not necessarily essential to a company's potential for success.

Companies considering potential investment in almost any developing country expect to encounter difficulties. The level of difficulty they will accept depends on 1) the expected reward or profit, and 2) the prospect of eventual changes in operating conditions that will reduce the level of difficulty. Investors will put up with far greater difficulties in countries such as China, India, or the former Soviet Union, where the potential rewards are enormous, than they will from small countries in Sub-Saharan Africa, where the potential rewards, even if all goes well, are far more modest. Similarly, companies will accept difficulties in countries possessing a valuable and scarce resource that they otherwise would never accept. The continued activity of Western oil companies in countries such as Angola, or of mining companies in countries such as Zaire, attests to that.

The policy and institutional reforms required to attract productive investment are largely the same as those required by domestic companies if they are to begin exporting successfully. The presence of capable local companies is itself an inducement to potential investors. Working with a qualified local company can lower the initial investment cost to a foreign company. Combining a foreign company's market access, production technology and management skill with the superior local experience and knowledge of domestic business, labor and political conditions of a local partner is a more efficient route to export success than for a foreign company to undertake a project entirely on its own.

It is often a bitter truth for a country to accept that, unique as it perceives itself to be, and as self-evident its advantages, it is one of many countries with similar or superior endowments in important areas. It is difficult for a country to realize that investors are rarely swayed by considerations of culture or sentimentality and that here again, most African countries are at a disadvantage with respect to countries such as India or China or the countries of

Eastern Europe, which have large and prosperous ethnic populations in Western industrialized countries, whose investment decisions may indeed be colored by ethnic and cultural attachment. Realizing this can, however, be a country's first step on the path towards undertaking the policy reforms needed to give it a competitive advantage in the international investment and export market.

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