Assessment of the Business Environment and Business Opportunities in Mozambique and Sofala

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Abbreviations

ADA	Austrian Development Agency
AGOA	African Growth and Opportunity Act
CPI	Investment Promotion Center
CTA	Confederation of Business Associations of Mozambique
EBA	Everything But Arms
EPA	Economic Partnerships Agreements
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GTZ	Gesellschaft für Technische Zusammenarbeit
HIV/AIDS	Human immunodeficiency virus/acquired immunodeficiency syndrome
ICC	International Chamber of Commerce
ICSID	International Center for the Settlement of Investment Disputes
IMF	International Monetary Fund
MDG	Millennium Development Goal
MIGA	Multilateral Investment Guarantee Agency
OECD	Organistion for Economic Co-operation and Development
PARPA	Plano de Acção para a Redução da Pobreza Absoluta
PPP	Public Private Partnership
PRSP	Poverty Reduction Strategy Paper
PSOM	Programme for Co-operation with Emerging Markets
SADC	Southern African Development Community
SME	Small and Medium Enterprise
UN	United Nations
UNIDO	United Nations Industrial Programme
UNDP	United Nations Development Programme
USAID	U.S. Agency for International Development
VAT	Value added tax
VIDC	Vienna Institute for Development and Cooperation

Executive Summary

Mozambique, a nation of 19 million people, is a country of economic extremes. After a long war for independence, a mass exodus of skilled workers following independence, and a bitter civil war that destroyed much of the infrastructure, Mozambique has achieved an impressive record of economic growth over the past decade. The key contributors to this turnaround were a combination of political stability following the return to peace, deep economic reforms, large foreign investment flows, and sustained high levels of foreign assistance. With GDP having grown by more than 8% during the period 1994 to 2004, Mozambique has turned into one of the fastest growing economies in the world. However, growth in Mozambique has been characterized by stark regional inequalities and extreme income distribution disparities. The county remains amongst the poorest nations in the world, ranking 171 out of the 177 countries in the UN 2004 Human Development Index.

Economic recovery and the recent strong growth in Mozambique was primarily funded through foreign savings. Between 1990 and 2003, 100% of public investment was financed by inflows of external capital and private foreign direct investment (FDI) was six times higher than private national direct investment. Since 1998, foreign direct investment to Mozambique averaged at approximately $300 million per year. Two related phenomena – the mega-projects, which account for more than 90% of cumulative FDI flows over the 1989-2004 period, and the interest of South African business in the Mozambican economy – have driven foreign direct investment activity over the past few years.

The massive inflow of foreign private capital has contributed to improve business confidence in the Mozambican economy. Foreign investors have also brought technology, expertise, and training to the country, and foreign direct investments are generating fiscal revenues, which can be employed in the social sectors. However, foreign investments have failed to create substantial backward and forward linkages to the rest of the economy and have contributed little to the creation of jobs. FDI has been highly concentrated, with the Maputo area having absorbed 75% of all foreign direct investment, and has thus contributed to the distortion of the Mozambican economy.

Although the business environment in Mozambique has improved in recent years, Mozambique remains one of the world's most difficult places to do business. Several international surveys, including the World Bank "Doing Business in 2005" report, rank Mozambique's business constraints among the worst in Africa and even the world. Regulations governing businesses registration and licensing are antiquated, intransparent and often contradictory, frequently implying long delays and high costs for starting up a business. Trained human resources are extremely scarce in Mozambican. Thus, despite low wages, labor unit costs in Mozambique are relatively high on a regional basis.

Lack of affordable finance remains one of the most fundamental business constraints for Mozambican companies, which also presents a problem to foreign investors looking for appropriate partners. Corruption in Mozambique is widespread, if not endemic, and presents a serious threat to all sectors in the country. The judicial system is largely ineffective, also with respect to commercial disputes and enforcing contracts. Although Mozambique's tax system has undergone major reform over the past decade, the effective tax burden on companies not qualifying for fiscal incentives is high in comparison to Mozambique's neighboring countries. In general, the constraints in the business environment affect smaller businesses considerably more than larger ones.

The government essentially remains committed to further improving the business environment and is fully aware that a continued high level of foreign direct investment is necessary for sustaining economic growth. Mozambique's fiscal incentives, for example, make the country a highly competitive location for new investor. Macroeconomic and political stability, a huge underused workforce, natural resources, a prime geographic location in Southern Africa, and a liberal trade regime, are some of the attractions the country offers potential investors. In addition, further improvements in the business environment are very likely to occur over the coming years.

Investors and entrepreneurs agree that business opportunities do exist in Mozambique, but that the "streets are not paved with gold". Generally, foreign as well as local investors only consider businesses where profit margins are high and anticipate substantial unexpected costs when doing their business planning. Most foreign investors concur that a very clear business strategy, experience in other Sub Saharan African countries, deep pockets, and a physical presence in the country are absolutely necessary when starting a business in Mozambique. Given the small size of the internal market and the limited purchasing power of Mozambican consumers, most investments are oriented towards export markets.

Apart from the exploitation of natural resources, agriculture, certain manufacturing subsectors, and tourism hold the greatest potential for foreign investors. Investments in these latter sectors are usually labor intensive and can thus contribute significantly more to employment creation and poverty reduction than capital-intensive mega-projects. However, Mozambique has so far not been able to attract substantial amounts of foreign direct investment to these sectors. Especially the agricultural sector, including agro-processing, faces a wide range of challenges that has deterred many prospective investors.

The business environment of Sofala is faced with the same challenges as the rest of the country. Yet, many business constraints are higher in the central provinces than in the rest of the country, and Sofala especially has a reputation for being less business-friendly and from suffering from a higher level of bureaucratic burden than most other provinces in Mozambique.

1. Introduction and Preamble

This report is part of larger study that the Austrian Development Agency (ADA) has recently commissioned to assess the potential to apply the new ADA instruments "Business Partnerships" and "Development Partnerships" in Mozambique and especially in Sofala. The study served as a case study for the new area of the Austrian Development Cooperation called "Private Sector and Development" as well as contribute to the preparation of the new Austrian country program with Mozambique. The study was commissioned by the Vienna Institute for Development and Cooperation (VIDC) and ADA.

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2. The Country Setting

Mozambique, a nation of 19 million people, is a country of economic extremes. While Mozambique is one of the fastest growing economies in the world, with GDP having grown by more than 8% during the period 1994 to 2004, it remains amongst the poorest nations in the world. It is ranked 171 out of the 177 countries in the UN 2004 Human Development Index. Nevertheless, in view of the recent social and economic progress, Mozambique is one of the few developing countries that is likely to meet the Millennium Development Goal of halving its poverty level by 2015 if the present trends are sustained.

After 10 years of war, Mozambique gained its independence from Portugal in 1975. In the immediate period following independence, a mass exodus of Portuguese and other foreigners meant that most of the country's skills left. The Portuguese had restricted the local population's access to education to such an extent that at independence only forty Mozambicans had been educated to university level. Property and productive infrastructure were abandoned, and the country inherited an economy distorted by 400 years of colonial rule.

Following independence, the ruling Frelimo party established a one-party socialist state. During the 1980s, Mozambique was riven by a civil war, fuelled by the apartheid regime in South Africa. This conflict exacted a dreadful social and economic toll. With more than 4 million Mozambicans displaced, 1,5 million refugees in neighboring countries, and destruction of large amounts of infrastructure and other productive assets, Mozambique became one of the world's poorest nations in a very short period of time. This war lasted twelve years, before a peace agreement with the opposition Renamo movement was signed in 1992.

The elections of 1994 restored a link between the government and the population, which the war and structural adjustment of the 1980s had undermined. Mozambique's government confronted the political and economic crisis with determination, setting in motion a remarkable process of reconciliation and economic recovery. The Poverty Reduction Strategy Paper (PRSP or PARPA in Portuguese) process initiated in the year 2000 was in many ways the first national policy consultation since the mid-80s, and local and urban council elections in 1998 and 2003 added a further dimension to this. The fundamental objective of the PARPA, which presents the government's main economic policy objectives, is to reduce the incidence of absolute poverty from 69% in 1997 to less than 60% in 2005 and less than 50% in 2010. The PARPA envisions broad-based economic growth as the main engine for achieving this objective.

With an annual growth rate of 8 % since 1994, Mozambique achieved the fastest rate of growth in Africa and one of the strongest in the world. Per capita income doubled from $139 in 1990 to $276 in 2004. Exports have grown even faster, at a rate of 10% a year since the early 1990s, largely due to a few mega-projects that have come on-line over the past years. Also, the government's tight control over spending and money supply, combined with financial sector reform, successfully reduced inflation from 70% in 1994 to currently 10 % (*FAO* 2005; *World Bank* 2005a). As a result of the impressive economic turn-around, relative political stability, and the government's commitment to poverty reduction, Mozambique came to be viewed as an African role model for conflict reconciliation, political transition, and economic reform.

A breakdown of performance by sector over the 2000-2004 period shows that agriculture was the fastest growing sector, averaging 27,9% growth. It was followed by manufacturing (2,8%), commerce (12,5%) transport and communications (11,7%). According to the government, this pattern is likely to persist in 2005, although it expects a notable decrease in the manufacturing sector owing to the completion of the Mozal aluminum expansion plant and the gas pipeline to South Africa (*Economist Intelligence Unit* 2005). Generally, Mozambique is still an agriculturally based economy. The vast majority of the Mozambican workforce (an estimated 9,2 million) works in this sector, while the service sector (including government) employs only about 15% and industry about 5% of the workforce (*Grobbelaar* 2005, *USAID* 2005).

However, growth in Mozambique has been characterized by stark regional inequalities and extreme income distribution disparities. The Maputo area has seen the lion's share of the country's GDP growth, which has become a major source of political tension and strong discontent in the centre and the north. Mozambique is still highly centralized and with most of the country's resources concentrated in and around the southern capital of Maputo. Although the mega-projects have, in the past years, played a less important role in driving GDP growth than widely believed, the economy is in fact still growing at two speeds. Growth is mainly taking place in new, dynamic, capital-intensive sectors with the help of large inflows of foreign direct investment (FDI). Economic activity is weak in the more traditional sectors, which, according to most analysts, reflects an adverse domestic business environment (*Economist Intelligence Unit* 2005; *Grobbelaar* 2005; *Nathan Associates* 2004a; *World Bank* 2005b).

The private sector in Mozambique faces unique challenges because of the simultaneous legacy of colonialism, state-controlled plan economy and civil war. With economic reconstruction, liberalization of trade, and the state's divesture and deregulation of the economy, considerable progress has already been achieved in improving the business environment. Yet, local entrepreneurs are still faced with red-tape, deficient legal framework and administrative barriers. Mega-projects largely remain "island projects" with limited impact on total job creation and are geographically highly concentrated. It is widely acknowledged that the future of sustainable development in Mozambique will mainly have to rely on dynamic and innovative SMEs. However, SME development encounters severe obstacles, including a very scarce presence of national entrepreneurs, obsolete technology and unsophisticated, outdated production processes, a lack of standards of all kinds, substantial difficulties in the business environment of SMEs, as well as a number of other challenges, which will be described in more detail in the following chapters.

As far as poverty reduction is concerned, Mozambique remains one of the poorest countries in the world, despite its impressive growth performance over the past decade. A 1996-1997 poverty study indicated that 69% of the population lived below the absolute poverty line. A similar survey done in 2002-2003 shows that this head-count measure of poverty has fallen to around 54%, a significant progress. However, poverty is still severe and widespread. There has been some improvement in UNDP's Human Development Index over the past ten years, yet, Mozambique is still the 6th poorest country on the planet according to this measure. More significantly, perhaps, is that UNDP estimates that Mozambique scores considerably better than it ought to, i.e., the nation's wealth and basic public services are still skewed away from the poorest so that the country does worse than economic numbers would indicate.

In addition, some key groups, including female-headed households, orphans and vulnerable children, have hardly benefited from the gains in poverty reduction (*UNDP* 2004). Although

Mozambique is probably on track to achieve the PARPA goal of reducing the poverty rate to 60% by 2010 and to reach the first Millennium Development Goal (MDG) of halving extreme poverty by 2015, it is very unlikely that the country will achieve the other Development Goals on gender equality, access to safe water, maternal mortality and malaria. Three out of four Mozambicans are illiterate and 20 % of the children die by the age of five. HIV/AIDS remains one of the greatest threats to the development of the country, with life expectancy consequently falling from 47,1 years in 1997 to 37,9 years in 2004. The prevalence rate among people aged 15-49 years is now at 16%, compared to 8,% five years ago (*OECD* 2005a; *UNDP* 2004).

Even worse, these grim averages mask stark regional inequalities and extreme income distribution disparities. 65 % of the population receive 25 % of total income, while five percent receive 50% of total income, making Mozambique into a highly inequitable society, even by African standards (*Fozzard 2002*). The majority of the extreme poor live in rural areas and their expectations and needs are only slowly being addressed. Even the *World Bank* (2005a) believes that the overriding challenge to development in Mozambique is the distance between the small, modern, well educated, and partly wealthy urban elite that runs the country's economy and politics and the vast majority of the population that still relies on traditional practices, leaders and believes for guiding their lives.

Another concern for Mozambique's long-term development is its dependence on external aid, which is a direct result of its uneven economic expansion and the weak state of the local private sector. Since 1986, Mozambique has received $8 billion in external aid, or almost $600 million a year, which represents about 17% of annual GDP. In recent years, external aid financed half of government spending and 75% of public investments (*OECD* 2005a). Over time, the flow of aid to Mozambique is expected to move towards the regional average, i.e. 6% to 8% for Sub-Saharan Africa (excluding South Africa). Yet, it is expected that donor support will remain strong, and more and more donors are willing to deliver an increasing share of aid as general budget support. The reasons provided by donors for this support include the strengthening of accountability, predictability, intra-governmental co-ordination, and potentially lower transaction costs. There are concerns, however, regarding the risk of greater donor coordination leading to a worsening of the already unequal bargaining power between government and donors (*IMF* 2005b).

Thus, Mozambique still faces formidable challenges. The population is becoming increasingly disaffectionated with the lack of visible results in terms of improved service delivery and the government's inability or unwillingness to address the rising tide of corruption. Further challenges and risks to sustained growth and poverty reduction include a very weak human capital base, distortions and weaknesses in key sectors, inadequate infrastructure and institutions, a weak business environment, and vulnerability to environmental disasters such as floods and draughts.

3. Foreign Direct Investment to Mozambique

Since 1987, the Mozambican government has worked to create an environment to attract foreign investors. With a few exceptions, such as fishing, 100% foreign ownership is permitted, including commercial banking. In 1993, a new Investment Act was passed, and in 1997 the Investment Promotion Center (CPI) was restructured to serve as primary agent for promoting and facilitating investment in Mozambique. In 1999, legislation providing for the establishment and operation of industrial free zones, the local term for export processing zones, was adopted. The combination of political stability, macroeconomic stability, economic reform, trade integration and investment promotion has attracted large flows of investment, including a number of so called mega-projects.

Mozambique started from basically no foreign direct investments in the 1980s, rising to around $50 million per year in the mid-1990s. In 1998, construction on the $2,3 billion Mozal aluminum smelter began, which marked the beginning of several large scale foreign investments in Mozambique. Since 1998, foreign direct investment to Mozambique averaged at approximately $300 million per year, bringing the total stock of FDI capital to over 50% of GDP in 2003 (*Nathan Associates* 2004a). Between 1990 and 2003, nearly 100% of public investment and approximately three quarters of private investment in Mozambique was financed by inflows of external capital, which demonstrates the dependence of Mozambique's economy on foreign savings. Over the same period of time, private foreign direct investment was six times higher than private national direct investment.[1] Two related phenomena – the mega-projects, which account for more than 90% of cumulative FDI flows over the 1989-2004 period, and the interest of South African business in the Mozambican economy – have driven foreign direct investment activity over the past few years (*OECD* 2005a).

Since the late 1990s, South Africa has evolved into the largest investor in Mozambique, representing 49% of total FDI. In fact, Mozambique has been the second largest recipient of South African investment in Africa, after Mauritius, and the biggest recipient in SADC. South African investment is followed by that of Britain (30%), Portugal (11%) and Japan (6%) (*CPI* 2005). South African companies have invested in 18% of the 1,800 private investment projects approved in Mozambique between 1990 and 2003. However, South African private investment is highly concentrated in very large projects. As far as the direct weight in terms of value is concerned, South African investment represents 40% of all FDI for this period. Between 1990 and 2003, projects in which South African corporations were the driving force have absorbed even 85% of all foreign direct investment (*Castel-Branco* 2004). In fact, South African investors control three out of four sugar estates, three out of four breweries, all soft drinks bottling plants and large cereals mills, and most tourism facilities in Mozambique (*Goldstein* 2003).

According to the *CPI* (2003), between 1990 and 2003, 53% of foreign direct investment was allocated to industry, 20% to mineral resources, 7% to the financial services sector, 7% to agriculture and agro-industry, 4% to tourism and 3% to transport and communication. Six industries (aluminum and energy, natural gas, heavy/mineral sands, sugar, beer and cement), with a total of nine corporations operating 15 plants, have absorbed 63% of total FDI. Foreign direct investment to Mozambique is thus driven by mega-projects concentrated in

[1]Between 1990 and 2003, private investment in Mozambique was financed by FDI (36%), national direct investment (6%), and loans and other sources, mostly in the form of non-market based inflows of foreign capital (58%). Public investment has been entirely financed by external flows of capital through official multilateral and bilateral grants and loans, and has mostly been allocated to infrastructure, social sectors and post-war rehabilitation programmes (*Castel-Branco* 2004).

very few industries and dominated by a handful of international investors, the majority of them being South African. Most notable among the mega-projects is the $2,3 billion investment (phase I and II) in the Mozal aluminum smelter outside Maputo, which went into production in 2000 and is reported to be the most efficient aluminum smelter in the world. Mozal alone is responsible for 48% of total industrial output and represents 75% of manufacturing exports, 60% of exports of goods and 42% of total export revenue of Mozambique (*Castel-Branco* 2004).

The regional allocation of foreign direct investment has closely followed the sectoral dynamics of these investments. Between 1990 and 2003, Maputo City and the Province of Maputo absorbed 75% of all FDI. The Maputo area incorporate the largest industrial park in the country. Investment concentration is mostly due to the presence of Mozal and the sugar, beer, soft drinks, cement and cereal milling industries in and around Maputo, which are the most dynamic sectors in terms of growth, exports and investments.

Most investors coming to Mozambique are motivated by several reasons. Some of the mega-projects, such as the Sasol gas pipeline and the heavy sands project in Northern Mozambique, are clearly resource-driven investments. An *UNIDO* (2003) survey on foreign direct investment to Africa found a higher share (90%) of investors running resource-based or low technology based operations in Mozambique than in any other Sub-Saharan African country of the survey sample. Mozal, on the other hand, has been made possible through the availability of cheap energy and the granting of generous investment incentives.

Most investors coming to Mozambique also seek to penetrate the local market. However, the Mozambican market is still very small, and many investors build on the future potential rather than the current size of the market. While cheap labor is often cited by Mozambican officials as a reason to invest in Mozambique, most companies do not mention this as a main reason for coming to Mozambique. Rather, the low capacity and skills level of Mozambican staff lowers labor productivity and increases unit labor costs to above regional levels. This is also exemplified by the fact that, with the exception of a few mega-projects, most foreign investors in Mozambique invest in relatively small companies and employ few staff, also by African standards (*UNIDO* 2003).

Most of the larger South African companies, including multinationals and para-statals, also invested in Mozambique for strategic reasons, i.e. to position themselves advantageously vis-à-vis their competitors in Sub-Saharan Africa. In addition, several large South African investments in Mozambique have been politically driven, or at least politically sanctioned. The Maputo Development Corridor, for example, was strongly supported by both the Mozambican as well as the South African governments. For some of the smaller South African companies it is the geographical proximity of the Mozambican market that has provided the overriding impetus. Other South African investors are following their customers. This is especially true of the financial sector and the tourism and leisure industry. Very few South African companies give profit margins as the main reason for investing in Mozambique. Also, for the majority of South African companies, the contribution of their Mozambican operations to their parent companies earnings is small (*Castel-Branco* 2004, *Grobbelaar* 2005). Through their regional experience, South African investors, even the smaller ones, have generally been able to handle the adverse business environment in Mozambique much better than investors from overseas.

The overall impact of foreign direct investment and especially of the mega-projects on the economy in Mozambique has been the subject of intense debates over the past years. New data suggests that the mega-projects have not been as central to the strong performance of the economy as previously believed. The contribution of the mega-project sector to GDP growth peaked in 2001, when it accounted for a 3,2% rise in GDP growth as compared to the overall growth rate of 13,2%. Since then, its contribution has been decreasing steadily, it drove only a 0,6% rise in GDP in 2004, out of a 7,2% GDP growth rate (*Economist Intelligence Unit* 2005). Yet, the mega-projects and other foreign investments have still been responsible for the largest part of export growth and helped the narrowing of the external current account deficit over the past years.

Possibly the most important impact of the massive inflow of foreign private capital has been to improve business confidence in the Mozambican economy and to give the country credibility as an investment destination. For example, many smaller South African companies have followed the larger investors to Mozambique. Foreign investors have also brought technology, management expertise, best practices, especially with respect to employee benefits, and workforce training to the country. In addition, the expansion of foreign businesses into Mozambique has contributed to an increase in consumer choice and a consistent and reliable supply of goods and services to local businesses and consumers. In some cases, including that of Mozal, large foreign investments have also stimulated improvements in the infrastructure. Indirectly, the mega-projects and other foreign direct investments are expected to generate fiscal revenues, which will, at least partly, be employed in the social sectors and other priority areas of the PARPA. In the short to medium term the impact on tax revenues will be rather modest as a result to the fiscal incentives granted to foreign investors. In 2010, however, the mega-projects are projected to contribute fiscal revenues corresponding to three percent of GDP (*Bolnick* 2002, *MIGA* 2005, *Nasir* et al 2003).

Yet, the overall impact of FDI to Mozambique has been less beneficial than initially expected. The most significant failure of foreign direct investment has been that relatively few linkages have been established with the local business community. The mega-projects are essentially enclave activities with few backward and forward linkages to the rest of the economy. While the 2000-2005 PARPA expected that mega-projects will contribute to broad based growth and poverty reduction by attracting and fostering labor intensive small- and medium size enterprises, there is little indication yet that this has happened. The slow development of domestic business and productive capacities, including the small pool of entrepreneurs and qualified workers, is the key reason why linkages emerge with difficulty (*Nathan Associates* 2004a, *OECD* 2005a). Several donor-funded projects, including MozLink and PoDE, have, with some success, provided matching grants, loans and technical support to help Mozambican-owned firms establish linkages as suppliers to joint venture or foreign-owned companies, including the mega-projects.

The mega-projects source most of their inputs from South Africa, and there has been some concern that this might lead to the crowding out of domestic firms. A recent study on South African businesses in Mozambique revealed that South African businesses procure less than 10% of their production input from local suppliers (*Grobbelaar* 2005). However, *Castel-Branco* (2004) believes that no significant inducing, precluding or displacement of local investment has taken place at a significant scale, because not only is domestic investment capacity low, even most of those firms that have been displaced by foreign competition would in any case have been unable to continue their operations. The superior technology and (relative) financial strength of South African companies have also contributed to the domination of the local industry.[2] While this is also the case with other foreign investors, the sheer volume of South African investment in the market has created some resentment. Because of their strong presence in the Mozambican economy, South Africans have been singled out as responsible for the crowding out of local business.

Most foreign direct investment, in particular the mega-projects, are very capital intensive and have contributed little to the creation of jobs and the absorption of the growing labor force. A study of mega-projects underway or planned in 2002 found that they would ultimately create only 5,000 direct jobs and perhaps 15,000 indirect jobs in supporting industries, with each job "costing" well over $1 million in investment (*Andersson* 2002). While overall investment in the sensitive agricultural sector has been relatively small, it has led to significant job creation. For example, South African investment in just two sugar mills and estates, at a fraction of the cost of the Mozal and Sasol mega-projects, created more than 3,000 permanent and over 5,000 temporary positions for seasonal workers (*Grobbelaar* 2005).

Generally, foreign direct investment has not caused, but has contributed to the distortion of the Mozambican economy. These distortions reach across wage and income levels, and manifest both in the geographical divide between Mozambique's development corridors and the rest of the country, as well as between urban and rural areas. While the impact of foreign direct investments and especially of the mega-projects on poverty reduction has probably been rather limited, they have certainly not worked against the alleviation of poverty. Mozambique's huge development backlog, it's limited entrepreneurial base, substantial dependence on international donor assistance, almost non-existent domestic savings and very low revenue stream, means that the country will have to continue to rely on foreign direct investment in order to sustain high growth rates and ultimately also to contribute to poverty reduction. Yet, most actors in Mozambique, including government and donors, are aware that a broad-based and sustainable growth will only be possible through the strengthening of the local small- and medium enterprise sector.

[2] The South African economy is 40 times larger than the Mozambican economy.

4. The Business Environment in Mozambique

4.1. General Business Environment

Although the business environment in Mozambique has improved in recent years, Mozambique remains one of the world's most difficult places to do business. In the most recent Quality of the National Business Environment Index of the Global Competitiveness Report 2005-2006 (*World Economic Forum* 2005) Mozambique ranks 99 of all 114 rated countries, with only three other African countries faring worse than Mozambique.[3] Similarly, the *World Bank* (2005b) rates Mozambique's administrative barriers and institutional constraints among the world's worst in its Doing Business in 2005 report. For example, the report shows that starting a new business in Mozambique takes on average 153 days, compared to 60 days as Sub-Saharan African regional average and 25 days for OECD countries. In a recent survey conducted in Madagascar, many managers of international corporations mentioned that they had considered Mozambique before settling in Madagascar. While the advantageous location of Mozambique as well appealing investment incentives had attracted them, upon further investigation they rejected Mozambique because of the difficulty of day-to-day operations and because they were not convinced that promised incentives would materialize (*Nasir* et al 2003).

Over the past year, several detailed studies on the business environment in Mozambique have been conducted, and all concluded that investing and doing business in Mozambique remains complicated and very costly (*Confederation of Business Associations of Mozambique* 2004, *Grobbelaar* 2005, *Nathan Associates* 2004a). More than 80% of South African investors in Mozambique describe the business environment as "not very business-friendly" (*Grobbelaar* 2005). The key constraints and obstacles confronted by Mozambican as well as international businesses in Mozambique include: corruption, administrative barriers, low labor productivity, the inefficiency of public administration, a weak legal and judiciary system, inadequate infrastructure, lack of finance, the small size of the market, smuggling, theft, and poor repayment of VAT. All of these issues will be discussed in detail in the following chapters.

The Guebuza government is considered pro-business and most ministers as well as other high-level government representatives speak out in favor of foreign direct investments and the importance of improving the business environment. While some important steps into the right direction have been made, such as the passing of new regulations for licensing commercial and industrial activities, progress in other areas has been slow. The government sends out conflicting signals to the national and international business community, and in some cases it has even back-paddled on earlier commitments. For example, there has recently been some rhetoric about foreign workers and even foreign ownership coming from certain ministers, such as the Minister of Labor. Some observers believe that this has created considerable insecurity among investors and that some companies are currently holding off their investment decisions. However, there is little doubt that the government will remain essentially pro-business and keep working on improving the business climate, with some uncertainties though, regarding the pace and depth of reforms.

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[3] The broader Growth Competitiveness Index is designed to measure the condition of an economy and its propensity to achieve sustained economic growth in the medium to long term and is composed of three pillars: the quality of the macroeconomic environment, the state of a county's public institutions, and the country's technological readiness. In this index, Mozambique is on the 91st place out of 117 rated countries, but still ranks in the lowest quartile among African countries (*World Economic Forum* 2005).

All surveys and observers agree that the constraints in the business environment affect smaller businesses more than larger ones. While the laws and regulations do not treat international investors differently from national ones, larger companies, whether national or international, are usually better prepared to deal with the adverse business environment than smaller ones. A recent survey confirms that even South African businesses, in spite of the resentment their strong presence in Mozambique has created among some Mozambicans, are not targeted specifically for discriminatory treatment (*Grobbelaar* 2005). Yet, large investors are generally more positive about the business climate than smaller ones. This does not come as a surprise, as they are granted preferential treatment by the government and are more insulated from the domestic economy. For instance, Sasol was allowed to create its own customs terminal in order to speed up imports of inputs needed for the Pande-Tamene gas pipeline. Additionally, large foreign businesses have access to finance, technology and markets through the companies they are affiliated with.

Most of the constraints impacting negatively on the overall business environment and on private sector development had already been identified several years ago. While significant government as well as donor resources have been devoted to the process of removing these obstacles, progress has been slow and the reforms has so far yielded only limited results. Several reasons have been put forward to explain this apparent discrepancy. First, and maybe most importantly, Mozambique is still in a transition from a centrally planned economy into a market driven one. Habits and behaviors from the past, where state-owned enterprises dominated the economy and the inherited public administration was designed to maintain law and order, are still prevalent. Therefore, the proposed changes bring about a fear of loss of control and, at times, antagonism among the various stakeholders (*Barros* 2004, *Nasir* et al 2003).

Second, public administration is weak and remains largely unreformed. It does not yet have the capacity to act as an agent of change that provides an enabling environment and facilitates private sector-led development. While business regulation as well as the investment regime have to some extent been reformed, the implementation of these reforms has been slow and the interpretation of certain regulations by the lower levels of the administration is often controversial. This is also exemplified by the fact that most South African companies surveyed in the study conducted by *Grobbelaar* (2005) confirmed good access to the Mozambican government at the top ministerial level. However, most of their problems stemmed from their interaction with the lower tiers of the Mozambican bureaucracy, where capacity is thin and greater opportunities for rent seeking exist.

Third, despite the commitment from policy makers and other high-level stakeholders to reduce the barriers of doing business in Mozambique, there is a lack of appropriate structures to follow up on the agreed agenda between the relevant parties as well as a lack of adequate prioritization in removing these barriers. Third, the private sector as well as private sector organizations are weak and fragmented. This is partly the legacy of the colonial times, when indigenous Mozambicans were not allowed to own businesses, and partly the direct outcome of the socialist era, when private sector activities were not encouraged. As a result, the entrepreneurial class is still thin and dominated by a limited number of larger corporations, in many cases owned and/or run by former and current top-level government representatives or people associated with these. Private sector organizations are also considered to be weak and without sufficient independence from government and/or the international donor community.

In spite of the difficulties encountered, most foreign investors are predominantly happy with the performance of their investments and most consider expanding their operations in Mozambique in the coming years (*Grobbelaar* 2005, *UNIDO* 2003). According to Business Environment Assessment 2004 of the Confederation of Business Associations of Mozambique (*CTA* 2005), 61% of the interviewed entrepreneurs are of the opinion that the business environment has improved over the past 5 years, while 32% stated that the business climate has deteriorated, with the remaining 18% not seeing any change in the business environment. An earlier study conducted by *UNIDO* (2003) came to similar results. However, the large majority of entrepreneurs interviewed expressed their disappointment with the pace of reforms and stressed that improvements in the business environment could have been much greater if the government had been more committed to enacting change (*CTA* 2005).

Although the government is genuinely interested in attracting more foreign investment and acknowledges the need to improve the overall business environment, the foreign donor community has also played an important role in the reform process to date. Simply the fact that so many donors have "bought in" into the Mozambican story has probably sent a positive message to foreign investors about the security of doing business in Mozambique. Yet, a recent evaluation (*Batley*, *Bjornestad* and *Cumbi* 2005) comes to the conclusion that general budget support has had only a moderate effect on private investment in Mozambique, mainly because the deeper second generation of policy reforms to improve the business environment have lagged behind. However, the government and the Budget Support Group agreed to give these reforms increased attention in the near future. Currently, a number of individual donors, including the European Union, GTZ, the Swiss, USAID, the Finnish and the Japanese, have started or are considering to start new initiatives to improve the enabling environment in Mozambique.

Suggested Readings:

Confederation of Business Associations of Mozambique (2004): "*Mozambique – Business Environment Assessment*, 2004", CTA, Maputo

World Economic Forum (2005): *Global Competitiveness Report 2005-2006*, World Economic Forum

World Bank (2005): "*Doing Business in 2005: Removing Obstacles to Growth*", World Bank, Washington, D.C.

4.2. Political and Macroeconomic Stability

Political Stability: In December 2004, the third consecutive multiparty presidential and parliamentary elections took place, a considerable achievement in a country that lived, after independence, through a 16-year long war until 1992. The elections are considered to have been the most controversial since multiparty democracy was introduced in 1994, with considerable evidence of widespread fraud, although it is unlikely that this would have altered the overall result. While not accepting the legitimacy of the results, the opposition Renamo party subsequently came to accept the status quo, partly due to Frelimo's overwhelming victory, and partly because the donor community rejected calls for a rerun. More than a decade after the end of the war, the distrust between the two main parties remains strong and relations will most probably continue to be fractious.

A significant factor in favor of Mozambique's international profile is the decision of Joaquim Chissano, the former president, to stand down after 18 years in power and not to seek re-election. This was hailed by many both inside and outside the country as a landmark in Mozambique's short democratic history, and even in Africa as a whole. Since the election, it has become clear that the style and substance of governance under the newly elected president, Armando Guebuza, differs considerably from that of his predecessor. The most notable difference is that it will mark the end of the period of pluralism and national reconciliation that characterized the previous presidency. Mr. Guebuza, one of Mozambique's wealthiest businessmen, is closely aligned with the hard-line wing of the party and has installed some rather controversial ministers rooted in Frelimo's anti-colonial ideology.

The main priorities that the new government has established include strengthening the administration of justice, which is in paralysis, and the fight against corruption. There is also a continued strong commitment to poverty reduction and other social and economic policies established by the previous government. Outside Frelimo there is resignation rather than enthusiasm over the outcome of the previous election, following 30 years of the party's uninterrupted rule and a series of prominent corruption and murder scandals that have highlighted the impunity of its ruling elite.

Macroeconomic Stability: Since the early 1990s, when annual inflation averaged more 50% per year and the local currency, the *Metical*, was seriously overvalued, Mozambique made tremendous progress in achieving macroeconomic stability. Relative political stability following the return to peace, deep economic reforms, and sustained high levels of foreign assistance lead to low inflation, high levels of foreign investments, and high growth rates.

Despite a sharp increase in petroleum prices, inflation declined more than expected to 9.1 percent at end-December 2004 and dropped to even lower levels during mid-2005, driven by lower food prices. The easing of inflation expectations has already contributed to a reduction in interest rates. Strong growth in traditional exports, the completion of two mega-projects, and improved terms of trade helped narrow the external current account deficit, excluding grants, by one third to 13.8% of GDP in 2004. This, together with greater-than-anticipated donor support and large private capital inflows, contributed to boost net international reserves, which led to a strong appreciation of the metical in real effective terms in 2004 (*IMF* 2005a).

As Mozambique will remain heavily dependent on donor funding to finance it fiscal deficits for quite some time to come, the government is not expected to implement substantial changes that could upset the donor community. The *IMF* (2005b) as well as the *Economist*

Intelligence Unit (2005) expect that the fiscal deficit in 2005 and 2006 will be more or less in line with official estimate at 6,5% of GDP. However, the efficiency of public spending has been of serious concern, as it has not been as effective as expected in meeting social objectives. Progress to address this is expected to be slow, given the qualitative difficulty of improving institutional capacity. While the *IMF* (2005b) indicates confidence in the government's overall macroeconomic programme, it believes that Mozambique needs a second wave of reforms to deepen and accelerate structural changes to consolidate its macroeconomic environment and to sustain high and broad based growth.

Suggested Readings:

Economist Intelligence Unit (2005): *Country Report: Mozambique*, Economist Intelligence Unit, London

Organization for Economic Development (2005): *African Economic Outlook 2004/2005*, OECD, Paris

Swisspeace (2005): *Fast Update. Mozambique. Semi-Annual Risk Assessment. January 2005 to June 2006*, Swisspeace

4.3. Good Governance

International investors as well as donors have attached increased importance to the issue of governance in Mozambique. While the country has made significant improvements in the areas of political stability and government effectiveness since 1996 (*Kaufman*, *Kraay* and *Mastruzzi* 2005), progress has been slow in other areas, such as public sector reform, decentralization, legal sector reform, judicial reforms and fighting corruption. Lukewarm political will, coupled with limited budget and human resources, pose major challenges. Private sector development has suffered tremendously from these delays, but most stakeholders, including investors, the civil society and donors, believe that the government is by and large moving into the right direction.

Corruption in Mozambique is widespread, if not endemic, and presents a serious threat to all sectors in the country. Mozambique has, in fact, developed an unenviable worldwide reputation for corruption, as publicized by the international press and rated by international surveys. In southern Africa, only Zambia and Angola are faring worse than Mozambique in terms of corruption and most people feel that corruption has become worse since 1999, according to a survey that the government has refused to publish. The survey highlights not only public sector corruption, but also shows that private sector corruption is a major problem (*Hanlon* 2005).

Senior officials often have conflicts of interest between their public roles and their private business interests. Investigations rarely result in convictions, unless the accused has a relatively minor status in society, while senior officials are seldom, if ever, investigated. Partly because of the small size of the economy, partly because no competition policy exists yet, abuses of market power and collusive behavior add to the costs of doing business in Mozambique. Civil society, however, has become more vocal on corruption related issues, and the media is generally unafraid to report on corruption. Considering both loss of effective foreign direct investment and forgone FDI, corruption in Mozambique can be viewed as having reduced FDI by up to 50%, according to a 2002 study (*Eames* and *Thery* 2002). This leads to the conclusion that GDP growth remains below its potential at least in part because of corruption.

However, the new president has put the fight against corruption high on his agenda and some movement and progress has been noted in this respect. The Anti-Corruption Law was approved in 2004, and an anti-corruption strategy has been passed by the Council of Ministers in September 2005, but the High Authority for the Combating of Corruption has not yet been created formally. Many alleged corruption cases were reported to the newly established Anti-Corruption Unit, but the rate of concluded investigations and convictions has been extremely low so far. And the government has recently signed the UN convention and the SADC protocol on corruption. Yet, it remains to be seen whether the government really has the political will and capacity to follow through with its anti-corruption agenda. The acid test in this respect would be the ending of the impunity of the ruling elite.

The **judicial system** is largely ineffective in Mozambique. Aside from antiquated laws and procedures, insufficient human resources, low wages of judicial magistrates, poor management, and endemic corruption plague the performance of the legal and judicial system. Over the past years, only little progress has been made in the justice sector reform programme. The ratio between investigated and sentenced cases of reported incidents in the area of economic crime and corruption continues to be low. As a result, the public has little confidence in judicial institutions. The weakness of the justice system also poses serious challenges to the enforcement of human rights, access to justice, the promotion of social justice, and improving the business and investment climate.

The judicial system is also largely ineffective in commercial disputes and enforcing contracts. The World Bank ranks Mozambique near the bottom of the international scale as measured by time delays and procedural complexity. According to the 2005 Doing Business Report (*World Bank* 2005b) it takes, on average, 580 days to resolve a commercial dispute in Mozambique. Dispute resolution is in fact one of the most worrying issues for the Mozambican business community as it increases the risk and cost of doing business. According to a recent survey, 61% of interviewed entrepreneurs consider that the dispute resolution system has worsened, while only 16% noted improvements (*CTA* 2004a). An official announcement in late 2004 established that 13,000 cases were awaiting resolution in court, of which 7,000 cases were labor cases, implying that each of the approximately 70 judges had to deal with 7,000 pending cases. Accordingly, most disputes among Mozambican parties are settled privately or go unresolved. The business community is still small enough so that a damaged reputation from a commercial dispute or accusation of illegal activity can put the survival of a business at risk. For foreign investors, Mozambique offers recourse to arbitration.

Suggested Readings:

Barros, de, G. (2004): *Mozambique Country Economic Memorandum 2005. Private Sector Development Contribution to the Mozambican CEM*, AFTPS, Maputo

Kaufman, D.; Kraay, A.; Mastruzzi, M (2005): *Governance Matters IV: Government Indicators for 1996-2004*, World Bank, Washington, D.C.

4.4. Business Regulation

Regulations governing businesses in Mozambique are antiquated, intransparent and often contradictory. Bureaucracy associated with all aspects of doing business remains a serious problem. Investors face a myriad of requirements for permits, licenses, approvals, and clearances, all of which take significant time and effort to obtain. Bribes are often expected or even requested to facilitate transactions. While the issue of red tape[4] has received a lot of attention over the past years, culminating in the publication of the "Red Tape and Corruption Assessment" conducted by *Eames* and *Thery* in 2002, relatively little progress has been made in this respect.

The law and amendments on business **registration** generally do not make a distinction based on investor origin. The lengthy registration period can be problematic for any investor – national or foreign. Over the past three years, three different surveys have established the time of registering a business in Mozambique: 138 days according to the 2003 Investment Climate Assessment (*Nasir* et al 2003), 14 different procedures and 153 days according to the *World Bank* (2005b), and five months (or 152 days) according to the 2004 Mozambique Business Environment Assessment (*CTA* 2004a). While any of these numbers could be disputed, their proximity suggests that reality has not diverged too much from these figures. In any case, there is a broad consensus in the business community that the registration process for firms is extremely complex, time-consuming and costly. The *World Bank* (2005b) revealed that the regional average for registering a business is 63 days.

The same study established that the average cost of registering a company in Mozambique equals 96% of per capita income, while the 2004 Business Environment Assessment (*CTA* 2004a) states an average cost of four times GDP per capita. Very few small entrepreneurs are willing to endure this process and pay such a high price, meaning that many businesses may give up on an investment or remain unregistered. Larger companies and most foreign investors usually employ experienced consulting firms to speed up the process.

Investors, whether national or foreign, must register with the Investment Promotion Center (CPI) and pay a percentage of their investment to this organization, if they want to take advantage of any investment incentives. While the CPI can provide helpful information, not only on the registration process, it usually does not provide effective support in working through the process or provide assistance once a company is established. The only Austrian company using the services of the CPI to date had a rather positive impression of the institution. Generally, progress has been very slow in the area of business registration, in spite of numerous appeals to the government by the business community. It continues to await the fulfillment of the government's promise, made in 2004 during the 8th Private Sector Conference, to reduce the time to register a company to 2 to 3 days, in line with neighboring countries.

Licensing regulations for industrial and commercial activities have recently been revised and the associated processes simplified. Unfortunately, the opportunity to completely modify the system was lost, and both forms of licensing continue to require a number of subsequent bureaucratic processes. Obtaining a license to open a restaurant, for example, consists of seven distinct processes, requires 92 different documents, and payment of 12 individual fees.

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[4] "Red tape" can be described as excessive, confusing, or meaningless regulation which does not support a legitimate governmental purpose or which costs more in application and compliance than the benefit it provides (*Eames* and *Thery* 2002).

The process is still centralized in Maputo and vulnerable to arbitrary decisions and demands for bribes by lower level public servants. Investors still need licenses for each jurisdiction they want to operate in. More recently, one-stop-shops have been established in all provinces. However, they have so far not been given sufficient autonomy and decision making power to considerably speed up the process and are therefore considered by many as just another layer of bureaucracy ("one-more-stop-shop").

The **Commercial Code** is currently under revision and should allow for more modern commercial transactions. The previous code dated back to 1888 and created a number of difficulties in the day-to-day operations of businesses. The new code is likely to reach the National Assembly by early 2006. Regulations for **inspections** of commercial and industrial activities have also been revised. Previously, inspections in relation to public health, environmental, labor, fire and safety standards were undertaken in a arbitrary, inconsistent and uncoordinated system by a great number of different authorities. Inspections were widely perceived as not aiming to bring about compliance with the existing laws and regulations, but rather to fine and frequently extort bribes from companies. Due to poorly defined competencies between the different authorities, the same business was sometimes visited by central, provincial, and district level government authorities for the same inspection purpose. It remains to be seen whether the new regulations will change these practices and actually put more emphasis on educating rather than fining entrepreneurs.

Suggested Readings:

Confederation of Business Associations of Mozambique (2004): "*Mozambique – Business Environment Assessment*, 2004", CTA, Maputo

World Economic Forum (2005): *Global Competitiveness Report 2005-2006*, World Economic Forum

World Bank (2005): "*Doing Business in 2005: Removing Obstacles to Growth*", World Bank, Washington, D.C.

Links

Confederation of Business Associations of Mozambique: http://www.cta.org.mz

Investment Promotion Center: http://www.cpi.co.mz

4.5. Human Resources and Labor Regulations

Mozambique's estimated workforce is 9,2 million, of which only 17% earn regular wages. In general, the workforce consists of two groups: a small and relatively well educated group and a large barely trained one. In 2004, the government increased the county's minimum wage by slightly more than the 2003 inflation rate of 13%, resulting in a minimum wage for industry, services, and civil service of $47 per month and a minimum wage for agricultural workers of $34. However, the minimum wage does not even meet half the typical family's basic needs. Most working Mozambicans therefore derive income from more than one source to make ends meet and often grow corn or other crops and vegetables for personal consumption (*USAID* 2005).

Labor unions created during the socialist years of the 1970s and 1980s remain relatively strong and have recently asserted greater independence from the ruling Frelimo party. Total membership among Mozambique's fourteen unions is close to 200,000. The key concern for the unions is the minimum wage, but they are also exerting considerable pressure on the government to maintain the extremely pro-poor worker provisions. While the unions are becoming more vocal, they still lack the financial and institutional capacity to be very effective. Generally, industrial relations are very smooth in Mozambique and more stable than in neighboring countries, with not a single industry or national strike in Mozambique since independence.

All business environment assessments of the past years concur that weak **human resources** is one of the most critical challenges the Mozambican private sector as well as international investors are faced with. Mozambique's adult literacy rate is estimated to be only 40%, with huge disparities between urban and rural areas.[5] General education levels are low and most of the workforce is not trained at all or very poorly trained. In a 2003 survey among foreign investors in Africa, Mozambique was the only country where investors did not feel that the availability of skilled labor has improved (*UNIDO* 2003).

As a result, labor productivity is low; according to the 2003 Investment Climate Assessment even lower than in any of eight Sub Saharan African countries considered in the study (*Nasir* et al 2003). The high HIV/AIDS infection rate in Mozambique is starting to further reduce the productivity of human resources. Thus, despite low wages, labor unit costs in Mozambique are relatively high on a regional basis. Companies usually have to pay a premium on skilled labor, and the difficulty and cost of finding and retaining skilled technicians and supervisors remains to be one of the biggest impediments to increasing productivity. This, however, is also the result of the distorting impact the international aid community has had on the Mozambican labor market. Many of the best candidates are absorbed by the aid agencies, which pay well and offer a vast range of benefits that most private sector companies can not offer.

Yet, Mozambicans are generally described as trainable and motivated to learn. Most foreign-owned companies and some local enterprises have dedicated training programmes. According to a recent study amongst South African investors, most companies have found training very successful in raising productivity, skills levels, and in instilling a more business-oriented attitude amongst staff (*Grobbelaar* 2005). In general, foreign-owned companies pay higher real wages and offer better working conditions than local companies. However,

[5] In urban areas, only 28% of the population is literate (44% of men and 15% of women), whereas 65% are literate in urban areas (80% of men and 54% of women) (*Grobbelaar* 2005).

foreign investors have so far only created limited employment opportunities, as discussed in Chapter 3.

Mozambique's **labor regulation** is highly inflexibly and does not accord with international standards. It is commonly acknowledged that this seriously impedes job creation in the private sector. The Doing Business in 2004 report (*World Bank* 2004a) establishes that Mozambique has the 8th least flexible labor market in a survey of 145 countries. The study shows that, on average, it costs 141 weeks of wages to retrench a worker in Mozambique, while the average in Africa is 60 weeks, and in OECD countries it takes 40 weeks of salary to shed off excess workers. This data is further corroborated by the 2003 Investment Climate Assessment (*Nasir* et al 2003), which showed that 71% of managers surveyed felt that layoff procedures and cost of retrenchment are a problem.

There are currently 7,000 labor cases awaiting resolution in Mozambican courts (according to a source in the Ministry of Labor the number could even be as high as 44,000), and employers almost always loose law suits against workers. Although employees who are terminated for a just cause are not eligible for severance benefits, the process of laying off a worker are often drawn out in courts for such a long time that companies relent and pay severance to workers, even if they are caught stealing or otherwise violating terms of their employment (*Nasir* et al 2003).

As a result of rigid labor regulations and the constraints of the labor market, it is more difficult to hire workers in Mozambique than in most other countries of the region. Additionally, Mozambique has one of the most inflexible working hours in the world (*World Bank* 2004a). The hiring of expatriates has been one of the most contested aspects of the Mozambican labor law. While some progress has been noted in 2003, the hiring of expatriate workers remains extremely cumbersome, time-consuming and expensive compared to most countries in the world. When submitting a request for hiring an expatriate, the company has to attach a long list of documents, including a declaration from the Employment Center stating that the position can not be filled by a national. While most companies understand the government's need to support the local workforce, the overly protective regulation is widely considered to hamper companies' ability to upgrade themselves (*Barros* 2004).

The rhetoric about foreign workers has also been promoted by the Minister of Labor, who is closely aligned with the hard-line anti-colonialist wing of the Frelimo party, frequently stating that there is no single job filled by a foreigner that could not be performed better by Mozambicans. However, many other government representatives and ministers understand that expatriate labor is expensive and would not be hired by companies unless necessary, and that labor regulations need to be adjusted to international standards. Yet, the discussions have created insecurity among investors and many fear that this will lead to a setback in the revision of the labor law, which has already been postponed to end-2005 and might well slip into 2006.

Suggested Readings:

Barros, de, G. (2004): *Mozambique Country Economic Memorandum 2005. Private Sector Development Contribution to the Mozambican CEM*, AFTPS, Maputo

Nasir, J. et al (2003): *Mozambique Industrial Performance and Investment Climate 2003*, CTA, CPI, RPED, Maputo

4.6. Finance

The **financial sector** in Mozambique has evolved considerably in the last decade, resulting in a substantial increase in the type and number of operating financial institutions. Progress has also been made in implementing structural reforms in the banking system. After corruption and even murder scandals hit the commercial banking sector in the early years of this decade, the situation of the sector has improved considerably over the past years, with a sharp decline in nonperforming loans. The International Financial Reporting Standards (IFRS) will probably be adopted shortly and bring loan classification and provisioning in line with best international practices. The regulations of the newly adopted Financial Institutions Law were approved by the Council of Ministers in late 2004, and the revision of the regulatory framework for microfinance activities was recently completed (*IMF* 2004, *IMF* 2005b).

However, the financial system still faces numerous problems that constrain private investment and private sector development. High real interest rates and stiff collateral requirements have discouraged firms from forming or expanding and have inhibited productivity gains. Competition in the banking system is still limited, resulting in high-cost operations and very conservative banking practices. Weaknesses in the real economy elevate lending risks, while a lack of accurate accounting information and problems with contract enforcement limit banks' ability to assess credit risk and recover loans. These and other factors have also impaired the development of non-bank financial institutions such as stock and bond markets.

The agricultural and agro-industry sector has the least access to formal financial institutions. Overall, only 16% of credit goes to agriculture – and mainly to large and foreign owned farms – while 35% goes to industry and 49% to trade and other services. This bias is also the result of a banking sector heavily concentrated in the capital Maputo, with only two banks offering nationwide service.

In fact, **lack of affordable finance** is one of the most fundamental business constraints for Mozambican companies. 84% of the firms surveyed in the 2003 Investment Climate Assessment (*Nasir* et al 2003) reported that cost of finance was a severe problem, making cost of finance the most cited investment climate constraint during the survey. Given the high cost of finance, the high level of collateral requirements, and the procedural delays in obtaining credit, Mozambican firms are severely capital-constrained, and most have to rely on their own resources to meet their investment and working capital requirements.

According to the survey cited above, companies in Mozambique rely on their internal funds to finance 90% of their working capital requirements and 65% of their investment needs. Only 12% of businesses had bank overdrafts and 29% bank loans. The data also showed that smaller companies face greater constraints in obtaining external finance. Large foreign-owned businesses usually have access to finance through the companies they are affiliated with. While real interest rates have come down considerably over the past year, this has not necessarily been reflected in improved access to finance by Mozambican companies. In their search for appropriate local partners, foreign investors, including Austrian businesses, have made the experience that lack of finance is one of the key constraints faced by Mozambican companies. In many cases partnerships have failed or have not even been forged because the local firms have not been able to come up with the required financial resources.

Little progress has occurred with respect to **funding options outside the banking system**. The use of supplier credit, discounting bills, and financial or operational leases is rare. Business transactions are primarily cash-based, which increases the cost of doing business for the entire sector. A wide range of initiatives by government agencies, private sector associations, and donor agencies have sought to promote SME and microenterprise lending. While government' special funds for SMEs and support services have been implemented on a very small scale and with limited impact, some donor supported programmes have been more successful, especially in the area of microfinance. Overall, support to SME funding is still rather fragmented, which also reflects the lack of a national private sector development policy and limited dialogue between government, donors, and the private sector (*OECD* 2005a; *UNDP* 2004)

Suggested Readings:

International Monetary Fund (2004): *Republic of Mozambique: Financial System Stability Assessment*, International Monetary Fund, Washington, D.C.

Nasir, J. et al (2003): *Mozambique Industrial Performance and Investment Climate 2003*, CTA, CPI, RPED, Maputo

4.7. Infrastructure

Mozambique's infrastructure, never well-developed, suffered tremendous **devastation during the prolonged war**. Bridges were demolished, roads mined, power transmission facilities destroyed, and railroads heavily damaged. Further destruction occurred when the devastating floods hit Mozambique in 2000. Over the past 15 years, Mozambique received vast amounts of foreign aid directed at improving infrastructure, which has helped the country on its way to recovery. Rehabilitation, however, is still ongoing: work on an ambitious program to improve major north-south highways has begun, the construction of a new bridge over the Zambezi river will commence soon, and railways and highways in east-west corridors are being improved. The privatization of the ports of Maputo, Beira and Nacala has significantly improved port operations, and the management of airports has also been upgraded. Considerable improvements have been made in the area of telecommunication, with rising competition in the wireless sector, following the recent entrance of a second wireless operator.

Yet, progress in **infrastructure improvements** has been somewhat **uneven**. Many larger cities have relatively well-developed transportation, energy, water, sanitation, and telecommunications systems, while large sections of the country have few or none of this infrastructure in place. Companies operating in more remote areas, such as farmers, agro-processing businesses, or tourist facilities, often have to provide and maintain there own infrastructure, including roads, power, water, and sewage. For investors, these constraints frequently offset the advantage of abundant availability of land and cheap rural labor when comparing Mozambique to other countries of the region.

The 2003 Investment Climate Assessment (*Nasir* et al 2003) identifies **electricity** as the most serious infrastructure problem for the Mozambican manufacturing sector, with 64% of companies ranking it as a major or severe problem. More than twice as many firms singled out power as the number one infrastructure problem as did those that prioritized the next most important problem – the condition and density of roads. In this study, the median firm suffered power interruptions about five times a month, and the median loss to production due to power outages was 2% of sales, with more power outages and thus sales losses reported in the center than in the south of the country. **Transportation** continues to be a problem outside Maputo and especially so in the rural areas. For example, road transport from Maputo to Lusaka averages $0.021 per ton-km, whereas road transport from Beira to Lusaka is nearly seven times higher at $0.139 per ton-km (*Nathan Associates* 2004a). In addition, only very few ships call at secondary ports such as Beira. These constraints clearly reduce the attractiveness of Beira and Sofala in general as an investment destination.

Suggested Readings:

Nathan Associates (2004): *Removing Obstacles to Economic Growth in Mozambique. A Diagnostic Trade Integration Study*, Nathan Associates, Arlington

Nasir, J. et al (2003): *Mozambique Industrial Performance and Investment Climate 2003*, CTA, CPI, RPED, Maputo

4.8. Taxation

Mozambique's tax system has undergone **major reform** in the last decade. The government simplified the system, broadened the tax base, and replaced a cascading turnover tax with a 17% value added tax (VAT). As a result, the ratio of tax revenue to GDP has gradually increased from 11.1% in 1999 to 13.7% in 2004. The principal sources of domestic revenue are value added tax (39%), income tax (22%), and other taxes on international trade (14%). However, Mozambique's tax ratio is still one of the lowest in Sub Saharan Africa, mainly because of (1) a narrow tax base due to generous tax exemptions, especially for mega-projects, (2) a high rate of non-compliance, and (3) ineffective tax enforcement.

Under the new tax regime two **new income tax codes** have been introduced: a company tax, with a basic tax rate of 32%, and an individual tax with marginal tax rates ranging from 10% to 32%. The government has also gradually reduced import duties. The standard tariff rates currently range from 0% on designated basic goods, 5% on capital goods, to 25% on consumer goods. While a recent study on Mozambique's tax system (*Nathan Associates* 2004b) finds that the tax reform program is solidly in line with low income developing countries, several distortions remain and the business community continues to have serious concerns. The general perception is that poor administration of the tax regime rather than the tax system as such creates problems for companies.

The **VAT** works reasonably well and the rate of 17% is only slightly above the regional average. Yet, the VAT refund mechanism is highly intransparent and delays are frequent – delays of three to four months – or even up to one year – are widely reported. The resulting cash flow constraints are negatively affecting companies to the extent of firms closing down (*CTA* 2004a). Many companies reported that they had to pay bribes in order to receive the refunds (*Nasir* et al 2003).

The basic rate of the corporate tax of 32% is in line with the regional average. Yet, the **combined burden of company tax plus tax on dividends** works out to be the highest in the SADC region. Looking more deeply, the marginal effective tax rate – a measure of the extent to which the overall tax system reduces returns on investment – ranges from 48% to 56%, a burden that can certainly deter investors. In contrast, investors who qualify for fiscal incentives face a low to moderate marginal effective tax rate (*Nathan Associates* 2004b).

Mozambique offers **fiscal incentives** that make the country a highly competitive location for new investor. This, however, tilts the playing field in favor of new investors over established producers. In addition, large companies or projects like Mozal have the clout to negotiate industrial free zone status and other tax incentives, while smaller investors are not able to do so. The business community continues to be highly critical about the degree of discretion exercised by tax officials in determining assessments and penalties, which often lead to unpredictable tax bills, arbitrary fines, and corrupt practices. Smaller companies usually suffer more from the discretionary nature of tax enforcement and the complexity of the tax system than large firms. Finally, the special customs regime for manufacturers creates a huge advantage for larger enterprises, to the detriment of smaller firms that tend to be more labor-intensive (*Nathan Associates* 2004a, *Nathan Associates* 2004b).

Suggested Readings:

Nathan Associates (2004): *Tax Reform and the Business Environment in Mozambique*, Nathan Associates, Arlington

4.9. Foreign Trade

Rapid expansion of **exports** has been the main source of growth during the past ten years in Mozambique. Since the early 1990s, exports have expanded at a rate of 10% per year, doubling Mozambique's exports-to-GDP ratio. Mozambique has thus become one of the rare countries in Africa that managed to increase its share in world exports over this period. Since 2000, when Mozal started coming on-stream, the increase in exports was mainly driven by mega-projects. In 2004 alone, exports increased by 70%, to $1.5 billion, of which $1 billion relates to aluminum and gas exports, following the completion of the two mega-projects, the Mozal expansion plant and the Sasol gas pipeline (*Economist Intelligence Unit* 2005). Outside of aluminum and electricity, exports have grown only to a very limited extent over the past ten years. Mozambique's major export markets are South Africa, Zimbabwe, Portugal, Spain, and the United States. Apart from aluminum and electricity, the main export products are tobacco, prawns, lobsters, cotton, wood, coal, citrus, and cashew nuts.

The export led growth was induced by political and macroeconomic stability, and moderate improvements in the trade regime, investment climate, and business environment. The strong response of exports to only limited improvement in the policy environment suggests that the private sector is very responsive to changes in the incentive system (*Barros* 2004). In general, because the internal market is too small and the purchasing power of Mozambican consumers too low, economic growth will continue to depend on exports. Given Mozambique's low savings rate, foreign direct investments will remain to be important to sustaining growth. However, in order to have an impact on employment creation and poverty reduction, growth will have to be more broad-based, with special emphasis on SME development, and not put too much emphasis on mega-projects.

Mozambique's **trade regime** is quite liberal, but still marred with bureaucratic constraints. The country has liberalized its imports considerably. The trade weighted average import duty is about 9%, one of the lowest in Africa. There are basically no non-trade barriers. Yet, export and import procedures still hamper the flow of goods in and out of the country. According to a study conducted in 2002 (*Nasir* et al 2003), it took an average of almost 12 days to clear goods after they arrived at the port of entry and an average of 17 days to clear goods for export. Yet, customs has made considerable progress in its modernization and is supposedly approaching final implementation of world-standard laws and procedures. While large firms report no particular problems with export procedures, smaller and medium-seized firms continue to complain about a lack of transparency and inconsistent interpretation by customs officials (*Nathan Associates* 2004a).

Market access is not a binding constraint on export growth at this time, but may be a serious constraint in the medium term. Mozambique is a member of the World Trade Organization (WTO) and is accorded preferential access to certain markets, including those of its neighbors, under the SADC Trade Protocol, of the United States under the African Growth and Opportunity Act (AGOA), and of the EU under the ACP/Cotonou Agreement – which will soon be replaced with Economic Partnerships Agreements (EPA) – and the Everything But Arms (EBA) initiative.

Suggested Readings:

Nathan Associates (2004): *Removing Obstacles to Economic Growth in Mozambique. A Diagnostic Trade Integration Study*, Nathan Associates, Arlington

4.10. Other Issues – Guarantees, Incentives, and Land

Guarantees: Mozambique is a member of MIGA and OPIC (both insurers against non-commercial risks), and offers recourse to arbitration through the International Center for the Settlement of Investment Disputes (ICSID) and the Paris-based International Chamber of Commerce (ICC). The government provides a range of international best-practice guarantees to foreign investors, including security and legal protection of property, freedom to import equity capital, the remittance of funds abroad, repatriation of capital invested upon liquidation or sale, and just and equitable compensation in the event of expropriation (which has not happened since the end of the war).

Incentives: The government has been quite successful in creating an effective incentive system to attract foreign direct investment. A variety of tax incentives exist to encourage FDI, which vary according to the region of the country and nature of the investment, but often include a 50% to 89% reduction in taxes. There are special provisions for agriculture, hotels and tourism, large-scale projects, and mining and petroleum investments. Customs exemptions are possible for the importation of capital equipment and raw material. To qualify for these incentives, a minimum investment of $50,000 and a pre-approval from the Investment Promotion Center are necessary.

The government grants special fiscal, labor and immigration arrangements to companies operating in designated Rapid Development Zones in the center and the north of the country, such as the Zambezi River Valley in Sofala. Investments in these zones are exempt from import duties on certain goods, from real property transfer tax, and are granted an investment tax credit equal to 20% of the total investment. Yet, these special incentives have so far not been very successful in attracting investments to locations outside the Maputo area. As already mentioned, many incentives favor larger investors over smaller ones, and very large investors are usually able to negotiate even better deals. However, the government is currently considering to improve the investment incentive system for both foreign and local small- and medium enterprises.

Land: While private ownership is protected under the Mozambican law, outright ownership of land is not allowed. Land in Mozambique is owned by the government and cannot be sold, transacted, mortgaged or pledged as security. The government grants land-use rights to individuals for up to 50 years – renewable for another 50 years. If existing buildings are purchased, the right to use the land comes with it. Several studies have found that obtaining land can be a serious obstacle for business start-up and expansion (*CTA* 2004b, *Nasir* et al 2003). Land registration records often do not exist or are not readily available, which makes it difficult for a prospective investor to ascertain whether land-use rights to a specific parcel may be acquired. Also, the process of registering land-use rights can take a long time, frequently up to one year, and the cost of doing so can be high, especially for smaller companies.

Links

Investment Promotion Center: http://www.cpi.co.mz

5. Business Opportunities in Mozambique

Mozambique's resources and geography suggest a significant untapped potential for more investment, stronger growth and higher exports. Mozambique has enormous expanses of arable land, nearly six times the amount now being farmed, and is rich in natural resources, including oil, gas, and minerals. The country's location makes it ideally suited to be a transportation hub. Mozambique shares borders with several countries, and has a long coastline dotted with deep ports. The country also has great potential as a tourist destination, and its labor resources are underused in rural as well as urban areas.

However, Mozambique has so far not been able to fully exploit these potentials. As discussed in the previous chapters, an adverse business environment has deterred domestic and foreign investors from starting new businesses and/or upgrading their operations. Mozambique remains one of the most difficult and costly places in the world to do business for several reasons, including high administrative barriers, low labor productivity, lack of finance, the inefficiency of public administration, a weak legal and judiciary system, corruption, and inadequate infrastructure.

Mozambique has the size of France and England together, with a population (19 million) similar to that of the Netherlands. Most of the population is highly dispersed and transportation is a huge challenge in most of rural Mozambique. Additionally, disposable income in Mozambique, even in relatively affluent Maputo, is low. Thus, the internal market is too small and the purchasing power of Mozambican consumers too low to sustain most investments. Therefore, the majority of investments, especially the larger ones, are oriented towards export markets. Even a good number of smaller businesses depend at least partly on export business.

Most investors and entrepreneurs agree that business opportunities do exist in Mozambique, but that the "streets are not paved with gold", as one representative of a business association put it. Mozambique as a market place is often compared with the "wild west", with intransparent regulations, arbitrary decisions by the authorities governing the business sector, collusion and unfair competition. Generally, foreign as well as local investors only consider businesses where profit margins are high and anticipate substantial unexpected costs when doing their business planning. Also, most foreign investors agree that a very clear business strategy, experience in other Sub Saharan African countries, deep pockets, and a physical presence in the country are absolutely necessary when starting a business in Mozambique.

Agriculture is by far the most important sector in Mozambique. It employs 80% of the workforce, accounts for 20% of GDP, and comprises more than a third of Mozambique's exports (excluding exports from Mozal). Investments in the agricultural sector are usually labor intensive and thus contribute substantially more to employment creation and poverty reduction than capital-intensive mega-projects. At present, less than 15% of the county' arable land are under cultivation. In general, the agricultural sector faces enormous challenges, including low levels of education of the rural population, limited and ineffective extension services, high transportation costs, unpredictable climatic conditions in many parts of Mozambique, low productivity and yields, limited agro-processing capacities, high costs of seeds and other inputs, ineffective producer organizations, and limited export development services such as post-harvest management, finance, and assistance in complying with foreign import regulations and other requirements. Fewer than 10% of existing farms use high-yielding seed varieties or modern inputs.

Yet, with the country's strategic location, range of climatic and soil conditions, and abundance of land and water, Mozambique could become a substantial supplier of agricultural products to its neighbors, especially the larger and more affluent market of South Africa, as well as the distant, but wealthier, markets of developed countries. Agricultural products that hold potential, in particular for export, include major crops (cashew, coconut, cotton, sugar, tobacco); horticulture (citrus fruits, cut flowers, vegetables); basic food (maize, rice cassava); and diversification crops.

Mozambique enjoys preferential access for its agricultural products in the SADC regional market and in the EU market under the ACP/Cotonou program, which is soon to be replaced by Economic Partnership Agreements. The country has also some opportunities in the U.S. market available to Sub Saharan Africa. Despite these preferences, foreign market barriers remain significant in many agricultural products. Such barriers include quotas, high out-of-quota tariffs, export subsidies, and domestic support programs (*Nathan Associates* 2004a).

So far, Mozambique has not been able to attract substantial amounts of foreign direct investment to the agricultural sector; only 7% of total FDI was allocated to agriculture and agro-industry between 1990 and 2003. In recent years, citrus and horticulture production have become emerging sectors. Several citrus plantations have been rehabilitated by local investors with the help of donor supported programmes. One programme, MozLink, has been able to provide links between new horticultural producers and foreign companies that mentor them and provide them with technical assistance. On the other hand, several international corporations that had considered investing in agro-processing in Mozambique over the past years, decided not to enter the market, mainly because the production capacity of local producers as well as the quality of the produce was not sufficiently reliable to ensure the required supply of products.

Although small, Mozambique's **manufacturing** sector has been growing significantly since 1998, accounting for one-forth of GDP in 2003. Most of rise in output, however, is tied to the Mozal aluminum smelter, which now accounts for approximately 50% of total manufacturing output. Other manufacturing is highly concentrated in three subsectors: food processing, cement and beverages. The crisis in the textile and clothing sector has continued over the past years, with all of the four large clothing plants now closed. Cheap imports and second hand clothes have ruined the market.

From the standpoint of private sector and export development, manufacturing subsectors that are both labor-intensive and for which Mozambican products enjoy significant margins of preference in regional or developed country markets include leather products, textiles and clothing, processed foods and fruit juices. However, very few substantial investments have been made in these subsectors to date. In order to encourage producers of intermediate goods to establish backward linkages to agriculture and forward linkages to manufacturing, some donor support might be required.

Tourism is probably one of Mozambique's most promising service sectors for investors. Tourism arrivals have increased continuously since the 1992 peace accord, with approximately 400,000 tourists visiting Mozambique in 2001, the last year for which data are available. Tourism contributes just 1.2% to Mozambique's GDP, compared to South Africa, where it contributes 8%. According to official data, formal employment in tourism increased from 25,000 in 2000 to 32,000 in 2004. Most tourists coming to Mozambique are attracted to wildlife, culture, and the natural beauty of the more remote areas. Thus, tourism could generate jobs and provide income for significant numbers of the country's poor. There is also room for regional tourism integration, given that three-fourths of the tourists visiting Mozambique arrive from South Africa.

Yet, Mozambique’s tourism industry faces serious challenges. Infrastructure, particularly transport, is underdeveloped, expensive, and of substandard quality. Air transport, road networks, energy distribution, and telecommunications all need substantial improvement, as do water quality and waste management. In addition, land-use rights and land tenure pose serious obstacles. Application, registration and licensing processes for tourist facilities are intransparent and cumbersome. There are also critical restrictions regarding labor regulations that constrain investment in tourism, especially with respect to employment of seasonal workers and expatriates. Finally, local sector-specific expertise and capacities are very limited. As a result, almost all tourist facilities, even most smaller hostels in the cities, are foreign owned, mainly by South Africans. Starting up a tourist business in Mozambique usually requires a larger investment and more time than in most other countries of the region, given the need to import expertise and establish basic infrastructure for running the facility. Although often quoted as high-potential areas, neither eco-tourism nor community tourism have so far attracted substantial investments.

Suggested Readings:

Economist Intelligence Unit (2005): *Country Report: Mozambique*, Economist Intelligence Unit, London

Nathan Associates (2004): *Removing Obstacles to Economic Growth in Mozambique. A Diagnostic Trade Integration Study*, Nathan Associates, Arlington

6. Sofala – Business Environment and Business Opportunities

Sofala province is located in the center of Mozambique and has an area of nearly 70,000 square kilometers. Its 1.5 million inhabitants are mainly concentrated in the central part of the province along the Beira corridor. The capital of Sofala, Beira, has over 500,000 inhabitants, which makes it the second largest city in the country. Sofala was severely affected by 16 years of civil war, more than any other province in the country. Its railway infrastructure was completely destroyed and its power supply systems damaged, while road transportation came to a standstill. Cash crop agriculture and industrial activity, once powerful income and employment generators, were reduced to a minimum. The majority of the population (70%) migrated to the cities, mainly Beira, contributing to the collapse of state services and an increase in unemployment to 80%. The social and economic crises created during and after the conflict provoked a set back of up to 25 years for the entire province.

Although a large-scale rehabilitation programme was initiated after the war and considerable improvements have occurred, Sofala is still considered as one of the most underdeveloped and poorest provinces of Mozambique. Yet, according to the poverty studies conducted in 1996-1997 and in 2002-2003, Sofala transformed itself from the province with the highest poverty headcount to the province with the lowest poverty headcount in 2003. Although these results were strongly influenced by a number of statistical biases, in particular with respect to the timing of data collection and the selection of the sample in the 1996-1997 survey, there is little doubt that, over the past years, Sofala made up some ground in terms of poverty reduction (*Government of Mozambique* 2004a).

The **business environment** of Sofala faces the same challenges as the rest of the country, including low labor productivity, the inefficiency of public administration, administrative barriers, a weak legal and judiciary system, corruption, poor infrastructure, lack of finance, and the small size of the market. However, in many of these areas constraints are even higher in the central provinces than in the rest of the country, as discussed in the previous chapters. Sofala also has a reputation for being less business-friendly and from suffering from a higher level of bureaucratic burden than most other provinces in Mozambique. The 2003 Investment Climate Assessment (*Nasir* et al 2003), the only business environment study desegregating data by region, confirmed this assumption. Both the time to register a business and the number of permits required to do so were reported higher in the central provinces of Mozambique than in the north or the south. Whether the newly established one-stop-shop in Beira will impact positively on the licensing process still remains to be seen. Also, the number of inspections was higher in the center than in the other parts of the country, with an average firm being subjected to some type of government inspection (such as health, labor or safety) six times per year.

In addition, Sofala has the highest HIV/AIDS rate in Mozambique (approximately 25%), which is starting to become an enormous burden on the social fabric of society as well as on the productivity of human resources. Many entrepreneurs inside as well as outside Sofala also put forward cultural and political reasons for the underdevelopment of the province. Being the stronghold of the opposition Renamo party, there has always been the notion that Sofala has not been given as much attention from central government as the rest of the country. Probably as a legacy from the fierce civil war, the entrepreneurial base in Sofala is much smaller than in other provinces, with only very few local companies of considerable size and a high turn-over rate of existing companies. Finally, the crisis in Zimbabwe has had a huge impact on business activity along the Beira corridor and the province in general, with Beira being the main entry and exit point for goods from and to Zimbabwe.

While Sofala has been the country's second largest destination of total foreign investment to Mozambique over the past years, most FDI went to very few large projects, mainly in infrastructure, such as the port of Beira and the rehabilitation of the railway. Only 35 investments (local and foreign) were registered with the Beira Investment Promotion Center for the entire province between January 2003 and August 2005, amounting to approximately $260 million. However, one investment (railway rehabilitation) captured the largest share ($150 million) of the total volume. Almost all larger investments were foreign and concentrated in Beira, with most going to the fishing industry and the transport sector, some to agriculture and agro-processing, and only two to manufacturing.

While business is still sluggish in Sofala and the province has so far not been able to master an economic take-off, there are some encouraging signs. The construction of a bridge over Zambezi, which will commence soon, and the ongoing rehabilitation of Sena railway line to Malawi will foster economic development and help to make Sofala more attractive to investors. The port of Beira has the reputation of being well managed and has the potential to act as an important hub for the 20-25 million people in Mozambique and the neighboring countries that could be reached via Beira. In addition, the provincial government as well as the local business associations are very committed to attracting investors. Over the past years, discussions have been going on regarding the establishment of an export processing zone in Beira, however, serious doubts have been voiced whether sufficient funds for the construction of the required infrastructure can be mobilized and whether the zone would be able to attract the necessary amount of investors to cover its costs, considering that even the new export processing zone in Maputo has great difficulties in doing so.

So far, no comprehensive study of **business opportunities** in Sofala has been conducted. The most promising sectors for local as well as foreign investors are agriculture and agro-processing, tourism, and selected manufacturing subsectors. As far as agriculture is concerned, 80% of the arable land is unexploited. Possibilities exist for the cultivation of rice, maize, sweet potatoes, beans, cotton and sugarcane, as well as for fruits and vegetable. For most fruits the harvest season in Sofala starts eight weeks earlier than in South Africa, providing an attractive window of opportunity for export.

However, the agricultural sector in Sofala faces the same challenges as in the rest of Mozambique. Sofala may even be more underdeveloped than other provinces, with only 0.7% of smallholder farmers using fertilizers and pesticides and 2.5% using animal traction. The Zimbabwe crisis has affected the smallholder agricultural sector more than most other sectors in Sofala. Sofala currently produces some fruits and vegetables, including, pineapples, banana, tomatoes, and onions, in quantities that cannot be absorbed by the local market. So far, very few investments in agro-processing have been made in Sofala, with the exception of the Sena sugarcane-processing factory (now the largest employer in the country) one medium-sized maize mill, two sugarcane processing plants, and one soy processing plant, all funded by foreign investors. For most agricultural products, not even basic processing capacities, such as selection and packing facilities, exist in Sofala.

Several foreign investors had looked into the fruits and vegetable subsector, but all of them have pulled out again. The main reason being, as in the rest of Mozambique, the unreliable quality and insufficient quantity of products, scattered production, and the inexistence of intermediary traders. One investor from Saudi Arabia came to purchase mangos in larger quantities, but decided to leave again after three years, as the local producers could not guarantee the required quality and quantity. Before leaving, the investor established a plantation of mango trees and is planning come back in six to seven years, when the trees are expected to produce the necessary quantities.

Sofala has so far not been able to attract many farmers that left Zimbabwe for political reasons, while about 100 Zimbabwean farmers settled down in the neighboring Manica province. Their investments helped to create jobs, diversify agricultural production, and create agro-processing capacities. Given their capital-intensive production techniques, however, the potential for relevant know-how transfer to the local population is limited. Additionally, their domination of agricultural production in some parts of the province is widely perceived as a politically sensitive matter.

As far as tourism is concerned, so far very little development has taken place in Sofala. With the famous Gorongosa National Park, the Marromeu Buffalo Reserve, eight hunting areas, three forest reserves, and a 300 kilometer coastline, Sofala has considerable potential to become once again an attractive destination for local and foreign tourists. Although wildlife was heavily affected by the war, the process of recovery has been initiated, with populations of the major game animals (elephants, lions, buffalos) slowly growing. Yet, environmentally destructive practices such as slashing and burning as well as questionable gaming practices have, for example, put the rehabilitation on the Gorongosa National Park at risk. Also, the tourist infrastructure in Sofala is severely constrained, and very few investments have taken place in this sector, more specifically, none since January 2003.

Other business opportunities in Sofala include fishing, textiles and clothing, and wood processing. The fishing industry is dominated by foreign companies and fishing quotas have been fully assigned for the coming years. One jeans manufacturer has recently decided to set up shop in Sofala, mainly to take advantage of import quotas granted to Mozambique by developed countries. Given that hardwood can no longer be exported in an unprocessed form from Mozambique, at least not legally, opportunities for wood processing are currently explored, also in Sofala.

7. Conclusions

Mozambique has undergone fundamental economic and political change over the past 10 years. The country has achieved an impressive record of economic growth, mainly through a combination of political stability following the return to peace, deep economic reforms, large foreign investment flows, and sustained high levels of foreign assistance. Although the government has put considerable effort in improving the business environment, Mozambique remains one of the world's most difficult places to do business. Mozambique's advantages seem to be outweighed by the impediments that firms face at the operational level. While larger investors are usually able to work their way around the various constraints in the business environment, smaller companies face tremendous challenges.

Summary of Key Findings

- On the positive side, Mozambique offers macroeconomic and political stability, a huge underused workforce, natural resources, a prime geographic location in Southern Africa, a liberal trade regime, and attractive fiscal incentives for new investor.
- Exploitation of natural resources, agriculture, certain manufacturing subsectors, and tourism hold the greatest potential for foreign investors.
- In spite of improvements in the business environment in recent years, Mozambique remains one of the world's most difficult places to do business.
- Constraints in the business environment affect smaller businesses considerably more than larger ones.
- Regulations governing businesses registration and licensing are antiquated, intransparent and often contradictory, frequently implying long delays and high costs for starting up a business.
- Lack of affordable finance remains one of the most fundamental business constraints for Mozambican companies.
- Infrastructure remains poor in more remote areas, especially as far as electricity and transportation is concerned.
- Corruption in Mozambique is widespread, if not endemic, and presents a serious threat to all sectors in the country.
- The judicial system is largely ineffective, also with respect to commercial disputes and enforcing contracts.
- The marginal effective tax rate is one of the highest in the SADC region.
- The size of the internal market is small and the purchasing power of Mozambican consumers limited, requiring most investors to produce primarily for export markets.
- Sofala has the reputation for being less business-friendly and from suffering from a higher level of bureaucratic burden than most other provinces in Mozambique.
- As a result of the small and weak entrepreneurial class, the identification of an appropriate local partner in Mozambique is one of the key challenges foreign investors face.

Annex I Mozambique – Economic Structure

Annual Indicators

	2000a	2001a	2002a	2003a	2004b
GDP at market prices (MT bn)	56.9	71.1	85.2	103.8b	137.8
GDP(US$ bn)	3.7	3.4	3.6	4.4 b	6.1 c
Real GDP growth (%)	1.5	13.0	7.7	7.8 c	7.2 c
Consumer price inflation (av; %)	12.7	9.1	16.8	13.4	9.1 c
Population (m)	17.9	18.2	18.5	18.9	19.2 c
Exports of goods fob (US$ m)	364.0	726.0	679.3	880.2	1,506.Oc
Imports of goods fob (US$ m)	1,046.0	997.3	1,215.7	1,228.2	2,034.0 c
Current-account balance (US$ m)	-763.6	-657.2	-711.6	-515.6	-462.0
Foreign-exchange reserves excl gold (US$ m)	725.1	715.6	819.2	998.5	1,130.0
Total external debt(US$ bn)	7,038	4,449	4,609	n/a	n/a
Debt-service ratio, paid (%)	11.4	8.3	6.0	n/a	n/a
Exchange rate (av) MT:US$	15,227.3	20,703.6	23,678.0	23,782.3	22,581.3a

a Actual. b Economist Intelligence Unit estimates. c Official estimate.

Origins of gross domestic product 2002a	**% of total**	**Components of gross domestic product 2002a**	**% of total**
Agriculture, fishing & forestry	23.5	Private consumption	59.0
Industry	34.0	Government consumption	11.0
Manufacturing	12.6	Gross domestic investment	44.7
Services	42.5	Exports of goods & services	23.5
		Imports of goods & services	38.2
Principal exports 2002	**US$ m**	**Principal imports 1997**	**US$ m**
Aluminum	361.0	Machinery & equipment	139.0
Electricity	107.0	Vehicles, transport equipment & spare parts	113.8
Prawns	64.0	Fuel	92.3
Cotton	21.0	Textiles	43.4
Sugar	18.1	Metal products	38.9
Main destinations of exports 2003b	**% of total**	**Main origins of imports 2003b**	**% of total**
Belgium	30.3	South Africa	34.5
South Africa	17.3	Australia	10.4
Italy	11.6	US	5.1
Spain	11.3	Portugal	5.0

a Official figures. b Based on partners' trade returns; subject to a wide margin of error.

Source: Economist Intelligence Unit, Mozambique Country Report, May 2005

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List of Persons Interviewed

Government and Government Agencies, Mozambique

Soares B. Nhaca	Ministry of Labor	Vice - Ministro
Tomás Berhardino	Ministry of Labor	Permanent Secretary
Albino Mahumane	Ministry of Tourism	Director, Planning and Cooperation
João Macaringue	Ministry of Industry and Trade	Director, Market Services and Infrastucture
Daviz M. Simango	Conselho Municipal da Cidade da Beira	Presidente
Jose Ferreira	Ministry of Industry and Trade, Provincial Directorate, Sofala	Director
Omar Jalilo	Ministry of Labor, Provincial Directorate, Sofala	Director
Rui Rodrigues Ndongue	Ministry of Labor, Provincial Directorate, Sofala	Assistant Director
Antonio Limbau	Ministry of Agriculture and Rural Development, Provincial Directorate, Sofala	Director
Manfred Schug	Ministry of Agriculture and Rural Development, Provincial Directorate, Sofala	Advisor
Emilio Bento	Investment Promotion Center (CPI), Beira	Director
Emilio Bento Américo	Investment Promotion Center (CPI), Maputo	Economist
Horácio Eugénio Dombo	Investment Promotion Center (CPI), Maputo	Head of Free Zones and Special Projects Division
Maria Rita Freitas	Mozambique Export Promotion Institute (IPEX), Maputo	Director
Cecilia Emilio Candrino	Mozambique Export Promotion Institute (IPEX), Maputo	Senior Officer

Business Associations, Chambers, and Companies, Mozambique

Paolo Fumane	Confederation of Business Associations of Mozambique, Maputo	Coordinator
Jim LaFleur	Confederation of Business Associations of Mozambique, Maputo	Senior Economic Advisor
Hamid Taybo	ADEL Sofala	Director
Gabriel de Olivera	Associação Commercial da Beira	1° Vice Presidente
Prakash Prehlad	Associação Commercial da Beira	2° Vice Presidente
Eugénio Caetano	Associação Commercial da Beira	Secetário Permanente
Henk Son	Chamber of Commerce – Mozambique/USA	President
Almeida Matos Muthemba	Chamber of Commerce – Mozambique/EU	
Frans Ovens	BesText/ECOTEC	General Manager/Consultant
Louw Middel	Vodacom	Senior Specialist
Rui Costa	Companhia de Gestão e Comercio, Beira	General Manager
Paolo Fumane	Confederation of Business Associations of Mozambique (CTA)	Director
Gabriel de Oliveira	Association of Civil Construction and Public Works (AECCOPS), Beira	President
Zaide Aly	Trade Association Beira (ACB)	President
Jorge Funandes	Trade Association Beira (ACB)	Director
Carrie Davis	Association for Trade and Industry (ACIS), Beira	Executive Secretary

Others, Mozambique

Irene Novotny	Austrian Development Cooperation, Coordination Bureau, Maputo	Head of Office
Michael Butschek	Austrian Development Cooperation, Coordination Bureau, Maputo	Administrator
Ramon Ynaraja	European Union	Officer, Private Sector and Trade
Timothy Born	USAID	Team Leader, Trade and Investment Program
Julius Schlotthauer	USAID	Senior Economic Development Advisor
Irene Visser	IFC	Operations Officer, Private Enterprise Partnership for Africa
Nikolas Lamadé	GTZ	Head of Program, Sofala
Ashok Menon	Nathan Associates	Director, Trade Policy
Horst Hartl	GTZ	Head of Private Sector Development
Stefanie Ruff	GTZ	Officer
Markus Speiser	Elaion	Consultant
Shaida Seni		Consultant
Stefan Schmidt-Hayaschi	ECOTEC/PADM	Project Manager

Interview Partners in Austria, Europe and South Africa

Franz Schröder	Austrian Federal Economic Camber	Regional Director Africa
Manfred Schekulin	Austrian Federal Ministry of Economy	Director, Export and Investment Policy
Gertrude Leibrecht	Austrian Development Agency	Desk, Southern Africa
Margit Scherb	Austrian Development Agency, Knowledge and Quality Management	Head of Department,
Günter Schönleitner	Austrian Development Agency, Private Sector and Development	Head of Department
Kristin Duchateau	Austrian Development Agency, Private Sector and Development	Officer
Wolfgang Moser	Federal Ministry of Foreign Affairs, Department for Development Cooperation	Co-Financing Officer
Manfred Schnitzer	Federal Ministry of Foreign Affairs, Department for Development Cooperation	Desk Africa, Poverty, Rural Development and Decentralization
Wolfgang Nemety	Austrian Trade Commission, South Africa	Assistant Trade Commissioner
Gerhard Pevny	Logotronic	General Manager
Alexander Beyer	BEFA	Project Manager
Delia Meth-Cohn	Economist Intelligence Unit, Vienna	Senior Consultant
Bernhard Weber	ICEP - Institut zur Cooperation bei Entwicklungs-Projekten	General Manager
Hartwig Rupp	GTZ, Private Public Partnership – PPP, Berlin	Regional Coordinator Africa
Hans Stoisser	ECOTEC	General Manager
Andrea Schlehuber	EZA Fairer Handel GmbH	General Manager
Peter van Portvliet	Programme for Co-operation with Emerging Markets (PSOM), Holland	Officer, Africa