

TECHNICAL REPORT

Supporting Sustained Economic Growth and Development

Lessons from Successful Countries and Implications for Mozambique



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Contents

Supporting Sustained Economic Growth and Development	1
Four Cornerstones to a Strategy for Sustained Economic Growth	2
Agriculture	11
Labor-intensive Manufactured Exports	12
Regulatory and Bureaucratic Costs in Mozambique	17
Concluding Thoughts	21
Bibliography	23

ILLUSTRATIONS

Figures

Figure 1. Aid Flows Over Time for IDA Graduates and Marshall Plan Countries	4
Figure 2. Life Expectancy and Subsequent Growth	6
Figure 3. Institutional Quality and Growth	7
Figure 4. Government Effectiveness	9
Figure 5. Rule of Law	9
Figure 6. Control of Corruption	10
Figure 7. Regulatory Quality	20
Figure 8. Red Tape and Export Competitiveness	20

Tables

Table 1. Costs and Time to Start a Business	18
Table 2. Hiring and Firing Workers	18
Table 3. Enforcing Contracts	18
Table 4. Global Growth and Business Competitiveness	19
Table 5. Public Institutions, Macroeconomic Environment, and Technology	19

Supporting Sustained Economic Growth and Development

Lessons and Implications for Mozambique

During the last forty years about two dozen low-income countries have achieved either moderately high or very high rates of economic growth, sustained productivity increases, and poverty reduction. The best known are the East Asian “Four Tigers,” China, Malaysia, Thailand, and Indonesia, but other countries have achieved steady growth and poverty reduction as well, including Botswana, Mauritius, Tunisia, Chile, the Dominican Republic, Lesotho, and more recently India. For some the growth was spectacular, while for others it was more modest, but still important. For example, the Dominican Republic has recorded a seemingly modest growth rate of 2.5 percent per capita, but since this average growth was sustained for 40 years it resulted in a *tripling* of average real income.

Initiating and sustaining economic growth over long periods of time is one of the most difficult challenges facing governments of low-income countries around the world, but the achievements of these countries shows that it can be done. Experience shows there is no single recipe for success in development. Each country faces different circumstances and obstacles, and has different endowments (positive and negative) of geography, natural resources, and human capital. The strategy that worked in small, urban, resource poor, strategically located Singapore is different in many ways from that used in rural, resource rich, landlocked Botswana. The highest priorities for one country are not the same as for another; moreover, the highest priorities and challenges within a country change over time and during the course of development.

Yet there are several broad similarities across the countries that have been most successful in achieving rapid development over the past forty years. While the specifics varied across each country (and within each country during the process of development), there were several common elements across the development strategies pursued by the most successful developing countries. Four key elements stand out: macroeconomic and political stability, significant investments and efficient service delivery in health and education, establishing strong governance and institutions, and providing an environment conducive to private

sector development. These four "pillars of development," in one form or another, have been the cornerstones of the growth strategies of essentially all of the successful countries.¹

This note examines some of the key characteristics that have distinguished the most rapidly growing low-income countries from the slower growing countries over this period. It then gives special focus to one of the key elements: establishing a strong environment for private sector investment and entrepreneurship, especially for labor-intensive manufactured exports. Finally, it draws from these trends some possible implications for Mozambique. It makes three basic points:

Parts of this note are drawn from "A Framework for Economic Development," *University of Michigan Law Review*, forthcoming

Four Cornerstones to a Strategy for Sustained Economic Growth

A key insight is that the most successful countries *did not try to get everything right all at once*. Korea, Taiwan, China, Malaysia, and Indonesia, for example, achieved extraordinary development success during the past forty years, but they did not solve all of their problems right away (both because of capacity constraints and a recognition that some infrastructure, human capital, and institutional problems take many years to solve). In each of these countries there are still weak institutions, problems with corruption, and some specific markets that do not work well. The good news is that governments were able to put into place the most important changes to launch remarkable growth and poverty reduction *despite* some of these weaknesses.

Nevertheless, while these countries did not get everything right, there were clear similarities across their development strategies that laid the foundation for sustained growth. Although debate on the specific details continues, there is growing agreement on at least the broad characteristics that distinguish the most rapidly growing countries from those with slower growth. In particular, there are four key elements that seem to be common to successful development, and can be thought of as cornerstones for an effective development strategy. Countries that have emphasized one or two of these four elements but ignored the others have tended not to be able to sustain development, whereas countries that have made efforts in all four have been much more successful. The four cornerstones are as follows:

Macroeconomic and Political Stability. Economic and political instability undermine investment and growth, and are especially hard on the poor, who are least able to protect themselves against volatility. Relatively low budget deficits over time (with corresponding

¹ The specific list of key areas used here is broadly similar (although different in some respects) to that suggested by Lawrence Summers and Vinod Thomas in "Recent Lessons of Development," *World Bank Research Observer* 8-2 (July 1993), pp 241-54.

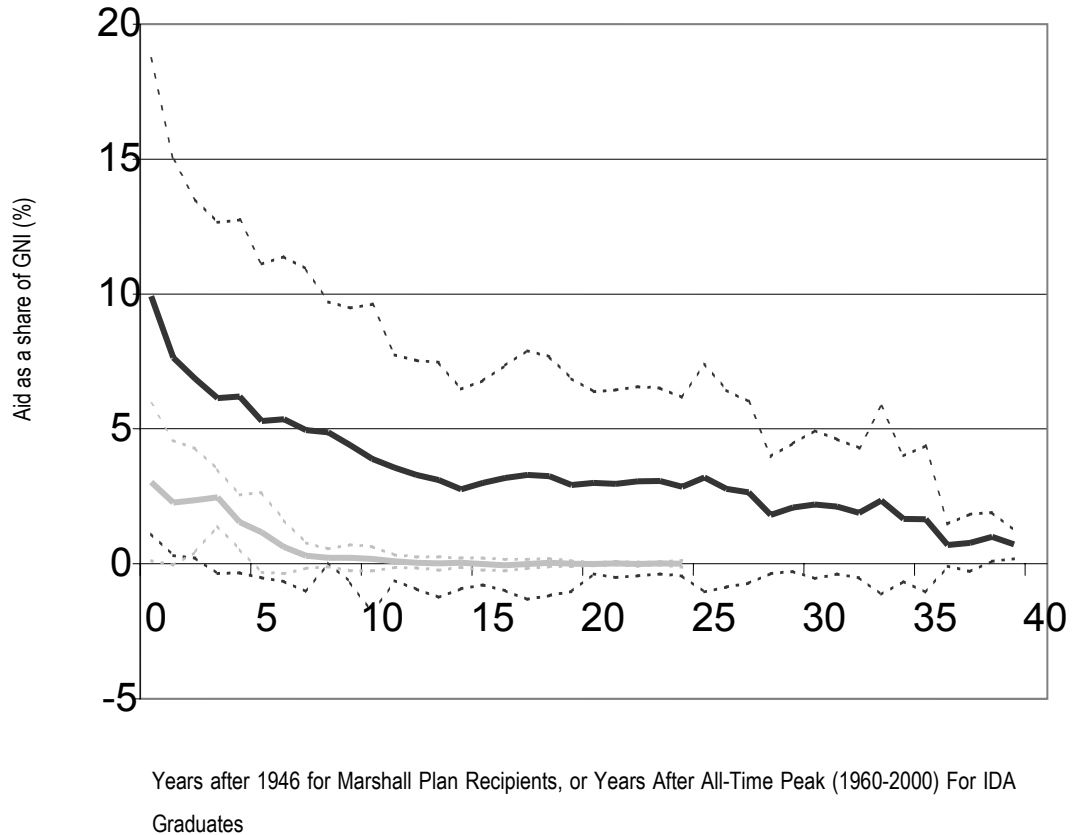
high rates of government saving), prudent monetary policy, appropriate exchange rates, suitable financial markets (depending on the stage of development), and sustainable foreign borrowing are the key elements to macroeconomic stability. Macroeconomic stability reduces risk for investors, whether they are multinational conglomerates or coffee farmers considering planting more trees. Modest or low rates of inflation make prices and profits much more predictable, supporting investment and growth. A broad tax base with modest tax rates allows governments to fund important social and economic programs while keeping budgets in balance. The particular mix changes over time: the poorest countries can appropriately rely on aid grants and concessional loans, and then build their tax base and reduce aid flows as the economy grows. Sustained political stability is equally important: all of the success stories were politically stable for long periods of time. Although some countries experienced periods of instability, they were for the most part short-lived. Collier (1999) and others have pointed out the insidious negative cycle of civil war in low-income countries: poverty increases the risk of conflict, and conflict undermines growth and entrenches poverty (World Bank, 2003).

In Mozambique, there is little question that the relative economic and political stability achieved since the early 1990s has contributed substantially to growth. Maintaining that stability going forward will be a key ingredient to sustaining growth over time. Exchange rate and reserve management have been strong. Debt levels after HIPC are more sustainable (although further debt reductions are feasible). Inflation rates have been moderately high for the last several years (partially due to drought and high food prices), but not high enough to be a drag on growth. Neither political nor economic stability can be taken for granted however. While stability is difficult to achieve, it is easy to lose, and a sudden loss of stability can come at great cost. Madagascar is a case in point, where years of stability were disrupted by election disputes in 2000 and 2001, which imposed great costs on exports, investment, and economic growth.

A key macroeconomic challenge going forward for Mozambique will be prudent management of foreign aid inflows. Aid flows have been large during the last decade, and are likely to remain so for the foreseeable future. Although a long-term goal for Mozambique should be to reduce the size of aid flows, there is no strong reason to hasten this process. Clemens and Radelet (2003) examined the pattern of aid flows for a group of 22 of the most successful developing countries since 1960 (the 22 countries that have permanently graduated from World Bank IDA lending). They calculated that for these more successful countries, the "half-life" of aid was about 12 years, meaning that on average it took about 12 years for aid as a share of GDP to diminish from its peak level to 50% of its peak, and another 12 years to reach 25% of the peak (Figure 1)..

Figure 1

Aid Flows Over Time for IDA Graduates and Marshall Plan Countries



— IDA graduates
 — Marshall Plan recipients

(The figure also shows the pattern for the Marshall Plan countries, where not surprisingly the half-life was much shorter). For this group of countries, aid flows peaked at about 10% of GDP on average, albeit with a large variation and several countries peaking at 20% of GDP or more. Note that these were 22 relatively successful countries—all formerly IDA countries that have graduated from IDA—so this should be seen as an upper end approximation of the speed of reduction of aid flows.

Even if Mozambique continues to be very successful, aid flows are likely to diminish more slowly than this pattern suggests, since Mozambique starts as a much poorer country than most of the countries in this sample, and therefore will take longer to “graduate” from aid. Consider the following: Starting with per capita income of \$200 today, if Mozambique

sustains very rapid growth of 5% per capita (about 7% overall growth), it will take 30 years for it to reach per capita income of \$865, which is the income level at which (broadly speaking) the World Bank usually shifts from concessional IDA lending to non-concessional IBRD lending (i.e., \$865 is the current “operational cutoff” for IDA lending). It would take Mozambique 41 years to reach per capita income of \$1,465, which is the current income ceiling for the Millennium Challenge Account. Thus, there is every reason to expect that Mozambique will be receiving significant aid flows for a very long time. So long as the country continues to pursue reasonable policies and build strong institutions, these aid flows can achieve high returns and contribute to continued growth and development.

Managing these aid flows raises several challenges, including: maintaining export competitiveness, integrating significant portions of aid into the national budget (including smoothing fiscal year timing issues), maintaining modest levels of inflation (usually requiring at least partial sterilization through central bank operations), coordinating and harmonizing donor approaches, minimizing the bureaucratic burden of aid, and managing aid volatility. On the last point, speaking very broadly, aid flows to very low income countries tend to be less volatile than FDI, other private flows, and earnings from certain commodity exports that are subject to large price variations; but more volatile than receipts for other commodities, and from labor-intensive manufactures. Although these are important macroeconomic issues, they can be managed in ways to minimize possible disruptive impacts of aid.

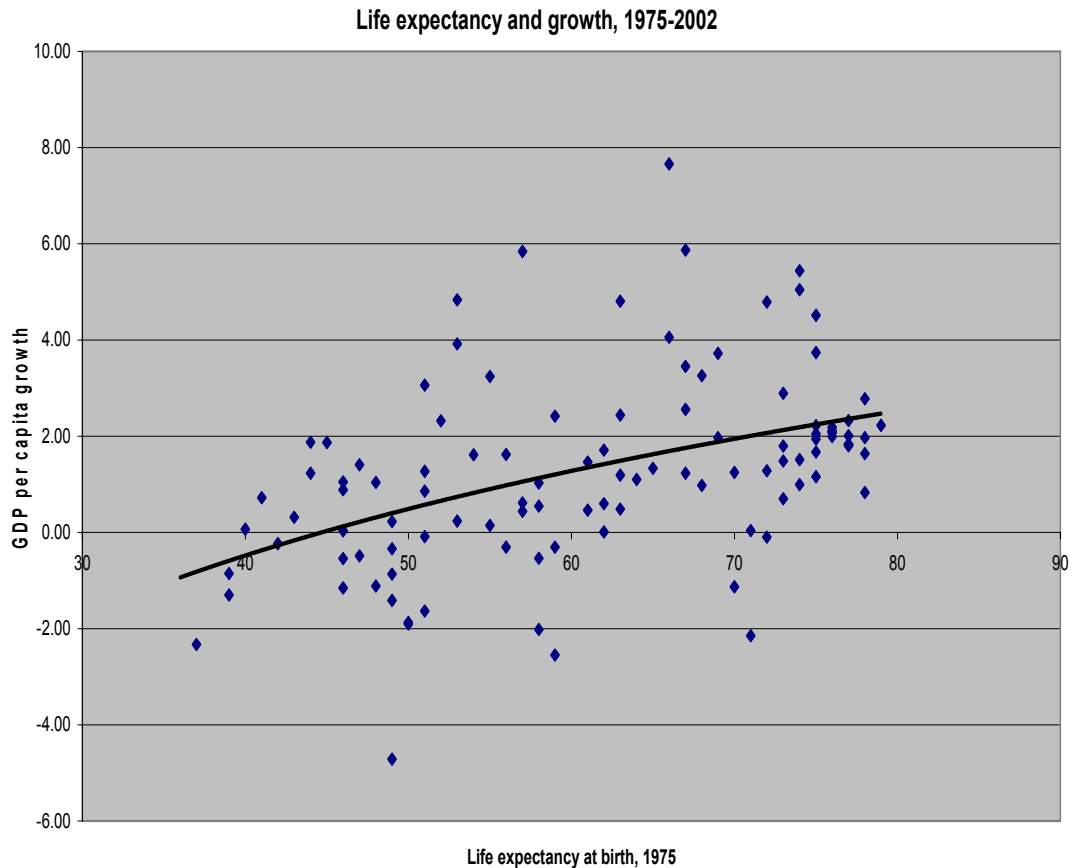
Substantial Investments and Effective Delivery of Services in Health and Education.

Countries with healthier, better-educated populations record faster economic growth, productivity gains, and poverty reduction. Indeed, there is a positive reinforcing cycle between growth and levels of health and education: investments and improved service delivery in health and education lead to faster growth and higher incomes, which in turn enables larger investments and better service in health and education. It is incorrect to believe, as some do, that better health and education are simply byproducts of development – they are key inputs as well.

East Asian countries made (and continue to make) significant investments in primary education, which enabled their populations to become healthier and much more productive members of the workforce. Investments in girls’ primary school education have had especially high rates of return, affecting girls’ skill levels, marriage age, and fertility rates, as well as the health and education of the next generation of children. Similarly, investments in basic health have very high economic rates of return (Bloom, Canning, and Jamison, 2004). Radelet, Sachs, and Lee (2001) found that the difference in life expectancy at birth in 1965 in East/Southeast Asia (55 years) and sub-Saharan Africa (41 years) was associated with a difference in per capita growth rates of 1.3 percentage points per year over the thirty years period – about one-third of the total difference in growth. Figure 2 shows the relationship between life expectancy in 1975 and the *subsequent* rate of economic growth from 1975-2002. Accessible basic health care facilities, clean water and sanitation, disease control programs, and strong

reproductive and maternal and child health programs help countries lengthen life expectancy and improve worker productivity.

Figure 2
Life Expectancy and Subsequent Growth



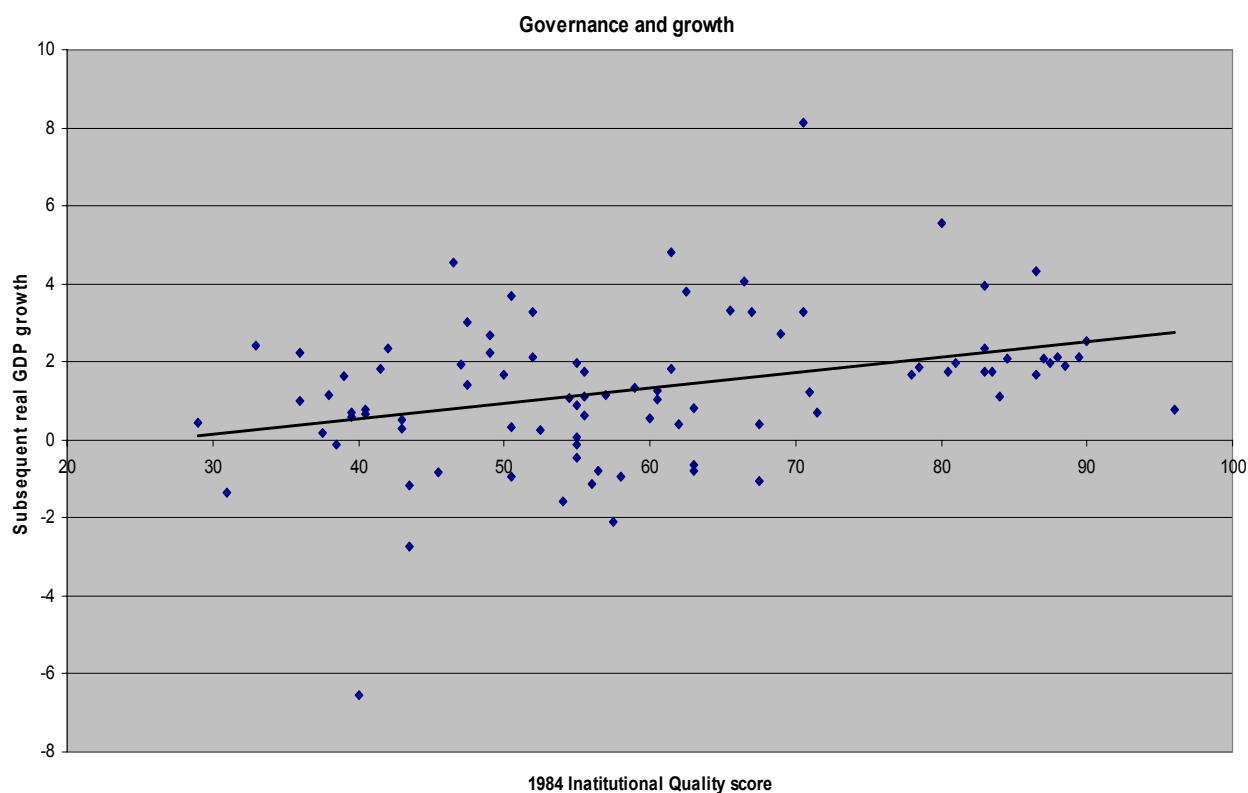
Countries with higher average life expectancy (and better health) tend to grow faster than countries with lower life expectancy.

Source: *World Development Indicators*, 2004.

The quality of service delivery is as important as the quantity. It isn't enough to build schools and increase enrolment rates: teachers have to show up, be motivated, and have adequate basic supplies (e.g., textbooks) in order to do the job (World Bank, 2004). Whereas governments obviously take the lead in policymaking, coordination, sensible regulation, and service delivery, governments cannot and should not try to take on all service delivery by themselves. Churches, charities, foundations, NGOs, and private service delivery agencies can all play important roles. In countries where governments have tried to monopolize service delivery and exert too much control, the quality and coverage of service delivery has suffered.

Strong Institutions for Governance. The most effective governments established institutions that helped facilitate (rather than hinder) strong economic management, effective social programs, and a robust private sector. Governance in the most rapidly growing countries varied widely from very effective (Singapore, Botswana) to more mixed (Indonesia and Thailand), but generally was better than in most developing countries. At lower growth rates, the quality of governance was weaker, but still generally better than for most low-income countries. Figure 3 shows a clear positive relationship between a country's institutional scores in 1984 and its subsequent rate of economic growth (the relationship becomes even stronger after controlling for other factors influencing growth).²

Figure 3
Institutional Quality and Growth



SOURCE: Political Risk Services, International Country Risk Guide, and World Bank World Development Indicators

In the rapidly growing Asian countries, government financial institutions generally were capable, including the central bank and the budget authorities in the ministry of finance. Most governments substantially improved their customs clearance procedures over time (at one

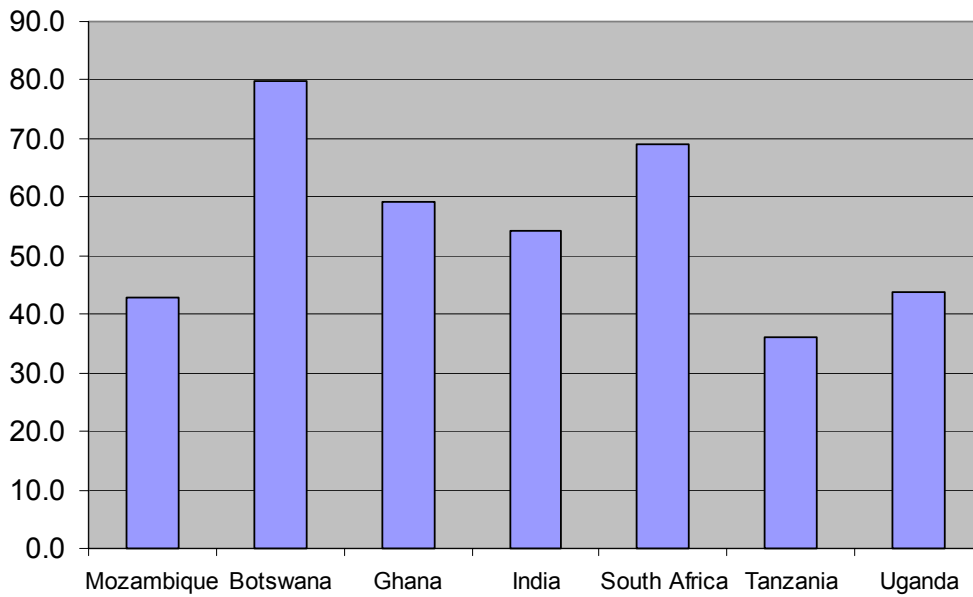
² The institutional rating is a common used in econometric analyses of growth, taken from the International Country Risk Guide.

point, Indonesia essentially privatized its customs clearance process). Levels of corruption, on average, were lower than in other developing countries (although they were high in several of the countries). Importantly, there was much less corruption and red tape in the most vibrant sectors of the economy, especially in the institutions working with manufactured exports (e.g., in the EPZs and duty exemption offices).

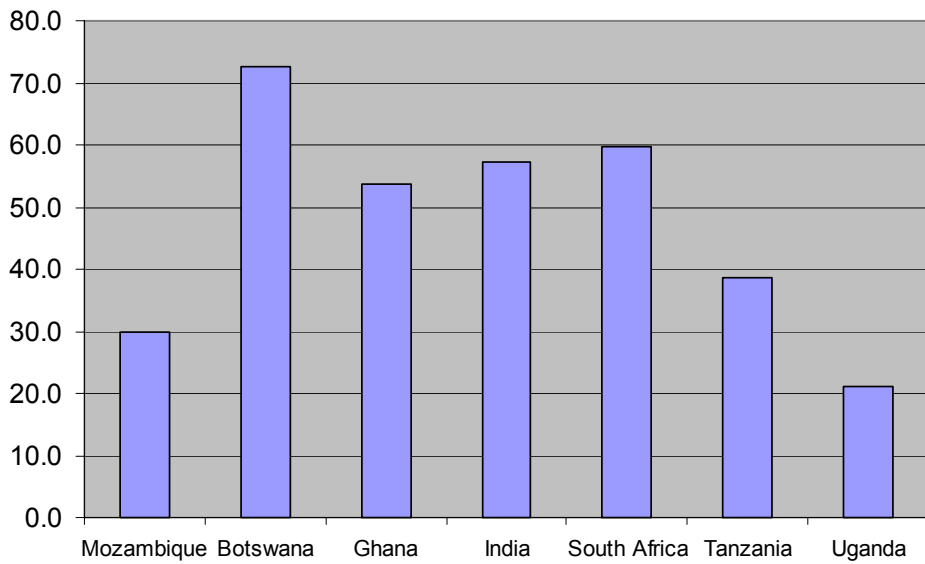
Also, many of the most successful countries developed a small cadre of highly trained and effective economic technocrats that guided economic policymaking. Indonesia's "Berkeley Mafia," for example, was a small group of economists trained (mainly) at the University of California at Berkeley starting in the late 1950s (when Indonesia was still extremely poor, unstable, and un-integrated with the world economy) that went on to hold key positions from the early 1970s through the mid-1990s and spearheaded that country's rapid development. Similar groups of technocrats were found in the other successful Asian countries, as well as some countries outside the region, such as Chile. Importantly, these economic decision makers were protected by their presidents from political pressures that might have undermined difficult decisions, which made them more effective in macroeconomic management and in introducing reforms that affected vested interests.

In general, as with health and education, there is a positive cyclical relationship between institutions and income in which stronger institutions help support growth and higher income countries are better able to build institutions. Very low income countries, including Mozambique, tend to have weaker institutions than lower-middle or upper-middle income countries. Although Mozambique's institutions are clearly stronger than they were a decade ago, there is a long way to go. Figures 4, 5, and 6 show Mozambique's percentile ranking (relative to all countries in the world) on three measures of institutional quality: government effectiveness, rule of law, and control of corruption.³ The figures show these scores for six other countries: Botswana, Ghana, India, South Africa, Tanzania, and Uganda. Mozambique's governance scores are roughly similar to those in Tanzania and Uganda, and below those of the other four countries.

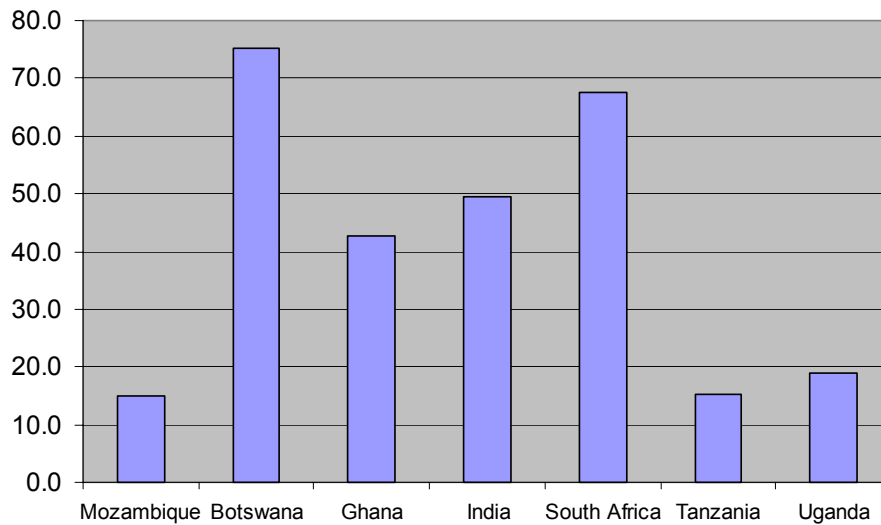
³ These data are drawn from the World Bank Institute's global governance database, which in turn are based on a wide range of survey on governance and institutional quality from a variety of sources. See www.worldbank.org/wbi/governance/data.html.

Figure 4*Government Effectiveness*

SOURCES: Kaufmann, Daniel, A. Kraay, and M. Mastruzzi. 2003. "Governance Matters III: Governance Indicators for 1996–2002," World Bank Policy Research Working Paper 3106, <http://www.worldbank.org/wbi/governance/pubs/govmatters3.htm>

Table 5*Rule of Law*

SOURCES: Kaufmann, Daniel, A. Kraay, and M. Mastruzzi. 2003. "Governance Matters III: Governance Indicators for 1996–2002," World Bank Policy Research Working Paper 3106, <http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>

Figure 6*Control of Corruption*

SOURCES: Kaufmann, Daniel, A. Kraay, and M. Mastruzzi. 2003. "Governance Matters III: Governance Indicators for 1996–2002," World Bank Policy Research Working Paper 3106, <http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>

Private Sector-led Growth, Focused on Integration with the World Economy. Development cannot happen in the absence of sustained growth of private sector enterprise. A dynamic private sector – whether small holder family farms or large manufacturing enterprises – is key to job creation and income generation, which in turn is central to poverty reduction. There is great debate on how best to create a dynamic private sector in low-income countries, including the appropriate role for industrial and trade policies, but there is no longer much debate about the centrality of a dynamic private sector. In most of the successful countries, the two key sectors for driving economic growth have been agricultural production and labor-intensive manufactured exports, although the details of their strategies have differed. Competitive firms that are fully integrated into the global economy have played a key role, helping to import new technologies, expand investment opportunities, and create new jobs. I discuss agriculture and labor-intensive manufactured exports in more detail in the next two sections.

Development strategies that have emphasized one or two of these cornerstones but overlooked the others have not succeeded. For example, Tanzania, Cuba, and Sri Lanka all emphasized health and education in the 1970s and 1980s, but totally undermined private sector production. Many countries have achieved macroeconomic and political stability, only to find that it is necessary but not sufficient for sustained growth. By contrast, the successful countries have tried to strengthen all four areas. Stability is needed to reduce risks and uncertainty. Investments in education in health improve skill sand worker productivity, without which wages will not grow over time. To increase incomes, economies must produce something, and only the private sector can be the engine for increased production over time.

And strong institutions are needed to support the operations of basic markets. All four pieces are needed to sustain growth and development.

Agriculture

Although rapid economic growth leads to a decline in the relative importance of agriculture, a healthy agricultural sector is critical for poverty reduction and long-term growth, as well as for establishing a strong manufacturing sector. The seeming paradox – which in reality is no paradox at all – is that strong investments and policies are needed in agriculture, even as it declines in economic importance. A healthy agricultural sector with rapid productivity gains is critical to reducing poverty, since in most countries that majority of the poor live in rural areas. In addition, increases in agricultural productivity over time allow workers to shift to other manufacturing and services, which in turn supports long-term growth.

Although agricultural performance was uneven across the most successful countries, agricultural productivity grew faster where governments took several key steps. First, they removed price distortions so that farmgate prices were kept close to world market levels, and removed artificial barriers and non-market institutions that limited farmers' incentives, choices and opportunities. Second, infrastructure has played a central role. A key to agricultural growth and rural poverty reduction in China, Indonesia, Thailand, and other countries with large rural populations was construction of feeder roads so that farmers could get their crops to market and bring in fertilizer and other inputs. Third, farmers had reasonable access to seeds, fertilizers, and pesticides (and in many cases governments subsidized fertilizer to ensure that it was used in appropriate quantities). Fourth, governments either dismantled or never established state-owned marketing boards and other monopolies (or monopsonies) in rural markets. Where these operated they have been especially detrimental to farm income and agricultural growth. Fifth, and partly related, export taxes have been enormously detrimental to agricultural production. Countries that have removed them have provided farmers with the incentive to increase investment and production over time. Sixth, in many countries, agricultural research allowed new seed varieties to be adapted, and facilitated the use of agricultural products in new markets (e.g., Malaysia's research into new uses for rubber trees, such as to make furniture, when world rubber prices fell). And, of course, the Green Revolution remains perhaps the best example of research into new technologies (largely financed by donor agencies). These investments produced huge payoffs in new varieties of seeds, fertilizers and other inputs that led to dramatic increases in agricultural production in Asia, which in turn was at the core of the so-called "Asian Miracle."

For a variety of reasons, governments in almost all countries provided protection or subsidies to some agricultural products. Since almost every country in the world has done so (including almost every rich western country), these kinds of policies are understandable and to some

extent to be expected. Nevertheless, even where they achieve important social or political goals, these kinds of policies have real costs which affect the economy either directly (through budget outlays for subsidies) or indirectly (through higher prices for consumers or downstream users for protected goods). Thus these policies should not be introduced lightly. As much as possible, the costs should be calculated explicitly to allow policymakers to weigh the costs and benefits (economic, social, and political) of any proposed policy. Wherever possible, these costs should be made transparent in the budget (e.g., through an explicit subsidy) rather than partially hidden (e.g., through tariff protection that gets absorbed in consumer prices).

A key principle is that where subsidies and protection are used, they should be used rarely. Interventions should be kept to a minimum and only used in the strongest cases. When production costs are high (because of poor infrastructure, inappropriate pricing policies, or other causes), governments often find it easier to provide protection or subsidies to compensate for these high costs rather than address the root causes. But this is short-sighted, and adds to costs rather than providing the foundation for long-term productivity gains. Many countries get on a slippery slope of protecting a small number of products, and then letting protection (and the associated costs) spread to areas where there is a weaker rationale for protection. Similarly, once protection is provided to a particular activity, it is easy for governments to increase the amount of protection to that activity over time. It is far easier for firms and other producers to advocate for more protection than to do the hard work required for productivity gains, but the first brings losses to an economy while the latter brings long term gains. Protected industries rarely bring about dynamic productivity gains (the key to long term growth), unless the protection is limited both in size and especially in time, and firms are pushed to become competitive on global markets relatively quickly rather than afforded more protection.

Labor-intensive Manufactured Exports

Almost all of the successful countries adopted strategies for diversifying from primary products to labor-intensive manufactured exports. The specific products varied by country, but usually included some mixture of textiles, garments, toys, shoes, electronics, furniture, and agro-processing. Indeed, with only a few exceptions, labor-intensive manufactured exports has been the *sin qua non* of development during the last 40 years in countries including China, Korea, Taiwan, Malaysia, Thailand, Indonesia, Mauritius, Tunisia, Costa Rica, the Dominican Republic, and others. In several other countries where overall growth has not been as high, labor-intensive manufactures nevertheless have been an area of strong performance, including Lesotho, Madagascar, Mexico, the Philippines, and Bangladesh. The only two major exceptions to this pattern are Botswana (which based its growth on prudent management of diamond deposits), and Chile, a middle-income country that has achieved steady (although not outstanding) growth with a mixture of agriculture and mineral exports,

along with some labor-intensive agro-processing. Otherwise labor-intensive manufactured exports have been at the core of almost every experience of sustained rapid growth since 1960.

Labor-intensive manufactured exports confer benefits to an economy that provide the foundation for sustained growth, and that cannot be easily achieved through exports of primary products or through production for the domestic market. These benefits include the following:⁴

- First, manufactured exporters can specialize their production to a much greater degree than is possible in import substitution. Developing country exporters can join in global production and distribution systems, even for very sophisticated products, based on their comparative advantage in one part of the production process. Firms can specialize in simple assembly, manufacturing packing supplies, or making simple components. Firms do not have to do everything – they can specialize in the thing they do best.
- Second, manufactured exports work in very competitive markets, so they are extremely efficient in their productive processes.
- Third, exporters can sell to a much larger market than can firms operating on domestic markets. Exporting firms can continue to expand their operations and take advantage of economies of scale. As a result, the market is not limited to the size of the domestic economy, so growth can continue for much longer periods of time.
- Fourth, a strategy of manufactured exports fosters technological progress. Rapid growth in manufactured exports requires close links with multinational firms that provide intermediate inputs, technology, and capital goods. These linkages provide a powerful means of “learning by doing,” either about the most appropriate machinery, the most effective management techniques, or the most efficient way to organize production. There is simply no realistic chance of this occurring if a country is not engaged in international markets.
- Fifth, once firms are engaged in international markets, they can “move up the ladder” to higher-end, more sophisticated products that require more skills and pay higher wages. Malaysia started by assembling simple electronics products in the early 1970s, then moved into simple production, and now designs, produces, and tests microprocessors. The skills imbedded in today’s workforce have their origins in production of much simpler products 30 years ago.
- Sixth, because production is labor-intensive and markets are global, this strategy has the potential to create large numbers of jobs for low-skilled or semi-skilled workers. Countries that have followed this strategy have tended to record large reductions in poverty, and one reason is that substantial numbers of workers are able to find productive, sustainable employment.

⁴ See Radelet (1999) for a more detailed discussion.

The basic policy package to provide an environment conducive to manufactured exports includes low (or zero) tariffs on imported inputs (especially capital goods); access to efficient port facilities; reliable roads, power, and other infrastructure; and a customs service that did not unduly delay or add to the cost of shipments. Rapid customs clearance procedures are essential, since buyers want both low cost and timely delivery, and delays in port can total undermine competitiveness. Duty free inputs are absolutely crucial, since firms have to operate against competitors that can purchase supplies at world prices.⁵ For the same reason, the most successful countries kept bureaucratic and regulatory costs to a minimum: since these costs cannot be passed on through higher prices, they reduce profitability and the incentives for new investment.

The question for policymakers becomes: How best to provide this kind of environment for labor-intensive manufacturers? Importantly, a strategy of broad-based economy-wide liberalization to try to tackle all of these problems has rarely been the means to achieve these goals, with the exception of Hong Kong and to a lesser degree Singapore. The successful countries recognized that there were many weaknesses in their economies—poor infrastructure, high tariffs, weak customs administration, burdensome regulations, weak governance—and they understood that they could not solve all of the problems for the entire economy at all once. *Instead, they established various forms of enclaves to act as export platforms with the goal of providing the environment necessary to allow firms to compete on world markets.* They did not leave export diversification purely to the markets: governments in each country introduced well-run institutions to facilitate exports such as export processing zones and bonded warehouse systems.⁶ Governments recognized broad areas in which firms were likely to be globally competitive (e.g., textiles, basic electronics, food processing, and data entry activities via satellite) and created an environment that investors saw as reliable, secure, and competitive. To do so, they examined markets from the perspective of the firm, and attempted to eliminate obstacles that undermined firm competitiveness, such as license requirements, slow and corrupt customs administration, frequent inspections, high tariff rates, and poor infrastructure. The idea is to make one part of the economy work well, and to expand it further to the rest of the economy over time.

⁵ A more controversial policy that is sometimes also used is tax holidays for new investment. Although many countries have introduced tax holidays, their impact on new investment is unclear. They may have some impact on footloose industries (which is the main focus of labor-intensive exports) but not on other investment. Moreover, the cost can be high, as the benefits are provided to firms that would have invested in any case. And of course income tax holidays do not help firms to become profitable (there must first be profits to be taxed), but rather allow firms to retain more of their profits. There is some evidence, however, that tax holidays can be useful to induce on the margin large investors that are seriously contemplating alternative sites, such as Intel in Malaysia and later in Costa Rica. Opinions on the efficacy of tax holidays remain divided, and a more complete investigation is beyond the scope of this paper. For a recent review of tax incentives in the SADC region, see Bolnick (2004).

⁶ A bonded warehouse is a firm that puts up a bond in lieu of paying import duties on inputs for exports. The bond is claimed only if duties become payable (e.g., if the firm fails to export). This method minimizes the need cash transactions. Unlike an EPZ, bonded firms can locate anywhere. In some countries these are referred to as standalone EPZs.

The striking fact is that every one of the successful labor-intensive manufactured exporters has used some kind of enclave, including China's Special Economic Zones, Malaysia's EPZs, the Philippines' use of the former Clark Air Force Base and Subic Bay Naval Base as electronics enclaves, Mauritius's EPZs, Tunisia's bonded warehouses, and the Dominican Republic's EPZs. Outside of natural export enclaves like Hong Kong and Singapore, governments have had to establish an enclave to facilitate export competitiveness. However, export platforms should not be seen as a strict alternative to economy-wide reforms, but rather a complement that can be introduced more quickly during a transition period until the economy more broadly can be competitive. Export platforms are not an excuse to postpone or ignore more broad-based reforms, but rather a way to gain a foothold in world markets while the more broad based reforms can be implemented over time. In Korea and Taiwan, for example, export platform facilities are no longer necessary (except for duty free inputs), as infrastructure, customs procedures, and regulations for the economy as a whole do not constrain exporters from being competitive.

It is important to recognize, however, that export platforms do not always work. Establishing an EPZ or bonded warehouse system is not silver bullet, and there are many countries that have set up EPZs that have had little impact on exports. Usually they fail because they are set up poorly so that firms' production costs are still too high to allow them to compete on world markets. Sometimes this is because of poor macroeconomic policies, such as an overvalued exchange rate, as was the case in Kenya in the early 1990s. Similarly, if firms inside zones continue to face high regulatory burdens, weak infrastructure, and slow customs clearance, they will fail. If EPZs are set up to achieve secondary goals such as regional development of rural areas, they will not succeed. Governments must be resolute in establishing export platforms with the sole objective of providing an environment where firms can be competitive on global markets, and to move aggressively to remove barriers and high regulatory costs.

Governments are sometimes tempted to extend duty-free benefits beyond exports to other firms producing for the domestic market. This makes perfect sense, but should be supported *only if the domestic firms that receive the duty free imports are operating at world prices without subsidies or tariff protection*. The idea of duty free inputs is to allow firms to operate at world prices. Firms selling to the domestic market under protective barriers do not meet this test. These firms sometimes argue that duty-free imports for exporters give exporters an unfair advantage, but this is only true if firms producing for the domestic market do not have protection. *In fact, providing duty-free imports to firms operating under protection undermines the incentives to invest in exports*. The combination of protective tariffs and duty-free imports can make these firms very profitable (with the cost passed on to local consumers), so domestic firms will be much less interested in exports. If duty free access is to be extended to firms producing for the domestic market, it must be done in conjunction with lowering their protective barriers.

Similarly, governments are sometimes tempted to require firms operating in EPZs to purchase from domestic suppliers. When this is *required*, it almost always fails. It is certainly a worthy goal to have exporting firms purchase their inputs domestically, but the way to achieve that goal is to make the domestic suppliers globally competitive, not to prematurely force high costs on exporters. There are usually good reasons why exporters do not purchase locally (e.g., high prices and poor quality), and to force them to do so will undermine the main goal of making exporters competitive. The process of making domestic suppliers globally competitive is not easy, and usually takes time. One step in this direction is to provide duty free inputs to domestic firms that supply exporting firms (sometimes called indirect exporters), or even to allow them to operate in the EPZs. The main point is that these linkages cannot be mandated.

Some observers object to EPZs as creating distortions, or for providing special benefits to some firms (exporters) but not others. This is simply the wrong way to think about them, and is based on the mistake of comparing the environment for exporters with firms producing for the domestic market, rather than comparing exporters with their competitors on global markets. Most low-income economies have very large distortions that create huge disadvantages for exporting firms relative to their competitors on global markets. From the perspective of global markets, export platforms *remove* distortions and the existing bias that works against local firms that want to compete globally. They are interventions designed to make markets work better. The correct comparator for the level playing field is competitors on global markets, not firms producing for the domestic market. It is important to recognize that export platforms are not permanent solutions or institutions—they should operate only as long as it takes to remove existing distortions and build infrastructure for the local markets. This process might take 10-15 years or longer. Korea and Taiwan no longer need EPZs or other platforms, since firms can now compete on global markets without these institutions.

This strategy is not the same as “industrial targeting,” in which government officials pick *specific firms* to receive special assistance and subsidies from the government. Industrial targeting has been tried in many countries and has achieved very little success. In most countries it leads to ad-hoc policies subject to political favoritism and corruption as firms continually vie to be among the chosen to receive special treatment. “Picking winners” through specific protection and subsidies more often than not leads to a bias towards producing for the domestic market and away from exports, so countries tend to lose the dynamic gains that come with producing for global markets. Some analysts suggest this strategy was at the core of Korea’s and Taiwan’s success, but research on the topic has reached mixed conclusions. What is clear is that industrial targeting was not at the core of the success of Hong Kong, Singapore, China, Indonesia, Thailand, Mauritius, and the majority of other successful countries.

Regulatory and Bureaucratic Costs in Mozambique

There is reason to believe that Mozambique has considerable potential for labor-intensive manufactured exports, especially in agro processing, textiles, garments, and perhaps shoes and toys.⁷ Mozambique has ample labor supply, access to good ports, low cost electricity, an adequate water supply, and the large South African market next door as clear advantages. It is true that Mozambique faces higher shipping costs to major markets than some other countries, and that may make it difficult to compete in some products (such as electronics, which tend to have smaller margins). But several of Mozambique's neighbor's have achieved strong success with this strategy, including Mauritius, Madagascar, Swaziland, and Lesotho, so Mozambique's location clearly does not preclude it from competing on world markets.

Perhaps the biggest barrier to manufactured exports from Mozambique is high regulatory and bureaucratic costs. Even where Mozambique has introduced EPZs, regulatory costs appear to remain high and undermine global competitiveness. All the evidence points to Mozambique having much higher regulatory costs than its neighbors. Tables 1-3 are summary tables from the World Bank's 2004 *Doing Business* report comparing Mozambique with 6 other countries. In many of the categories, Mozambique scores very poorly, including the number of procedures and amount of time required to start a business (Table 1), several of the labor market indices (Table 2), and the time required to enforce a contract (Table 3). Although some people believe these figures are too high, even with a downward revision they would probably still be unfavorable to Mozambique. Other sources paint a similar picture. The World Economic Forum's Global Competitive Report ranked Mozambique number 92 out of 103 countries in the world in 2004, and number 96 in its business competitive index (Tables 4 and 5). A third source, the World Bank Institute's global governance database, ranks Mozambique's regulatory quality below that of Tanzania, Uganda, Ghana, and India (Figure 7).

A significant number of Mozambican firms simply will not be able to compete on world markets when facing these kinds of regulatory costs. Figure 8 shows that impact of these costs on a hypothetical exporting firm. This firm sells its product on world markets for a price of 100. In the total absence of red tape (the bar on the left), 50 percent of its costs go to intermediate inputs, 30 percent to wages, and 20 percent to profits. The right hand bar shows the cost structure with regulatory and bureaucratic costs. For exporting firms, the costs of red tape *must* reduce either profits or wages. Firms cannot increase their price on world markets in the face of such costs, and they cannot adjust their input costs (presumably they are already purchasing the lowest cost inputs). Any bureaucratic costs reduce profits and the ability of the firm to pay the wages that it otherwise could. In these circumstances most firms simply will not bother to invest.

⁷ For an earlier analysis that reaches the same conclusion, see Sarkar (2001).

Table 1
Costs and Time to Start a Business

Country	Number of procedures	Time (days)	Cost (% of income per capita)	Min. capital (% of income per capita)
Mozambique	14	153	95.8	14.5
Botswana	11	108	11.3	0
Ghana	12	85	87.5	31.4
India	11	89	49.5	0
South Africa	9	38	9.1	0
Tanzania	13	35	186.9	6.8
Uganda	17	36	131.3	0

SOURCE: *Doing Business in 2005, World Bank.*

Table 2
Hiring and Firing Workers

Country	Difficulty of Hiring Index (0 to 100; 0=best)	Rigidity of Hours Index (0 to 100; 0=best)	Difficulty of Firing Index (0 to 100; 0=best)	Rigidity of Employment Index (0 to 100; 0=best)	Firing Costs (weeks)
Mozambique	72	80	40	64	141
Botswana	0	20	40	20	19
Ghana	11	40	50	34	25
India	33	20	90	48	79
South Africa	56	40	60	52	38
Tanzania	56	80	60	65	38
Uganda	0	20	0	7	12

SOURCE: *Doing Business in 2005, World Bank.*

Table 3
Enforcing Contracts

Country	Number of procedures	Time (days)	Cost (% of debt)
Mozambique	38	580	16
Botswana	26	154	24.8
Ghana	23	200	14.4
India	40	425	43.1
South Africa	26	277	11.5
Tanzania	21	242	35.3
Uganda	15	209	22.3

SOURCE: *Doing Business in 2005, World Bank.*

Table 4*Global Growth and Business Competitiveness (Ranking of 103 Countries)*

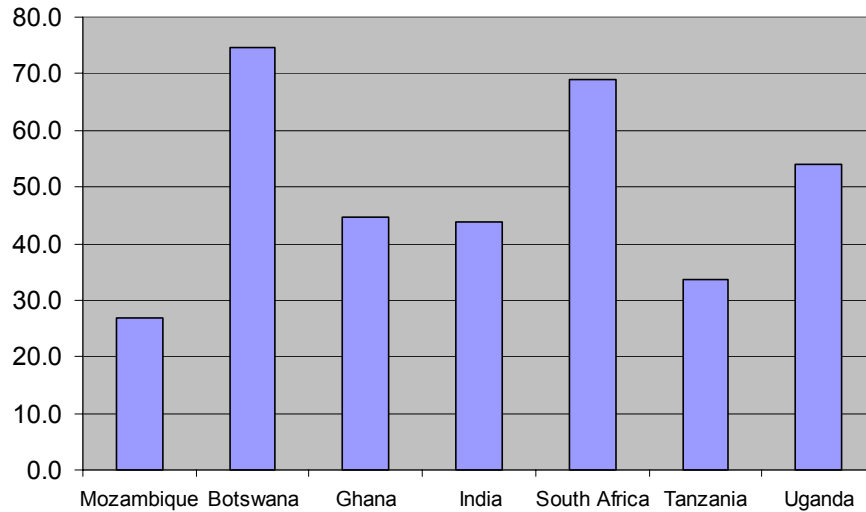
	Growth Competitiveness Index		Business Competitiveness Index
	2003	2004	2004
Mozambique	93	92	96
Botswana	36	45	62
Ghana	71	68	64
India	56	55	30
South Africa	42	41	25
Tanzania	69	82	90
Uganda	80	79	71

SOURCE: *Global Competitiveness Report 2004-05, World Economic Form.***Table 5***Public Institutions, Macroeconomic Environment, and Technology (Ranking of 103 Countries)*

	Public Institutions Index	Macroeconomic Environment Index	Technology Index
Mozambique	82	95	92
Botswana	26	30	59
Ghana	65	68	86
South Africa	43	40	40
Tanzania	59	76	81
Uganda	84	71	77

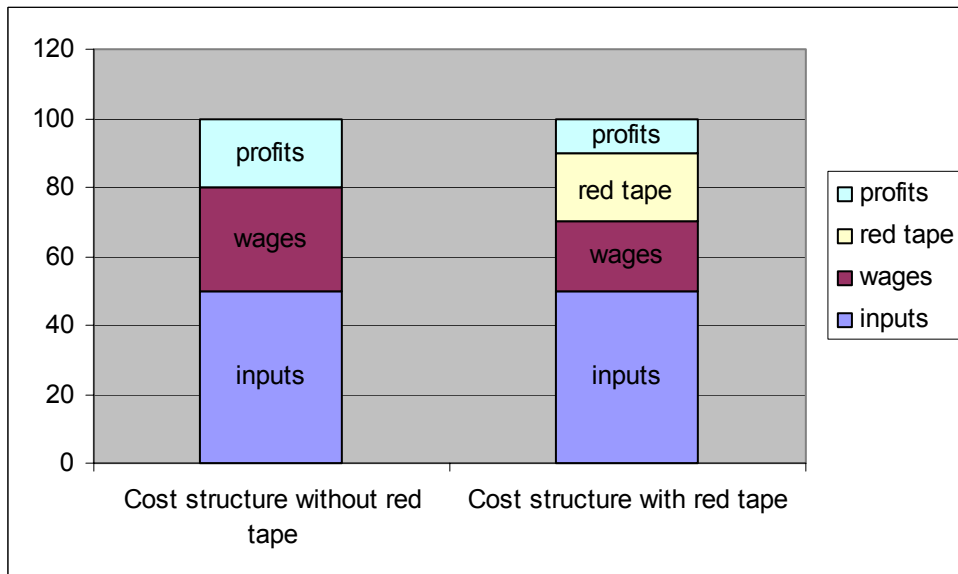
SOURCE: *Global Competitiveness Report 2004-05, World Economic Form.*

Figure 7
Regulatory Quality



SOURCES: Kaufmann, Daniel, A. Kraay, and M. Mastruzzi. 2003. "Governance Matters III: Governance Indicators for 1996–2002," World Bank Policy Research Working Paper 3106, <http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>

Figure 8
Red Tape and Export Competitiveness



Pursuing a strategy of labor-intensive exports in Mozambique is not without its risks. First, world markets for textiles and garments will undergo major shifts in the next few years as the multi-fiber agreement is phased out, and it is not clear how those shifts might affect

Mozambican firms. Second, some observers worry that China will dominate world markets in all labor-intensive products in the coming years. In my view there is some truth to this view, but it is generally overblown. It is certainly true that Korea-type growth rates are highly unlikely today, as there are many more countries involved in labor-intensive manufacturing than when the “Four Tigers” began to take off. But global production is much more differentiated today than it was 30 years ago, and there is room for many niche players as markets expand. China cannot and will not produce everything. Its imports are rising almost as fast as its exports, meaning it is becoming one of the world’s largest markets for exports from other countries. Indeed, many firms in Indonesia, Malaysia, and Thailand are now producing both intermediate and final goods for export to China. Moreover, as labor costs begin to rise in China’s coastal regions, firms reportedly are beginning to look to other locations, such as Vietnam.⁸ Third, and perhaps most worryingly, the continuing increase in HIV/AIDS prevalence rates is likely to deter investors in the coming years, adding yet another reason for new urging in fighting the pandemic. Of course, the impact of HIV/AIDS will go far beyond labor-intensive manufactured exports. Nevertheless, even with these caveats, it seems that there is significant potential for Mozambique to attract new investment in labor-intensive manufactured exports (including agro-processing), and that these investments could help sustain growth and development for the next generation.

Concluding Thoughts

Mozambique has made outstanding progress over the last ten years, far more than almost anyone could have imagined ten years ago. Its growth rate has been among the highest in the world, leading to rapid increases in income, reductions in poverty, and improvements in a range of development indicators. The challenge going forward will be to sustain this growth so that rapid development can continue for the next generation. The major drivers for growth from the last decade – reconstruction from the war, the introduction of the so-called mega-projects, and high levels of foreign aid – are unlikely to be able to spur rapid growth over the long term. The current pattern of growth can continue for several years, but not indefinitely. Mozambique must begin to make the shift to other sources of growth that can provide jobs and the dynamism to increase skills and productivity over time. Experience from other countries shows a way forward through agriculture and labor-intensive manufactured exports, including agro-processing and other light manufacturing for the world market.

Mozambique does not have to get everything right to sustain growth, but it needs to get a few key things right. It must focus on some high priorities that are both feasible to implement and can have a high payoff. But in order to set those priorities, it must have a clear vision of where it wants to go, what kind of economy it would like to have 5 or 10 years from now, and some

⁸ See *The Economist*, October 9th, 2004, page 39 (U.S. edition).

clear intermediate goals for how to get there. For example, if it would like to increase exports of agro-processing or other light manufacturers, it could set the goal of doubling these kinds of exports in 5 years. In order to achieve that goal, it could establish the more immediate goal of substantially reducing its business costs over the next three years. The government of Mozambique could loudly and publicly declare that in three years the World Bank's Doing Business Report will conclude that Mozambique is an attractive place to do business, or that in three years its rank in the Global Competitiveness Index will improve from number 92 to number 70. Once these goals are set (and declared publicly), policymakers are in a much better position to establish priorities. Other countries have made such progress, and there is no reason why Mozambique cannot do so as well.

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