57063

Findings

Africa Region. Number 87. May 1997

Findings reports on ongoing operational, economic and sector work carried out by the World Bank and its member governments in the Africa Region. It is published periodically by the Knowledge Networks, Information and Technology Center on behalf of the Region

How do Industrial Enterprises Respond to Policy Reforms?

Supply Response in Cameroon

Between 1986 and 1993, adverse terms of trade shocks combined with a rigidly pegged nominal exchange rate and various domestic distortions to reduce Cameroon's per capita income by roughly 50 percent. Though major policy reforms were slow to come, the CFA franc was finally devalued in 1994. Simultaneously, the Cameroonian government implemented a set of accompanying measures to reduce tax distortions and liberalize trade.

Although most analysts agree that the reforms were necessary for the revitalization of the Cameroonian economy, others maintained that the reforms de-industrialized the country. In fact, investment and exports have not increased as dramatically as in other cases of stabilization cum liberalization (e.g. Mexico in the 1980s) . One reason may be that the reforms were insufficient to decisively change the incentive structure at the "ground level". An alternative possibility is that though the incentive structure changed, firms have been unable to react, either because they have not had time, or because they are shackled by infrastructure problems and the institutional environment. Finally, it is possible that though the reforms have sent clear signals and firms *are* responding, this response is not apparent because the evidence has not yet been collected and analyzed.

A study conducted on more than 200 manufacturing enterprises in Cameroon, before and after devaluation and reforms, presents the following conclusions: the 1994 devaluation of the CFA franc dramatically increased the price of imported intermediate goods (Tybout and others, *How do Industrial Enterprises Respond to Policy Reforms? Recent Evidence from Cameroon*).This increase in costs was large enough to substantially reduce profits at some firms, particularly those that were heavily dependent upon imported intermediates. However, at firms using domestic inputs, and especially at firms producing exportable goods, the increase in input costs was more than offset by rising output prices, and profit margins improved. Labor costs rose by roughly the rate of inflation overall, so they went up relative to output prices in non-traded goods sectors, and fell relative to output prices in others.

Overall, real output did not grow much in the pooled sample of firms. This is not surprising, given that these firms experienced modest increases in real unit costs on average. However, changes in relative prices *did* seem to matter in terms of moving resources between activities. Firms that experienced declines in unit costs expanded (especially firms producing exportable goods) and firms that experienced increases in unit costs contracted (especially firms that relied on imported intermediate goods). By sector, wood products showed the most rapid real expansion.

Despite slow output growth, the pooled sample registered a cumulative rate of productivity growth exceeding 6 percent over the 1992/93 - 1994/95 period. Exporters appear to have done better than non-exporters, and medium-sized firms appear to have done the worst. These results are robust with respect to measurement technique, and can be obtained using either production or cost data. Hence, encouraging signs of efficiency gains are present.

The devaluation and accompanying reforms also influenced export supplies, but much less than expected. While firms with low unit costs and tradable goods increased their exports, the number of exporting firms did not increase dramatically after the devaluation. The most likely reason is that there are sunk start-up costs associated with becoming an exporter, and producers must be confident that the real exchange rate will remain favorable to them for a sufficient time to justify this type of re-tooling. The credibility of government assurances to investors and exporters that the reforms will not be reversed is yet to be established. Moreover, a highly restrictive and discretionary investment regulatory framework may have contributed to discourage foreign and domestic investors. Potential exporters may also have been discouraged by the costs of dealing with customs and port authorities.

In addition to wage and price shocks, the manufacturing sector was subjected to a major fiscal reform in 1994. The elimination of privileged tax regimes was meant to level the playing field by increasing tariffs and sales tax rates for firms previously receiving privileges. Also, by moving toward a uniform value-added tax that was neutral on production and scaling back tariffs, policy makers hoped to reduce the anti-trade bias of the fiscal regime.

Results of reforms

The proportion of manufacturing enterprises enjoying fiscal privileges dropped significantly after the reform. Thus, as intended, the fiscal reforms spread the tax burden somewhat more evenly across firms. Further, reductions in various types of tariffs shifted the tax base away from imports and toward broad-based production taxes. However, some large firms still enjoyed special treatment at the end of the sample period and small firms still evaded tax payments. Mid-sized firms, which bore a disproportionate share of the tax burden before reforms, appear to have shouldered an even *larger* share after the reforms were implemented. There is no evidence that the fiscal reforms systematically favored or hurt exporters. On the other hand, recorded tax collection did not increase, despite the fact that the firms interviewed were visited by tax officers at least once a year.

In sum, the reforms have indeed changed the incentive structure, and firms have reacted as one would expect. Output has shifted toward tradable sector activities, there have been some productivity gains, and there has been some increase in production. The fact that responses have not been more dramatic probably relates to 4 factors. First, the real costs of production have not declined on average. On the contrary, they have increased slightly. Second, since investing in new productive capacity and employing new workers both involve irretrievable costs, firms are reluctant to make these commitments unless they are confident that demand will grow. Similarly, few firms are unlikely to incur the costs of re-tooling to export unless they expect foreign operations to remain profitable in the medium term. This level of predictability is absent. Third, the data describe only one post-reform year, and this may have been insufficient time for firms to have radically changed their behavior. Finally, corruption, lack of infrastructure, financial constraints and regulatory burdens are often mentioned by firms as barriers to adjustment. It is difficult to quantify these forces, but they have doubtless played a significant role in moderating responses.

For more information on this topic, please contact Ms. Gloria Bartoli, Rm. J9-129, World Bank, 1818 H Street NW, Washington, D.C. 20433. Tel. no.: (202) 4734716. E-mail address: Gbartoli@worldbank.org

The study referred to in the article is: J. Tybout, B. Gauthier, G. Barba-Navaretti, and J. De Melo. 1996. *How do Industrial Enterprises Respond to Policy Reforms? Recent Evidence from Cameroon*. Mimeo. World Bank, Washington, D.C; a revised version has been published as "Firm-Level Response to the Devaluation in Cameroon," *Journal of African Economies*, Vol. VI-N1, 1997.

For copies of the article, please contact P.C.Mohan, Rm. J5-171, World Bank, 1818 H Street NW, Washington, D.C. 20433. Tel. no.: (202) 474-4114. Internet address: pmohan@worldbank.org

---