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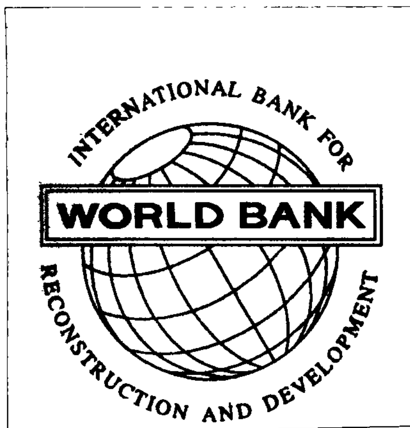

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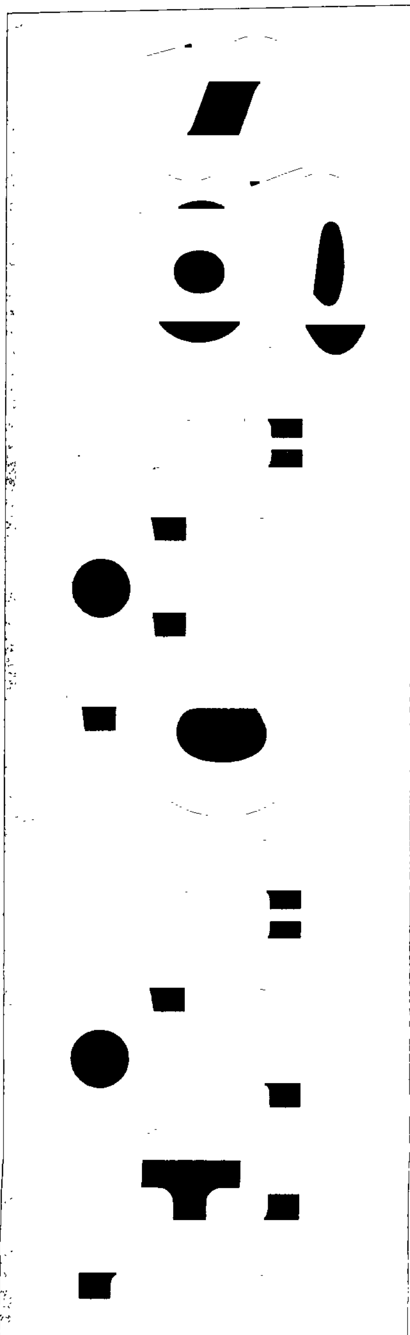

Private Sector and Infrastructure

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Madagascar: Incentives and Obstacles to Trade

Lessons from manufacturing case sudies

Since the mid-1980s the Malagasy government has pursued fiscal and administrative reform along with economic and financial liberalization. These efforts have contributed to steady GDP growth rates since 1995, averaging 4.1 percent between 1997 and 1999. Manufacturing has been keeping pace with GDP, its share hovering around 12 percent. Firms located in Export Processing Zones (EPZs) have experienced tremendous growth, (19 percent a year between 1995 and 1999), but their production still represents a relatively small share of value added. Most of the growth in the Malagasy economy has occurred in transportation, construction, and other non-tradable sectors. By contrast, the development of import-substituting (IS) firms has been considerably slower. In the past, IS firms became accustomed to producing for the domestic market under the protection of high import barriers. These companies are stagnating as they find themselves unprepared for the stiff competition from imports unleashed by recent liberalization.

The present market structure has created distortions, pulling resources into the EPZs (and to some extent, the non-tradable sector) from the rest of the economy. Given the right environment, all segments of the economy can thrive, contributing to a faster overall growth rate with a much broader base. Despite the dramatic growth of recent years, EPZs also face constraints, and there is considerable room for improvement. Firm-level studies allow for deciphering the impediments and challenges faced by these disparate groups. Madagascar must address these issues to improve productivity and competitiveness both inside and outside EPZs, as trade barriers fall around the world and the country becomes more integrated into the global economy.

Export Processing Zones

As part of the government of Madagascar's active promotion of exports since the early 1990s, it developed Export Processing Zones (EPZs) to attract foreign direct investment (FDI). Investors from China, France, Hong Kong, India, Malaysia and Mauritius and others responded. In 1999, entrepreneurs invested about FMG 328 billion, (around $US 51 million) in textile firms, while investment in agro-processing amounted to FMG 58 billion (around $US 9 million). Wood processing and data processing firms invested FMG 39 billion and FMG 20 billion respectively, (for example of one zone in 2000 see Table 1).

Table 1
Industrial Free Zone (Agglomeration of Tana and Antsirabe), 2000

Division	**Production** in billions FMG (% of total)	**Value added** in billions FMG (% of total)	**Average value added** in billions FMG
Textile manufacture	690.7(50.3)	122.6(32.4)	3
Manufacture of articles of clothing, making and dyeing of fur	546.1(39.8)	213.3(56.3)	4.5
Manufacture of leather and shoes	11.2(0.8)	3.9(1)	0.8
Wood manufacture(except furniture)	15.2(1.1)	3.1(0.8)	0.6
Manufacture of precision medical instruments and optics and clocks	25.2(1.8)	10.8(0.6)	3.6
Furniture manufacturing	52.8(3.8)	12.7(3.6)	2.1
Others	*32.4(2.4)*	*12.3(2.1)*	*1.8*
Total	**1373.6(100)**	**378.7(100)**	**3.3**

The Malagasy government offers several incentives to firms located in EPZs including a grace period on corporate taxes for the first 2-15 years of operations; exemption from customs duties and taxes on imported equipment; taxation of dividends at only 10 percent; and 99-year leases for investment in land. There is a VAT of 20 percent on imported inputs supposedly refunded within one month upon proof of exports, thereby preventing leakage of goods into the domestic market. Implementation of this VAT drawback scheme has been difficult and is an area of ongoing concern.

In the past several years, garment and textile firms have been flocking to Antananarivo and Antsirabe, where most EPZs are located. These firms currently account for almost 90 percent of the value of EPZ production in these cities. Encouraged by the effective implementation of the EPZ legislation, firms have taken advantage of some of the lowest labor costs in the world and preferential access to the US and EU markets. But most companies have not yet made irreversible investments and they can easily move if Madagascar loses its competitive advantage. Whether the industry will continue to prosper after the removal of quotas under the Multi-Fiber Agreement and the phase-in of local content rules under the United States' Africa Growth and Opportunity Act, depends on its ability to improve competitiveness vis-à-vis other major exporters including India, Bangladesh and the Caribbean Basin and East Asian countries.

Continued high growth rates in EPZs require a stable and favorable regulatory environment as well as substantial improvements in the provision of infrastructure and public services. For example, the growth of information technology firms is currently limited by the lack of bandwidth. Madagascar's low labor costs for literate, French-speaking workers has encouraged the establishment of firms that design web sites and Internet applications, perform data entry and provide Internet content for Francophone countries. High communications costs force firms to make large shipments of data via courier imposing high transportation costs and slow shipment turnaround times.

Common law sector

The Common Law sector consists of those firms operating outside of EPZs - import substituting firms (IS) and the non-tradables sector. Most of the recent growth in Malagasy economy has come from non-tradables sectors, including construction, transport, beverages and tobacco. Import-penetration ratios in recent years have on the whole increased, suggesting that the weak growth of IS firms is likely due to import competition, (Table 2). IS firms producing for the local market have been protected by formal and informal barriers to entry in the past and have not yet fully restructured to face competition from imports. Consequently, resources have been flowing out of traditional IS industries toward non-tradeables that do not have to compete against imports.

Malagasy IS firms face a substantially more difficult business environment than do EPZ firms. Unlike firms in EPZs, they receive few tax incentives or duty exemptions and therefore, find themselves shouldering a disproportionate share of the economy's fiscal burden. Moreover, they bear the brunt

Table 2
Import-penetration ratios, 'competing' sectors (in %)

Branches	1995	1996	1997	1998	1999
Food	31.7	22.2	27.0	21.4	25.6
Beverage and tobacco	30.5	12.4	23.5	25.3	17.1
Textile & clothing	4.0	5.1	8.7	7.8	5.7
Wood	3.2	5.9	4.7	8.2	7.4
Paper & printing	32.1	30.5	39.1	44.3	49.4
Leather goods	8.0	7.1	25.1	28.3	27.4
Electrical equipment	6.1	3.5	4.8	4.0	6.9
Metal products	80.9	67.5	71.8	75.7	71.0
Chemicals	26.5	20.8	33.2	27.8	30.4
Energy	-	-	-	-	-
Construction material	38.7	20.9	20.1	29.5	24.2
Transportation equipment	23.6	15.4	28.7	23.9	30.5
Mining	10.9	10.6	12.4	13.1	9.9

Sources : IMF (2000) ; INSTAT ; Ministère du Commerce ; authors' calculations.

of government regulations and administrative procedures.

Among other concerns of IS firms, one of the most frequently cited is the quality, availability, and high price of local inputs. In addition, the aging capital stock in most firms means dependence on outdated and inflexible technology and frequent production breakdowns. The small size and fragmentation of Madagascar's market is also a frequently-cited explanatory factor for the weak price competitiveness of local products vis-à-vis imports. Firm-level interviews suggest that substantial barriers to regional market access persist in spite of preferential agreements.

Cross-cutting issues

The survey of representative industries identified a variety of factors that affect productivity in all industries and, taken together, dramatically reduce competitiveness.

Infrastructure

Currently, electric power appears to be adequate in the capital. However, firms report that voltage fluctuations and outages are increasing and that they plan to buy standby generating plants in the near future. Outside of Antananarivo, the electricity infrastructure is far worse. The rundown inland transportation infrastructure affects particularly the companies serving the domestic market. High shipping costs and inadequate air freight capacity significantly raise the general cost of international business. The high cost of physical and electronic communications between Madagascar and the rest of the world affects all sectors of the economy. The lack of bandwidth keeps the cost of connectivity high, effectively capping the size of the IT sector. Hopefully, telecommunications costs will come down as the market is deregulated. Already, the introduction of mobile phone licenses have helped lower the cost of voice communications.

Finance and banking

Finance is cited as a major problem by almost all firms surveyed. As difficult at it is to get short- term money, long-term finance is even harder. Credit is restricted because banks find it difficult to obtain reliable information on borrowers or to accurately assess their creditworthiness. More important, the judicial system is weak and ineffective, making it extremely difficult and costly for creditors to obtain recourse when a borrower defaults on a loan. Moreover, land tenure laws make it impossible for foreign banks to take title to land, rendering it almost worthless as collateral.

At the end of September 2000, more than half of all domestic credit was swallowed by the public sector, 'crowding-out' private investment. As a tight oligopoly protected by barriers to entry, the banking sector enjoys rents which it is not ready to dissipate: high intermediation margins, very profitable operations on the foreign-exchange market and high transactions fees.

Training and education

A factor common to all firms is the dearth of trained workers, especially skilled middle-level managers and technicians. Basic education appears to be declining and the few industrial training institutions that do exist appear to be suffering from neglect. Decreasing graduation rates are compounded by a decline in the quality of education. Another important void in the education system is the lack of training in English, the world's main business language.

Business environment

Despite the success of the EPZ system, government bureaucracy is still a burden and imposes high costs on business, especially companies producing for the domestic market. High taxes, the capricious enforcement of laws and regulations as well as corruption have made it difficult for these firms to restructure to meet the challenge of import competition.

Customs and the import/export regime continue to be burdensome. Corruption and inefficiency have resulted in high costs and slow shipping turnaround times. IS firms complain that the customs agency does not consistently enforce tariff duties, putting them at a disadvantage. Taxes are not much of a concern for EPZ firms because most of them are currently operating within a five year tax holiday. But firms producing for the domestic market, (especially the larger, more conspicuous firms), suffer many tax audits, inspections and other forms of harassment. Also, companies interviewed have noted that it has become increasingly difficult to obtain expatriate work permits and permission for overtime from the Ministry of Labor in a timely manner.

Recommendations

- Lower protection (perhaps a maximum rate of 20 percent, to be brought down to a uniform 10 percent) to make markets more contestable;
- Lower and more uniform taxation, in order to improve collection rates;
- Collect border taxes more regularly, at current rates, on final products;
- Lighten the fiscal burden on imported inputs;
- Encourage entry into the banking system and improve transparency of the regulatory framework;
- Adopt a competition law that does not give excessive power to the administration and implements 'checks and balances' in order to prevent the privatization of key infrastructure sectors from substituting a private-sector monopoly for a public-sector monopoly;
- Develop more effective competition policy, based on stable rules rather than discretionary powers, in sectors where ententes are present;
- Improve incentives for productive investment so as to compensate the high cost and unavailability of investment credit;
- Replace direct state intervention in agro-industrial transformation industries with a policy of incentives for private investment in agriculture; and
- Rehabilitate the highway infrastructure and what remains of the railway network.

To get beyond the current 'footloose' FDI, the regulatory framework must be improved. Suggested steps include:

- Delegate the level of decision-making authority needed to obtain EPZ status;
- Streamline company registration procedures including obtaining work permit visas for foreigners, and those for environmental compliance;
- Reduce the length of time (currently 4 to 6 months) to obtain EPZ status to the 21 days specified by law, and adopt a new law that will make it easier to obtain EPZ status;
- Take full cognizance of the fact that well-functioning property rights are a *sine qua non* for long-term development.

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