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SPEED – Support Program for Economic and Enterprise Development

Special Economic Zones in Mozambique

Concept Note

The full report on which this Note is based provides an overview of the existing SEZ program in Mozambique and includes a review and assessment of the goals and objectives, legislation, institutional regime, regulatory framework, processes and procedures and development opportunities and requirements in the context of global experience. The report makes recommendations for enhancing the development impact of the SEZ program.

International experience provides examples of SEZ stimulating transformative development, but it also provides many examples of SEZ that have failed to deliver significant growth and in some cases had large losses as badly located and designed zones failed to attract investors. Mozambique is pursuing SEZ as a tool for diversifying the economy from being depending on agriculture and the extractive industries. Can the existing SEZ program deliver the eagerly anticipated broad based economic growth?

Drawing on global experience, the lessons from SEZ in Sub-Saharan Africa, and Mozambique's record to date serious consideration should be given to making a number of policy and regulatory amendments to the current SEZ program. Recent reports on Mozambique's business enabling environment, trade regime and investment regulations and incentives all highlight substantive progress over the past two decades before going on to identify policies and regulations which continue to prevent Mozambique from being globally competitive. This is perhaps the first major signal that further reforms are required. For SEZs to succeed they must live up to their name and be 'special'-that is they must function in such a way that the facilities, procedures and regulations in the zone are globally competitive. Just being better than elsewhere in the rest of the country is not good enough. Without exception all the SEZ that have succeeded in stimulating broad based economic growth are globally competitive.

Following the peace agreement in 1992 Mozambique returned to political stability, embarked on a program of structural reforms which restored macroeconomic stability and began the transition from a centrally planned economy to a market economy. These initiatives all contributed to Mozambique achieving sustained economic growth in excess of 7 per cent over the past two decades. Despite this impressive achievement Mozambique continues to face development challenges with an estimate 54 per cent of the population living below the poverty line in 2007 and most of the growth taking place in foreign owned, capital intensive, export oriented "mega-projects" which have created few jobs and limited technology transfer to the rest of the economy. The challenge for the Government is how to transition the economy towards sustained broad-based economic growth.

Attempts to leverage the first ‘mega-project’ provided the stimulus for initiating the Industrial Free Zone at Beluluane close to Maputo Port and the Maputo Corridor. The investment promotion center (CPI) began in 1993 with the goal of attracting direct foreign investment, five years before the first major direct foreign investment was established- MOZAL, an aluminum smelter. In 1998 additional specific incentives were introduced for Special Economic Zones (SEZs) and in 1999 for Industrial Free Zones (IFZs). Initially these applied to MOZAL and the adjoining Beluluane area. The revised incentives for the IFZ included exemption from customs duty and VAT on inputs used for export production, a 1 per cent of gross revenue ‘royalty fee’ in place of income tax, and partial tax holidays.

The commitment to ‘tax holidays’ was reviewed by both the Ministry of Planning and Finance and the IMF in 2000 which concluded they were not cost effective and reported that 75 per cent of the investors would have made the investment without tax and customs incentives. More than two thirds of the respondents cited ‘strong’ administrative barriers as a constraint to doing business. In response the GOM introduced a comprehensive reform of tax policy and fiscal incentives in 2002 which reduced the standard rate of corporate tax to 32 per cent (although agriculture remained unchanged at 10 per cent) and abolished the surtax. Tax holidays were eliminated in favor of investment tax credits and accelerated depreciation, although a number of specific tax holidays remained.

Following the global recession in 2008 Mozambique introduced comprehensive fiscal benefits in 2009 which restored the tax holiday, customs duty and indirect tax exemptions, along with tax credits, and accelerated depreciation for different types of investment locating in the Special Economic Zones and the Industrial Free Zones as well as allowing for firm level zones anywhere in the country. The new incentives resulted in an uneven playing field for investors with small and medium scale investors incurring the much higher statutory rates.

Drawing on international experience of SEZ from around the world there is strong evidence that SEZ have the potential to be effective pilots for reform and to act as a catalyst for advancing economic transformation. But, a successful outcome cannot be guaranteed indeed there are numerous examples, many within Sub-Saharan Africa, that have failed to generate substantial investment or be large scale employers. Mozambique has a relatively short history of using SEZ as a development tool, indeed outside of the Beluluane SEZ, which was initially aimed at encouraging linkages to Mozal, the second SEZ in Nacala was only created in 2007 and the early years have been dominated by infrastructure development-with the airport scheduled to open in December 2014.

Notwithstanding the short period (essentially 2008-2014) that GAZEDA has been actively promoting inward investment in the SEZ and the IDZ it is possible to identify the key constraints that must be addressed for the Zone model to stimulate transformative change. Mozambique has a generous package of financial incentives, labor relations are not considered a major constraint, and investors considered GAZEDA to be pro-active and helpful in addressing their concerns. The major constraint facing investors was the poor infrastructure, primarily the unreliable power supply which made generators necessary and significantly increased production costs. There is currently a waiting list of investors to move into Beluluane who cannot commence until additional generating capacity is made available.

The incentive regime is unnecessarily complex with a wide range of potential benefits that are differentiated by type and location of investment. Ideally Mozambique would offer a single incentive package that would be available to all investors, irrespective of the origin of the investment, the type of product, process or service, and the location.

In summary the key lessons from international experience include:

1. **Special Economic Zones must be Special**. Simply being better than the rest of the economy does not work-the SEZ must aim to be globally competitive. Successful SEZ offer investors what they need in order to be able to compete in regional and global supply chains. SEZ offer a genuine improvement on the regular business environment. This means ensuring the SEZ delivers a business enabling environment that is internationally competitive (essential prerequisites-property rights, stable macro-economy, infrastructure, doing business, and trade facilitation).

2. **Pro-Active Government Support is essential**. Political buy from the top is necessary to ensure the whole of Government is committed to the SEZ. This will ensure it is integrated into the overall development strategy permit integrated strategic planning, and allow for funding an effective investment marketing strategy. International best practice points to SEZ regimes being promoted and administered by a powerful and autonomous government controlled entity which: oversees the laws, regulations and practices with the Zones, provides regulatory oversight for the infrastructure developers, and occupants; ensure the efficient delivery of all services including power, water, customs controls; and acts as the main intermediary with private developers and operators.

3. **The rest of the economy should also be moving towards international competitive. Successful SEZ maintain an ongoing dialogue with the rest of the economy,** to encourage linkages, and diversification. The SEZ are spatial enclaves but the extent to which they function well and bring benefits to the entire economy will depend on the wider business enabling environment. There is a direct correlation between the economy being more business friendly and the success of the SEZ in stimulating economic activity both within and outside the zone. For example, an overvalued exchange rate will reduce competitiveness both within and outside the zone. Equally a shortage of skilled labor in the economy will also be a constraint for investors in the zone. In Mozambique infrastructure constraints, primarily the shortage of electricity generating capacity and frequent voltage outages and fluctuations affect businesses throughout the economy and are delaying new investment.

4. **Ensure stable fiscal policy and provide transparent incentives.** Mozambique offers a wide range of fiscal incentives for both new investors as well as investment expansions in the SEZ. International best practice ensures a low stable rate of corporate tax for all activities both in the SEZ and outside in the rest of the country.

5. **The costs and flexibility of employment are important.** Creating large numbers of new jobs requires attracting labor intensive industries. This requires flexible labor markets and while wage levels are important it is also necessary to ensure employment regulations are not unduly restrictive.

6. **Maximize the role of the private sector in SEZs.** The most successful zones allocate responsibilities between the public and the private sector. Government should be responsible for developing the overall policy and strategy, designing the legal framework and enabling regulations and for providing

key public goods (e.g. security). In many of the most successful zones the private sector is largely responsible for the development and operation of the SEZ, including management of the zones and promoting inward investment.

7. **Ensure an effective investment promotion strategy.** SEZ are most effective when there is a unified investment promotion approach to attract FDI and are able to act as a genuine 'one stop shop' rather than one more stop. Multiple agencies promoting investment can dilute effectiveness and result in investors engaging in agency shopping to obtain improved incentives. Targeting investment to particular sectors where the country has a comparative advantage is more successful than a scattergun approach and can encourage external benefits and increased linkages once a critical mass is achieved –the concentration of apparel producers in Lesotho encouraged investment in activities with upstream and downstream linkages.

8. **Do not use SEZ as a platform for regional economic development**. Almost without exception SEZ aimed at serving as a vehicle for developing the poorer regions within a country do not succeed. There are often good reasons why a region may be lagging –lack of infrastructure, poor transport links to distant markets, and a shortage of skilled labor. In such an environment activities aimed at serving the national, regional or global market will only be able to compete with large subsidies.

As a relative late-comer to Special Economic Zones Mozambique has the opportunity to incorporate lessons learned into its own program. Specific recommendations for Mozambique to consider include:

1. **Ensure the application and approval process is transparent and automatic** by being free from administrative discretion. The government and administration of the incentives provided to firms in terms of the 2009 Fiscal Incentives could be made more transparent. CPI and GAZEDA should focus more on investment promotion and become effective One-Stop-Agencies for facilitating investment. The recent joint CPI-GAZEDA promotion activities are a welcome development;

2. **Expand the role of the private sector** through ensuring more effective coordination and communication and also considering increased roles for PPP in the development of the SEZ. The relationship between government and private sector investors is characterized by 'regular and conflictual interactions'. Recent policy reforms (e.g., 2007 Labor Law, and the 2009 Foreign Exchange Law) and specific regulatory procedures (e.g., work permit compliance, factory inspections, customs procedures) have led the private sector to question the depth of their dialogue with government and also whether their concerns are understood across the 'whole of government.' Many investors mentioned how they request GAZEDA and CPI to use their offices to address specific problems. The issuing of work permits for expatriate executives and technical personnel appears to be an ongoing problem.

3. **Establish a mechanism for collecting relevant data on the financial performance of firms locating in the SEZ** in order to ensure the systematic and ongoing evaluation of the impact of the fiscal incentives. All the SEZ should be required to show a financial return on the investments located in the zone.

4. **Simplify the investment and promotion institutional framework**. Currently the multiple agencies responsible for sector specific investment and export promotion contribute to a confusing institutional framework with evidence of inadequate capacity and limited day -to -day autonomy from the parent Ministry. The ongoing development of the new trade and export promotion, and investment promotion strategies are welcome developments. It is essential these strategies are aligned with appropriate mechanisms put in place to ensure effective coordination by the implementing agencies.

5. **Prioritize improvements to the Business Enabling environment, including trade facilitation**. Mozambique continues to face challenges in improving the Business enabling environment. In the 2015 Doing Business Mozambique remains a long way from the frontier (best practice) and ranks 127 out of 189 countries, and ranks 129th for trading across borders which takes into account the length of time and costs required to import and export.

6. **Ensure the SEZ delivers reliable and competitively priced infrastructure.** It is imperative to ensure the SEZ are able to meet the demand for electricity and water on the estates. Currently Beluluane industrial area has a waiting list of investors who cannot start until new generating capacity becomes available.

7. **Update incentives and regulations to address advances in regional integration in Southern Africa.** The requirement that firms located in the IDZ (specifically Beluluane) who wish to sell into the domestic market have to pay the full external duty on goods imported from South Africa should be modified to recognize the preferential rates of duty that applies on imports from within SADC.