Globalization and Domestic Policy Choices:

Issues and Lessons for Mozambique

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1 Introduction

Effective participation in the global economy poses important policy challenges for Mozambique. Trade policy is important. However, good trade policies include far more than import duties and trade agreements. And they work best in conjunction with complementary domestic policies.

2 Some General Lessons

2.1 Global Integration and Growth

The goal of economic development policies is to increase incomes and reduce poverty. Growth is essential to poverty reduction. And, as international experience shows, effective participation in the global economy is essential to growth. Low and middle-income countries that have succeeded in integrating themselves into the global economy have grown faster than richer countries. Those that have not have grown more slowly. Isolation is not a viable policy option, and this is especially true for a small economy such as Mozambique.

The question for Mozambique is not whether to globalize, but rather how to take advantage of global opportunities. Trade and investment policies have to focus on how best to open Mozambique to the global economy.

Foreign trade and investment policies have many dimensions. These include the structure of import tariffs, ease of customs procedures, transparency of rules with respect to quality and safety standards, tax policy and efficiency of transport and logistical networks. *Luckily, most of what is necessary for good trade policy can be done at home; it depends primarily on what we do for ourselves, and not what we negotiate with other countries.*

Good trade policies are not sufficient on their own to ensure satisfactory developmental performance. They need to be complemented by a wide range of other policies and institutions. 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 (finance, utilities, telecommunications, transport, etc.), and
- effective institutions and markets for human capital, especially in the form of education and flexible labour markets.

There is no unique set of policy and institutional prescriptions that apply to all countries and all situations. Political reality and differences in economic and institutional circumstances mean that each country must find a path that works best for itself.

While it is the private sector, and the decisions of investors, producers and workers that will drive a country's economic development, the role of the government is critical. It is the job of government to create an environment in which the incentives facing private decision makers are aligned with market forces and to ensure that fiscal, legal and other institutions facilitate competitiveness and do not distort or unnecessarily impede private actors.

2.2 Unbundling of Global Production and Import-Led Growth

Globalization has broadened development opportunities through the 'unbundling' or 'fragmentation' of global production. Vast improvements in information technology, transport and logistics, together with substantial freeing of international trade and investment have made it possible to unbundle value chains and allocate global production tasks for goods and services much more finely and in line with

comparative costs of production in different locations. International production has become truly global. For a simple example, see the following box on the Apple iPod.

1. Unbundling Global Production: The iPod

A recent MIT study of global production networks (Berger 2006) investigated the production of the Apple iPod.

"It contains a Toshiba hard disc, a Nidec disc-drive spindle, and ARM core processor, a Texas Instruments firewire controller, a USB interface chip from Cypress, and flash memory from Sharp. It is assembled by the Taiwanese company, Inventec. Half the retail cost of the iPod is made up of the cost of all the components and services that Apple buys in."

The iPod is an 'American' product, designed, marketed and sold by America's Apple Corporation. However, a more accurate description would be to say that the iPod is 'made all over.' This pattern describes a wide range of products from t-shirts to athletic shoes and computer software. It is made possible by advances in information technology, communications, logistics, and by the freeing of international trade and investment.

Source: Stern 2006

Countries that have participated successfully in these global production networks have experienced rapid rates of growth and poverty reduction.

The much discussed 'export-led' growth of east and southeast Asia is more accurately described and thought of as a story of *import-led growth*. Successful export industries were supported by policy regimes that reduced costs of importing raw materials and intermediate inputs through general trade liberalization and trade facilitation, often boosted initially by special measures to further improve access to inputs in world markets.

Two of the most successful institutional innovations in Indonesia in the 1980s, for instance, were

- the replacement of Customs by a Swiss pre-shipment inspection service that reduced the cost of importing by at least twenty percent in a matter of months, and
- an export facilitation program that freed exporters from import duties on intermediate inputs, from local content requirements and from all import licensing schemes on basic industrial raw materials, thus permitting them to compete on a level playing field against international producers.

Throughout east and southeast Asia such measures cleared a path for export-oriented investors while the governments tackled longer term issues of broader trade and regulatory reform.

These institutional innovations were magnets to investment in electronics, garments, footwear and other labour-intensive sectors. They resulted in average economic growth rates of 7 to 9 percent for more than a decade and a half, and reduced the incidence of poverty by massive amounts—from 40 percent in 1976 to 11 percent in 1995 in the case of Indonesia.

Mauritius, one of the clear post-colonial success stories in the southern Africa region, provides some interesting lessons from closer to home (see Box 2 below). While Mauritius benefited enormously from its policies to free exporters from the burdens of a protectionist import policies, failure to follow up with more deep-seated and general reforms created difficulties that have come to light as a result of the recent loss of trade preferences in sugar. Last year's government budget signals a bold attempt to catch up through a wide-ranging package of reforms.

The unbundling of global production chains provides a unique opportunity for countries like Mozambique to participate in international networks for production of many different goods and services. Taking advantage of these opportunities requires an investment environment that ensures low costs of doing business. Trade policy, broadly defined to include not just import and export duties and taxes but also logistics and trade facilitation will be critical.

2. Mauritius: Gains and Lessons from Globalization

Mauritius is one of the few African successes in global integration. But recent events have exposed some flaws

At independence Mauritius' economic prospects were bleak (see Meade 1964). It was among the poorest countries in the world. The population was too high for the island's limited land and natural resources. Any wage sufficient for landowners to hire the available labour force would be too low to support a subsistence standard of living. 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 5 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.

Central to this achievement were:

- recognition of special opportunities available in world markets, and
- export-promoting policy reforms—facilitation of the import of raw materials and the export of processed products, with minimal regulation or other interference.

Outward oriented investors in Mauritius were permitted to import what they wanted from any source they wished, to do any processing of these materials that they could do economically in Mauritius, and to export to any market.

An interesting feature of trade policy over the same period has been the continuation of relatively high rates of protection to a wide range of import substitution industries. Until very recently, the tariff structure has been characterized by high and variable rates, with an escalating pattern that encouraged inefficient local assembly industries. A long-entrenched myth about the importance and fragility of such import substitution industries perpetuated a high cost policy regime for an unusually long time.

It is only relatively recently, after recognizing the small amounts of employment in these industries and the high costs they impose on consumers, and after introducing a VAT that reduces budgetary reliance on import duties, that Mauritius began limited rationalization of its import duties (see Box 7 of Flatters 2002b). But many problems remain unaddressed.

It is a testimony to the effectiveness of the EPZ system that the export-oriented economy in textiles and other sectors developed so successfully in spite of these persistent import substitution measures. Mauritius now exports a wide range of manufactured products, including of course garments and textiles, but also sunglasses, watches and their parts, medical equipment and many other goods. In addition she continues to earn considerable income from tourism, and has begun to export banking and information processing services.

Nevertheless, recent losses in sugar preferences and consequent reductions in sugar prices have triggered a crisis that has awakened government to the risks of failing to proceed with more general trade and economic reforms.

According to the most 2006 Budget Speech of the Minister of Finance (Government of Mauritius 2006):

"We must no longer bury our head in the sand.…We simply cannot continue on the same path. It is the surest way to economic disaster and social upheaval. And those who will suffer most are the very people we want to protect: the poor, the vulnerable, the unemployed. We must charter a new course…

"Our plan requires us to stop subverting noble objectives with policies that achieve the very opposite. We must understand what is wrong with the current framework to accept that only wholesale change and adoption of a totally new paradigm is needed to emerge from the current mess.

"For example, we all want to promote SMEs but we make it impossible for them to operate in the formal sector. We want to encourage employment but we subsidise capital and impose high costs on those willing to hire. We want exports but we continue with a system that has a heavy anti-export bias. We want technology and a Cyber island but we make it hard for investors to come and even harder to establish residence and bring in needed skills.…

"Our greatest deficiency is the misery we have imposed on our workers. By protecting jobs we have made it impossible for our younger workers to find employment and for those who lose their jobs to get back to work. The inflexibility of some laws and the rigidity of some regulations and practices have consigned tens of thousands of our compatriots to the margins of development. They have been excluded by the very system that purports to protect them.

"It is time for the nation to embrace radical change and build a new, open and competitive service platform that is fully integrated into the global economy, like Hong Kong, Singapore and Dubai. Moving in this direction would benefit all Mauritians. Those with the lowest incomes and those currently unemployed will gain most. More important, by also removing other disincentives to small businesses and to hire workers, we will increase employment, reduce vulnerability and alleviate poverty."

3 Trade Negotiations and Trade Diplomacy

Most popular discussions of trade policy relate to what is best described as 'trade diplomacy' and centre on trade negotiations among national governments—for Mozambique these include the WTO, SADC, SACU, EPAs with the EU.

The main function of the WTO and other trade agreements should be to provide a mechanism for countries to commit to and lock in good trade policies. Among its most important initial motivations was the fear of outbreaks of trade wars among major economic powers in which the imposition of tariffs by one country to protect certain domestic interests would provoke retaliation by others and result in a mutually destructive escalation of protection.

3.1 Problems with Trade Diplomacy

The first lesson about trade policy, especially for a small country that cannot influence world markets, is that protection hurts only itself, and the benefits of any of its trade liberalization measures accrue to its own citizens.

Trade negotiations, especially under the WTO, are founded on a very different principle, a fiction that 'concessions' through tariff reductions are harmful to the country granting them and beneficial to its trading partners. *There is no doubt that some developing countries would gain from rich country tariff reductions on key labour intensive products such as garments and from reductions in agricultural subsidies and protection. But there is even less doubt that rationalization of their own tariff regimes would provide much greater and more direct gains.*

The World Bank estimated at the beginning of the Doha Round of WTO negotiations that under modest global trade liberalization scenarios world income gains 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. In other words, *most of the developing country gains from participation in the Doha Round could be enjoyed by staying at home and focussing on unilateral trade reform.*

There is little danger that any developing country would reduce its influence in WTO negotiations on trade in garments or agriculture by advancing its own trade liberalization program. However, the WTO can be used as a weapon to deal with opposition to reform by domestic vested interests.

Developing countries have argued for and been generally successful at obtaining certain special rights in view of their low-income status. Some of these, such as the ability to access generic medicines under less stringent licensing conditions than generally allowed by intellectual property provisions of the WTO regime, are clearly warranted and of great value. But others, such as the right to move more slowly in reducing import tariffs should be handled with great care. *Using the 'right' to delay trade liberalization is to forego the principal gains from participating in the global trading system, and thus will impede growth and poverty reduction.*

Trade negotiations should be used to promote and lock in good domestic trade policy, not to resist it.

3.2 Regional and Other Preferential Trade Agreements

International trade diplomacy has been increasingly dominated by regional and other preferential trade arrangements. This is certainly true for Mozambique, with SADC and SACU being just a small sample of discussions underway or at least contemplated.

For Mozambique *the key question 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:* Preferential trade arrangements cause costly trade diversion—they cause Mozambique to switch from low cost to higher cost sources of imports, reduce tariff revenues and provide little if any benefits to users of imports. This danger and its costs increase with the size of the tariff preferences that are granted. The simplest solution is narrow the gap between

preferential tariff rates and the tariff rates that are applied to imports from non-partners. In other words, the dangers and costs of trade diversion can be minimized by engaging in more general domestic tariff reform.

- *Regulatory Complexity:* The proliferation of special agreements increases the complexity of the rules for importing and exporting. Tariff rates depend on the origin and destination of the goods concerned. This results in substantial additional costs of compliance and enforcement of trade rules, and acts as a hidden barrier to trade.
- *Rules of Origin:* Most preferential arrangements require 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, they are often used an instrument of hidden protection by increasing the cost of qualifying for preferences. The solutions are to a) make rules of origin as simple and non-onerous as possible, and b) reduce the gap between preferential and non-preferential tariff rates.[1]
- *Policy Diversion:* Concentration on preferential trade negotiations and arrangements can divert scarce policy-making capacity from the more important and valuable tasks of domestic regulatory reform and non-preferential tariff reductions. Worse still, special arrangements are often negotiated for the benefit of a small set of rent-seekers with special interests in access to or protection from particular markets. The proliferation of such negotiations encourages this kind of rent-seeking and policy diversion.

Mozambique is currently a member of SADC and is considering an association with SACU. Both of these groupings are economically very small. *SACU is smaller than Finland and all of SADC is smaller than Turkey. Neither is large enough to serve as a strategic base for Mozambique to pursue successful 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.*

In addition, Mozambique's relatively high import duties, especially on final consumer goods, will divert imports of basic goods from cheaper global sources to more expensive South African suppliers. Joining SACU would lock Mozambique in to the common SACU tariff that is worse than Mozambique's in terms of its complexity and higher rates on key goods, especially garments and transport equipment.

If Mozambique could use membership in SADC and/or SACU to promote useful domestic trade policy reforms, this might overcome at least some of these problems. The best way to avoid trade diversion in SADC, for instance, would be to reduce Mozambique's general tariffs, especially on final consumption goods. Unfortunately, Mozambique's record so far has been quite the opposite. Rather than embracing SADC as a means to promote domestic tariff reform, Mozambique has taken every opportunity to backload tariff reductions on trade with its SADC neighbours. Of course, joining SACU would preclude Mozambique from conducting any further unilateral tariff reform.

Membership in SADC or SACU could be used as a reason to improve trade facilitation at its most important border points, especially with South Africa. This would yield large economic benefits. *But such improvements can and should be done independently of Mozambique's membership in SADC or SACU.*

Further general tariff reform and improved trade facilitation should be considered and undertaken regardless of any trade negotiations. Unfortunately trade diplomacy takes some of the country's best trade policy decision-making skills away from these key issues and reinforces protectionist tendencies and interests.

[1] See Flatters 2004 and Erasmus, Flatters and Kirk 2006.

4 Unilateral Trade Policies: Some Issues

While trade diplomacy can certainly be helpful, its main value, especially for a small country like Mozambique, is in assisting to motivate and commit to domestic reform. Trade negotiations, however, are at best an indirect way of achieving what can be done on one's own. Unfortunately trade diplomacy often stalls domestic reform, with serious and costly economic side effects.

International experience is clear on the economic benefits integrating successfully in the global economy. Nevertheless, a number of myths persist about reasons for resisting such integration.

4.1 Infant Industries

One of the most commonly used arguments for protection is that an industry is 'infant' and as such cannot compete without some initial protection against better-established competitors. Therefore it needs to be protected for a 'short' period of time. The argument is often combined with the claim that the infant is 'strategic' for the economy.

Consider the basic infant industry argument. Suppose that because of initial start-up costs or necessary learning a newly established firm or industry would not be able to compete immediately upon being established. First, if some kind of assistance is justified, import protection is not usually the best policy instrument to use. Not only does it subsidize the protected industry, it also imposes real economic costs on downstream users and/or final consumers. Employment gains are often small. See Box 3 for an example from Namibia (based on Erasmus and Flatters 2003).

3. Infant Industry Protection: Pasta in Namibia

The SACU agreement includes a provision for the protection of new 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 the local flour milling group that wished to build a new pasta factory, the government agreed to impose an additional import duty of 40 percent, to remain in place for four years and then be phased out gradually 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 virtually immediately at almost 100 percent of capacity—three shifts, seven days a week. It was obviously a commercial success. This should not be surprising in light of the very high levels of protection given. The effective rate of protection vis à vis South African producers was about 89 percent while vis à vis international competitors it was about 425 percent (based on cost data from the firm).

Other than rents created for the (South African owned) firm, what benefits does the infant industry protection give to Namibia?

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

What does the new 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 gives a product that is acceptable to some consumers, but disagreeable 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? The pasta factory operating at full capacity with three shifts employs a total of 20 workers (10 less than the minimum promised when applying for infant industry protection). But this low number does not even represent the net job creation from the factory. Prior to this factory, another local pasta producer served the local market with pasta made from flour purchased from the milling company that now operates the new pasta plant. Shortly after the new pasta plant commenced production, the old producer's line of credit was revoked and the factory was forced to close. Data have not been obtained on the number of job losses this caused. But it can be stated with certainty that the net number of jobs created by this infant industry protection is less than 20.

Second, why and on what basis should the government discriminate in choosing to subsidize the start-up costs of some firms and not others?

In practice, most governments are quite poor at picking 'winners.' And in countries where governments attempt to do so, investors become very adept at picking government's pockets. Infant industries often become perpetual children and impose long-term costs on domestic consumers, downstream users and taxpayers. Many fail before or after the end of protection. And others make excess profits from unnecessary protection and policy-sanctioned domestic monopolies.

There might, of course, be genuine problems with the investment environment that discourage new investment. If the problem is a weak investment environment, begin to repair it; don't make it worse by inviting rent seeking and engaging in costly and arbitrary 'infant industry' protection

Declining industries might be thought of as the opposite type of problem. The rise and decline of firms and industries is a natural and healthy phenomenon in a growing economy. This should not be discouraged by policies that try to entrench existing patterns of production. While some jobs might be lost in previous import substitution activities, many more new jobs will be created in export industries that were able to become competitive as a result of trade policy reform. In Indonesia, for instance, export industries generated on average 4 times as many jobs per dollar invested as in protected import substitution industries.

This is not to deny the social and economic value of policies and institutions to assist workers and vulnerable groups that are temporarily displaced as a result of these dynamic patterns. But adjustment assistance to workers does not require long-term industrial support to firms and industries that can no longer compete. Adjustment assistance can be given more effectively and at much lower cost if it is directed at workers rather than firms and industries. *Adjustment policy should concentrate on helping workers, and not on protecting particular jobs.*

4.2 Tax Incentives

Granting a tax 'incentive' to any activity, firm or individual requires that additional taxes be paid by others to meet any given budget target. This increases the overall economic costs of the tax system.

A recent McKinsey study reports on 14 case studies in Brazil, China, India and Mexico. They find 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 often are unnecessary and when they were necessary, promoted inefficient and non-competitive investments. India continues to give 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 over $300,000 per worker, with the principal result that Brazil became saddled with an industry with high costs and enormous surplus capacity.

South Africa's Motor Industry Development Program (MIDP) is giving a few European luxury car makers subsidies at a rate of over R14 billion (about US$ 2 billion) per year (my estimates, based on South African government data). For typical investors, the amount of subsidy has been 200 to over 600 percent of the amounts they have invested. This program was originally designed to provide temporary adjustment assistance for five years from its inception in 1995. It has been extended several times, is currently set to run until 2012, and the industry is pressuring the government for commitments to extend it beyond then.[2]

In recognition of these costs and dangers some countries are reducing their reliance on and streamlining tax incentives, paying more attention to simplifying their tax systems, and dealing more directly with underlying problems in the investment environment. As far back as the early 1980s

[2] See Flatters 2005b and Flatters and Netshitomboni 2006.

Indonesia abandoned the use of all tax incentives, simplified the tax system and lowered marginal rates. Some feared that this would cause Indonesia to lose out in competition for new investment in a region in which most neighbouring countries continued to dole out incentives. In fact over the next decade Indonesia's share of ASEAN's foreign investment doubled.

Tax incentives are costly. Furthermore, they are relatively unimportant to most investors. Investor surveys almost never find the tax system to be a major factor in investment decisions. The investment environment in almost all countries is plagued by much more important problems. Using tax incentives and thus damaging the integrity of the fiscal system should not be a substitute for dealing with them.

As for the overall structure of the tax system, *investors give greater weight to simplicity and stability than they do to tax incentives*.

4.3 Dumping and Subsidies

Two related arguments for protection are based on the claim that competitors are subsidizing their own industries and/or are 'dumping' their products in our markets.

The real argument is often simply that foreign competitors are able to produce at a lower cost than the claimant, and this is certainly not a legitimate argument for protection.

The principal costs of any subsidies are almost always borne by the subsidy-imposing country and have almost no effect on importing countries. In a few cases the subsidies are sufficiently large and widespread that they noticeably lower the world price of the good in question. While the subsidizing countries still almost always feel the main impact of the subsidies, there is some impact on other countries.

For net importers of subsidized goods, the appropriate policy response is to thank the subsidizing countries for their generosity. For net exporters, where the costs to exporters outweigh the benefits to consumers, is there any argument to be made for subsidizing or protecting domestic producers? No. Regardless of the reason for a low world price, any attempt to remedy the situation through offsetting domestic subsidies or protection imposes further costs that are borne domestically, and for economically small countries like Mozambique, with no effect on foreigners or international markets.

The only legitimate economic argument for anti-dumping actions is when dumping by a foreign seller is predatory in nature and will have the effect of creating a monopoly in the domestic market.

The simplest and best tool for preventing such predatory dumping is to maintain open international markets. In such circumstances it would be foolish for a foreign producer of steel or garlic to think that it could regain the losses incurred by temporarily dumping at below cost through selling later at a monopolistic price higher than in the world market.

The WTO has established rules for dealing with export subsidies and with dumping. These are aimed at preventing frivolous and harmful uses of protection and subsidies. Unfortunately these rules are less stringent than economically desirable and they leave considerable scope for measures that are harmful to the using country. Furthermore, developing countries are seldom challenged for their inappropriate (i.e. WTO-inconsistent) use of contingent protection (Bown and Hoekman 2007). As a result anti-dumping has become a form of disguised protection that is unfortunately sanctioned by WTO procedures.

The greatest problem with WTO anti-dumping procedures is that they do not require consideration of the interests of domestic consumers or downstream users of imported products. Imposing any tariff, temporary or permanent, to deal with so-called dumping, without taking into account the interests of domestic users is an invitation to rent-seeking and a recipe for bad trade policy. Fortunately WTO procedures do not prevent governments from taking these broader economic interests into account. But failure to do so will ensure that *anti-dumping will continue to be just another form of disguised and harmful protection* (see Stegemann 1991).

4.4 Market Failure and Policy Failure

A more general argument that is often made against trade liberalization and other types of market-oriented reforms is that markets are not perfect. Markets can fail in the sense that they give inaccurate signals about relative costs. This can happen when markets are incomplete or when there are significant 'external effects' of some activities—so that some of the consequences of individual actions are not built into market prices and as a result are under or over-provided relative to what would be optimal.

Research and development of new technologies is one area in which claims are often made for government action. While rich countries see this in the context of the development of new technologies, for poorer countries it is far less a question of finding new technologies than in gaining access to existing ones, and the best way to do this is through creating a friendly investment environment.

The biggest challenge facing low and middle-income countries is not usually to invent new technologies, but rather to create an environment that encourages foreign and domestic investment that capitalizes on existing and generally 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. As the experience of AGOA demonstrates, foreign buyers and investors can be a very effective lobby in battling protection in rich country markets. While African trade negotiators might have played a small role in the development of AGOA, the key actors were American buyers and investors that saw several African countries as potential new sources of supply in the face of quota scarcity and rising costs in Asia.

Often a much greater source of market failure is not the kinds of externalities that are so often discussed by economists, but rather failures of government policy and institutions. Industrial policy interventions are often justified on the basis of problems whose roots lie in policy failures elsewhere in the economy. Protection, investment and other incentives, for instance, are claimed to be needed because of the 'high cost' structure of the economy.

Why are costs high? The causes vary from country to country and over time. But the list generally includes some subset of the following complaints. Ports and customs are inefficient; telecommunications infrastructure is bad and highly priced; 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 have roots in weak government policies and institutions, and their solution 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, investment in human capital is maybe the most important market failure from growth and equitable development perspectives. The fundamental problems arise from an almost complete absence of capital markets for the financing of human capital investment at all levels of education and from the influence of family structure and income inequality on educational choices. Public support of investment in education and skills development should therefore be a critical element in any long-term development strategy.

4.5 Resources, Rents and Downstream 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 be an invitation to economic mismanagement.

State run oil companies in a number of countries have brought countries close to fiscal collapse by reckless spending of oil revenues and accumulating large debts based on expected future income, precisely the opposite of the prudent long-term rule of accumulating rents and spending only the current income from the fund.

Similarly, restricting primary product exports in order to encourage domestic processing can also result in substantial economic waste. Log export restrictions to encourage domestic processing in Indonesia, for instance, had the paradoxical effect of increasing forest exploitation and environmental damage while also facilitating massive amounts of rent-seeking activity, with huge economic costs to the country (see Box 4). South Africa has recently announced a program to tax diamond exports and to force exporters to sell a portion of their exportable product to a state trading house that will allocate the goods to domestic users. This is very costly way to support what almost certainly will be a small amount of almost certainly uncompetitive employment.

Policies such as these can turn resource rents from an asset into a curse.

4. Indonesia: Costly Downstream Processing in the Forest Sector

Indonesia is home of one of the world's richest endowments of tropical forests. Until the late 1970s she exported almost all logs in raw form to countries such as Taiwan and Japan where they were converted into veneers and plywood. Export earnings were in excess of $2 billion per year, but the government collected very few royalties.

In order to encourage more domestic processing, the government enacted an export tax on logs, but not on sawn timber or plywood. Labour cost differences were already beginning to shift processing investments out of high wage east Asia and into Indonesia, and the export tax was a small incentive to speed up the process. A year later, however, the government enacted a much stronger incentive, a progressive ban on log exports, implemented through an export quota designed to fall to zero in five years. The price of getting a share of the export quota and the corresponding high rents on log exports was to set up a plywood mill. Most newly built mills were inefficient and lost money. But that did not matter to investors as long as they viewed them as a necessary cost of engaging in highly profitable log exporting.

The management of the export quota was highly corrupt and virtually none of the log rents went to the government budget. Log export revenues plummeted and were only partially offset by increased plywood exports. Plywood mills were highly inefficient; their main purpose was not to produce plywood or to produce it efficiently, but rather to secure log export rights. Log rents were thus wasted in inefficient plywood production.

In the longer run, of course, plywood exports replaced log exports, and plywood efficiency gradually increased. The incentives, however, led to excess plywood capacity, creating a long-run demand for logs that was well beyond the Indonesian forest's sustainable or economic log production capacity.

The export restrictions did indeed serve the intended purpose of increasing domestic plywood capacity. But they did so at great cost. Despite its economic failure, the rent-seeking cronies of the government 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.

'Dutch disease' is the name given to the macroeconomic impact of resource exports on domestic costs and on the real exchange rate. Resource booms can raise costs and reduce the competitiveness of tradable goods producers through real exchange rate appreciation and through supply side pressures created by increased demand for non-tradable goods. This reduces the competitiveness of import competing activities and other exports. This can be dealt with through appropriate resource mismanagement, fiscal and macroeconomic policies. But failure to do so can be costly.

Resource rents are not the only source of 'Dutch disease.' Large inflows of foreign aid can have a similar macroeconomic impact. Recent research has suggested that the real exchange rate appreciation due to aid flows has had detrimental effects on the competitiveness of labour intensive manufacturing

industries in recipient countries and as such has blunted the effectiveness of aid in promoting development of low-income countries (Rajan and Subramanian 2005). This makes it even more important that aid be used effectively.

Resources are, in principle, an ideal base for taxation, since taxation of true economic rents creates no distortions in economic incentives. The challenge of designing a rent tax that does not distort incentives is not trivial, however, and in practice many resource taxes are not economically neutral (Boadway and Flatters 2003).

Taxing resource rents only when the goods are exported, for instance, creates potentially very harmful incentives to squander the rents being targeted. This was the case with the Indonesian log export restrictions and will be the most likely result of recently announced export restrictions and taxes on diamonds in South Africa.

Export taxes have even less justification when the commodities being taxed provide very little economic rent in the first place. This is the case for almost most agricultural products on which poor farmers depend for a living. Mozambique's export tax on cashews and Indonesia's export restrictions on rattan and cloves are good illustrations.

Abundance of a natural resource or a primary product can provide a 'natural' basis for economically competitive downstream processing activities. This advantage arises from differentials in transport costs in exporting the raw material relative to the processed product—processed goods are generally lighter and/or less bulky than the original raw materials and so are less costly to ship. Beyond this transport cost advantage, the overall competitiveness of local processing activities depends on the cost of complementary factors of production and technologies. There is no *a priori* reason to assume that the global distribution of endowments of these complementary factors will coincide with endowments of the natural resources themselves.

Restricting exports for domestic use means foregoing export sales at higher prices elsewhere. The cost of export restrictions is generally borne by the poorest of the poor—the farmers whose livelihoods depend on cultivation of basic export crops. This was certainly the case of export restrictions of logs, rattan, spices and fruits in Indonesia.

5 A Globalization Agenda for Mozambique

Mozambique has come a long way in a very short time in integrating itself with the global economy. This is especially remarkable in light of the social upheavals that have gone before and the natural disasters with which she has had to cope. Nevertheless, Mozambique is still a very poor country and much remains to be done.

Transport, information technology and communication cost breakthroughs have facilitated a major 'unbundling' of global production chains. This provides a unique opportunity for countries like Mozambique to participate in international networks for production of many different goods and services. Taking advantage of these opportunities requires an investment environment that ensures low costs of doing business. Trade policy, broadly defined to include not just import and export duties and taxes but also logistics and trade facilitation will be critical.

What strategy should Mozambique follow to fulfil the promise that has been shown by recent performance?

5.1 Focus on Domestic Reform

Mozambique's own domestic policies are far more important in determining her economic future than are the policies of the US, the EU or South Africa. Furthermore, Mozambique has very little influence over the policies of other countries and has similarly little influence over the outcome of trade negotiations in the WTO and elsewhere. In other words *Mozambique has a clear comparative advantage precisely in the area where it matters most—in managing her own domestic policies.*

Trade negotiations, whether in the WTO or with SADC, SACU or the EU, should be used primarily as a means of promoting and locking in domestic reforms. They should be distorted into an instrument for delaying domestic reform.

Domestic policy reform has to be broad-based. It has to deal with the entire regulatory regime, both at the border and behind it. Good trade policies work best in a supportive domestic policy environment.

Of course the government cannot tackle all regulatory problems simultaneously; some prioritization is necessary. In choosing its targets, the government should be guided by the overall 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 needs as well to be able to be able to identify and discount the pleas of non-competitive rent-seekers—those that seek protection and other special privileges to avoid rather than engage in competition. Developing and promoting domestic constituencies of competitive and outward-oriented investors is important in overcoming political resistance to growth enhancing reforms.

5.2 Import Policies

Mozambique has undertaken substantial tariff reform. Nevertheless, *import tariff 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 non-competitive import substitution industries, at a high cost to consumers and providing very little sustainable employment.*

Of equal or even greater concern are continuing problems with trade facilitation at the border.

Import policy reform should focus on both these problems.

Mozambique should continue with non-preferential tariff reform, and should not use external trade negotiations as reason 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 non-preferential tariff rate on final consumer goods should be reduced substantially. The number of rate bands should be reduced and the gap between them should be narrowed. To avoid costly trade diversion from preferential trade agreements into which Mozambique has entered, this process should proceed in tandem with the implementation of Mozambique's commitments in SADC that are just now finally coming into force.

Customs reform needs to continue, with greater emphasis on trade facilitation and less on methods of direct control to protect revenues. The main border crossing with South Africa has long been source of high transactions costs and unnecessary border delays. This is a matter of considerable concern to importers, exporters and consumers. This is a key border point in developing Mozambique's regional and global competitiveness and measures to increase competition and reduce costs should remain a key part of Mozambique's import reform program. The recently introduced security measures for scanning import and export shipments are another area of serious concern.

5.3 Export Policies

Development of labour intensive exports must be a high priority. This does not require that the government identify and give special support to selected 'winners.' Such an approach is simply an invitation to rent-seekers. Rather, it requires that it create a regulatory environment and a trade policy regime in which any competitive activity can thrive.

As indicated by the lessons of import-led growth in Asia and elsewhere, a key part of any export incentive program is to make it easy for investors and producers to import. Unnecessary and costly import and export inspections such as the new scanning requirements need to be carefully evaluated. Import duties need to be recognized as a tax on exports and reformed accordingly. Meanwhile, special measures must be undertaken to give at least partial relief through exemption from import duties on imported raw materials, and a smoothly functioning systems for crediting and refunding of VAT input taxes paid by exporters.

Of at least equal importance are all the behind-the-border barriers to investment and competitiveness posed by excessive and poorly implemented regulations, by other forms of red tape, by poor infrastructure and by weak and non-competitive service sectors. These impediments to business serve as barriers to entry and to domestic competition and as such are not necessarily seen as big problems to businesses serving the protected domestic market. However, they are a burden on consumers. And they are serious barriers to new investment and to international competitiveness. They are major impediments to Mozambique's successful global integration and to the growth of the jobs and the incomes that are necessary to reduce poverty.

Export processing zones that work can be a useful way to bypass some of these regulatory impediments to the development of competitive export industries. But, as important as they are, they should be viewed as a temporary stopgap and should not interfere with more fundamental reform.

Taxes, fees 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 as a tool to promote downstream processing activities. They hurt poor farm and plantation workers and any economic gains in downstream processing are outweighed by the costs in foregone primary exports and incomes of farm workers.

5.4 Investment Environment

Mozambique is widely and justifiably regarded by investors as a 'high cost' economy. This is largely due to well-known weaknesses in domestic regulatory and other policies. Creating an enabling investment environment involves several key elements.

The first is sound macroeconomic and fiscal policies. This is an area in which Mozambique has been relatively successful, and the main requirement is that this performance be continued. Tax policy implementation is area in which improvement is needed. Continued tariff reform will increase the burden on other taxes, and especially the VAT. The VAT treatment of exports is a delicate matter. It is a potentially large loophole for tax fraud. But excessive policing of input tax credit claims by exporters can be a serious impediment to export competitiveness. The use of tax incentives to attract investment is very tempting. However, international experience shows that such incentives are not necessary or important for attracting investors, they seldom help small or medium businesses, and excessive use threatens the integrity of the fiscal regime.[3]

The second foundation of an attractive investment environment is a transparent, and fairly implemented legal and regulatory regime. The problems in Mozambique are well known and have been highlighted in a variety of studies conducted in Mozambique by local consultants as well as the World Bank and other international organizations.[4] The government has been paying increased attention to these issues. This is something for which it should be applauded. But it needs to remember as well that *the problems require a much broader range of actions than simply improving the country's score on a few easily measured indicators. It requires a change in mindset in approaching a wide range of regulatory, fiscal and trade policy issues. New attitudes need to be displayed through concrete and meaningful actions on an ongoing basis.*

Ongoing reform is needed in areas such as land and labour laws, financial regulation, business licensing and in overall administration of the justice system, especially as it pertains to enforcement of private business rights and contracts. A competition policy that protects against the emergence of harmful and costly monopolies is another area in which the regulatory regime is important. However, competition law is difficult to design and administer well, and a much more useful first step 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 entry and to new competition, not to mention a source of high costs and lack of global competitiveness.

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[3] See Boadway, Flatters and Wen 1996 and Flatters 2005a.
[4] For instance, se FIAS 2001 and World Bank 2006.

The third element is efficient provision of 'public' infrastructure and other services. These include roads, transport, telecommunications and education. While such services were once regarded as almost entirely with the realm of the public sector, it is now realized that there is wide range of public-private institutional possibilities for their provision, and the challenge for the public sector is increasingly to create a regulatory environment and other incentives to ensure that these services are provided efficiently and at low cost, regardless of the ownership of the actual service providers.

6 Concluding Remarks

If Mozambique wishes to fulfil its development goals, it has no choice but to integrate with the global economy. It has made great progress in recent years, but much remains to be done. The current policy regime raises domestic costs, gives excessive rewards to rent seeking and discourages competition. Solving these problems is within the grasp and the power of Mozambique.

But there needs to be a clear division of labour between the private and public sectors. The public sector needs to take a leading role in ensuring the provision of basic health and education for all the people, and to create clear, transparent and non-intrusive regulatory, fiscal and legal environments. Trade and investment policy regimes that use protection, incentives and other measures to promote worthy goals almost always fail to achieve these goals and inevitably result in many unintended and costly consequences. The goal of the public sector should be to create an environment that encourages and facilitates productive investment, promotes trade and generates incomes and jobs for the citizens of Mozambique. The rest can be left to investors, producers and workers in the private sector.

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