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ENVIRONMENT FOR INVESTMENT IN MADAGASCAR: INSTITUTIONAL REFORM FOR A MARKET ECONOMY

FINAL REPORT

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PREFACE

This report on the investment environment in Madagascar is based on research and interviews conducted during the summer of 1992. A team of lawyers, an economist and investment banker coordinated by the Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland at College Park visited Madagascar between July 20 and August 23, 1992. Research on the Madagascar economy and institutional arrangements was conducted in advance, during and following the trip. A partial list of persons interviewed is attached as an Appendix to this report.

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This report was written by Hilton Root with considerable input from reports prepared by other team members. In particular, the report and analysis of the legal framework has benefitted from the contributions of Alain LeVasseur and Michael Krauss, although the author remains responsible for any errors.

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EXECUTIVE SUMMARY

This report is a product of a mission to Madagascar undertaken by the Center For Institutional Reform And the Informal Sector ("IRIS") at the University of Maryland at the request of the U.S.A.I.D. Mission in Madagascar. The purpose of this project was to examine the environment for investment in Madagascar, and determine which institutional reform efforts would most encourage the growth of a market economy. In particular, the IRIS team examined how the legal and regulatory environment and the investment process affect the prospects for market reform. Governance issues bearing on the prospects for market reform have also been raised. These issues are related to, but distinct from legal/regulatory reform. Progress in both areas can accelerate the pace of investment and restore the nation's economic well being.

Madagascar's economic future depends on creating a legal environment that will encourage both indigenous and foreign investment in the nation's vast economic potential. The government is currently unable to provide both physical and institutional infrastructure that attracts investors. The under-reporting and export of profits, as well as the proliferation of informal markets for many goods and services deprive the government of the resources for necessary services. However, the efforts of economic actors to evade compliance with official controls, reflect an economically irrational regulatory environment. Before Madagascar can hope to attract the investment upon which its future depends, a number of questions must be resolved. This report will raise some of those questions and propose a number of solutions.

Investors considering Madagascar will require answers to a long list of questions. Are the rules of the game subject to rapid change of reversal? Are the procedures for changing the rules arbitrary or whimsical? Are the rules of the game clear? Is the playing field level for all players? How available is information about economic opportunity and about political decisions? What is the extent of bargaining between groups that hold economic privileges? Are regime officials accountable? Are regime officials able to make commitments? What sanctions exist to ensure that the government lives up to its obligation? What degree of autonomy or independence does the legal system enjoy from the political system?

Unfortunately, evidence we uncovered suggests that the present legal and regulatory environment offers potential investors inadequate protection from the risks of arbitrary seizure or capricious decision-making by bureaucrats. Nor does the legal system afford adequate remedies in the case of bankruptcy or non-contractual damages (torts). Similarly, property rights are not adequately specified or protected. The stability of long-term macro economic policy is uncertain. The judicial system is not adequately protected from political influence. Because the bureaucracy is not adequately insulated from executive authority, it can not credibly protect investors from arbitrary rule enforcement by its members. Indigenous investors do not have the same rights as outsiders. The rights of citizenship of key players in the domestic economic system are not assured. Recourse for the settlement of commercial disputes is lacking and as a result traders require secondary social sanctions before they are willing to engage in trade. Key figures in the political hierarchy posses

market power that deters competition. The judicial system cannot provide protection from arbitrary behavior of government officials.

Solutions that can be immediately implemented as well as those that require time and significant training are offered in this report. A private system of dispute settlement is recommended. Traders who do not comply with decisions of arbitrators will acquire a reputation that will reduce their capacity to find future partners. The existence of a system of arbitration will allow reliable partners to distinguish themselves. A mechanism to establish reputations would increase confidence and reduce some of the contractual problems that arise during economic expansion.

Training judges and lawyers in international commercial practices and law will take a long time, but must begin immediately. The process for making investment decisions must be simplified. Unless of a strategic nature, investments should not have to pass an elaborate screening process. The ministry responsible for the screening should have sufficient powers to override other ministries should an impasse arise. A private agency that can offer investors reliable information about economic opportunities as well as the costs of doing business in Madagascar will be helpful. Mechanisms to coordinate economic decision-making between state and private sector representatives must be established. Information about rules and their enforcement must be available to all parties. Conflicts of interest and the abuse of executive authority must be constrained by the new constitution.

Until the legal and regulatory environment offers satisfactory solutions to each of these dilemmas, the level of investment needed to support growth will not occur. In order to address the difficulties outlined in this report we recommend the following specific measures be taken in the areas of the legal and regulatory environment; the investment process and the system of governance:

I. Legal and Regulatory Environment

1. An Independent Judiciary And The Rule of Law.

a. Rules and Practices.

•The judicial appointment process needs to be made open to public view and criteria for selection explained.

•The status of currently sitting judges must be reevaluated. If their terms are to be converted into lifetime appointments, a choice must be made whether their appointments should be reconsidered under new appointment procedures, or whether the simple act of extending their tenure will provide adequate independence and address questions of corruption.

•The statute establishing the General Inspection of Justice should specify minimum levels of staff and resources in order to free this body from dependence on the executive.

b. **Training.** Steps to train judges, as well as lawyers, in the fields of economics, business, trade and taxation, among others should be undertaken. Options include a series of short (for example, two week) seminars for sitting judges and additions to the curriculum at the *Institut d'Etudes Judiciaires*.

2. Improvements in the Adjudication of Commercial Disputes.

Until an adequate judiciary can be established, institutions should be developed to encourage the private arbitration of commercial disputes. Nothing can substitute for a judiciary when parties fail to accept the judgment of private arbitrators, but the economy needs a strengthened dispute solving mechanism now. Steps to establish private arbitration of commercial disputes should be undertaken immediately and parliament should modify appropriate legislation to provide for the effective implementation of such mechanisms.

A second best option to a private system for commercial disputes would entail assignment of commercial disputes to a special commission or to the executive branch as an interim measure until the courts are established to handle such disputes more effectively. Alternatively, the French system of special jurisdiction commercial courts might be a target.

A third option is to establish quasi-judicial tribunals to settle disputes independently of the executive and judicial branches of government. The goal is to create recourse to a transparent impartial institution to substitute for a politically dependent judiciary or anonymous civil servants, who avoid taking responsibility for their decisions.

3. Property Rights

The establishment of clear property rights is a prerequisite for promoting the development of an efficiently-functioning market economy. Currently in Madagascar, property rights are unclear and many conflicting claims exist. As many other countries discover, this severely retards growth. In order to clear the confusion surrounding property rights in Madagascar, we suggest the following initial steps:

- Experts in land tenure and registration systems should research the current hodge-podge of customary, socialist and civil property regimes. Procedures for settling ownership among these competing regimes are needed and an administrative structure for undertaking this task must be created.

- While private ownership is expanded alternatives to state "ownership" might be considered.

- Laws forbidding "speculation" in land need modification. In practice, there is considerable difficulty distinguishing "*speculation*" from productive investment.

- The ban on foreign ownership of land discourages long term investment and encourages the use of Malagaches "front" organizations. Such transactions are expensive to negotiate and are of questionable enforceability.

·The system of rent value regulation, especially for commercial property, is ineffective. To the extent this system encourages people to employ methods to avoid the application of the rates ("*pondérations*") it undermines respect for the law. It would be better to eliminate this system altogether.

·The property interests of landowners in minerals and their ability exploit these resources for profit need strengthening. Even in countries with limitations on the absolute freedom to extract minerals from land, a system of leases, property rights and administrative procedures insure investor confidence that their investments will not be confiscated.

4. Business Law

The problem of codification of Malagache business law is formidable. A review of civil and commercial codes by a team of Malagache, US and perhaps European experts is necessarily a first step. The team should contain at least one expert in comparative law. The reform should consider Malagache customary law, all useful portions of modern French codes and relevant areas of law codes from different legal systems that are applicable to Madagascar. The legal academy of Madagascar has already begun work on such a project. Sweeping reforms will be needed to correct the problems relating to the confusion and multiplicity of the sources of legal authority. Customary law must be studied to determine its applicability.

The Malagache team should work in close collaboration with an outside team of experts so that they will be able to call upon lawyers specialized in the various sections of commercial law under revision. These experts can introduce concepts which give the Malagaches a broader perspective on possible approaches. Support for ongoing reform efforts should be a priority.

Some specific items to review include:

·Reduce the legal standards which establish minimum terms for contracts. Currently, *dispositions d'ordre public* often so reduce the capability of private parties to agree on terms of their bargain that there is very little freedom of contract at all. This includes the reduction of the ability of administrators or courts to alter the terms of contracts.

·A positive rate of interest should be applicable to legal judgements at a level which encourages enforcement of court decisions. With annual inflation running at about 17%, the current legal rate, apparently at 6%, rewards debtors for delay.

·The role of passive investment should be reconsidered. The law which purports to wipe away "speculation" is ambiguous and can produce capricious judgements.

·In order to identify restraints on industrial opportunities in key investment sectors, a team of local and outside experts should conduct studies of the administrative rules, laws and decrees affecting these important industries. This should be accompanied

by an economic analysis of industry structure and operation. Such a coordinated study will suggest reforms of both specific industrial policies as well as broader efforts.

5. Tort Law

The lack of effective mechanisms for compensating non-contractual damages suggests a need for increased understanding in Madagascar of the importance of liability-assigning institutions to a market economy. The investor's need for information and rules permitting risk assessment must be emphasized and understood. Exposure to systems used in other common and civil law countries will be useful. Tort law must be coordinated with customary rules regarding trespass and other harms to persons or property. A team of Malagaches and outsiders can begin to apply local concepts of torts while simultaneously addressing the needs of foreign investors. Ultimately, many forms of insurance will not be available until the risks of doing business in Madagascar can be adequately assessed.

6. Bankruptcy Process.

Bankruptcy procedures should be liberalized and made less costly for all parties. Procedures for liquidating an enterprise are a necessary component of business law.

In order to liberalize the bankruptcy law, a working group of outside and Malagaches experts should be established. The objective of this group would be to provide a basis for reform and to create an understanding of reform issues among a group of opinion leaders. Specifically, the tasks of the groups would include the following:

- Catalogue the specific laws, decrees and *arrêts* which affect the ability of firms to close operations and the rights of creditors in that eventuality.
- Document the economic and operational impact of the current system on firms.
- Introduce the working group to other approaches to bankruptcy emphasizing the principles and incentives inherent in various economic systems. The interaction of bankruptcy with contract enforcement, property rights, banking, credit and labor law should also be studied.
- Conduct a seminar for a wide spectrum of Malagaches society on the issues at stake and the implications of improvement for firms in Madagascar. A similar but separate session for legislators and ministry officials should be held.
- Draft reform proposals by the working group or a subcommittee.
- Support for Malagaches groups working to advocate adoption of such a reform.

7. Improved Information on Legal Rules.

a. Collection of Information. All existing sources of law, including statutory, regulatory or customary rules must be compiled, sorted and integrated. This fundamental

exercise will support all the other legal reform efforts described above relating to torts, commercial law, property and bankruptcy.

b. Dissemination of Information. A group (possibly the same as in point a) is also necessary to systematically publish and circulate basic legal texts which are still unavailable, including statutes, codes, textbooks, decisions of key tribunals, etc.

c. Legal Center. The group or groups performing the above mentioned function could be located in a center for the administration of justice, which would perform information collection, creation and dissemination functions. Training could be centered here as well.

II. The Investment Process

1. Consolidation And Simplification of Investment Approval

A centralized structure that approves most investment applications without obstruction from other governmental units is most effective. Only this solution will prevent the development of a discrepancy between policy statements and implementation. The process of foreign and domestic investment approval should be simplified and consolidated in fewer ministries. In addition, the following recommendations should be implemented in order to improve the investment climate in Madagascar:

·Conflicting and overlapping statutory requirements should be systematically identified and eliminated.

·A single text describing requirements for registration should be prepared and published.

·The same text should specify the steps in the review process and the criteria for approval. Screening should be abandoned except perhaps of those investors seeking government provided investment incentives. A negative investment list can be adopted that specifies a certain small number of sectors from which foreign investors are barred, but which otherwise provides foreigners the same access as natives in all other sectors. Restrictions on equity ownership should be removed so that all investors can freely transfer equity in their own companies. Investors should also be free to use expatriate employees.

·The remaining criteria for approval should preclude bureaucratic second-guessing of the investment decisions of entrepreneurs. Except for a very narrow list of investment areas (for example, in arms production), approval should be automatic. Information collected should not be of a nature to compromise competitive positions if released to competitors. The screening process now allows unscrupulous officials to "confiscate" the ideas of other entrepreneurs.

·The screening process must be reformed to prevent officials from confiscating new ideas and projects.

·Time frames for approval should be established with automatic approval at the expiration of that time. In addition, the texts of the *agrément*s should be published within a specified number of days after issuance.

· A request for an *agrément* should trigger immediate permission to acquire the foreign currency needed so as to permit banks and private companies to hedge or secure their foreign currency exchange needs.

·A process for review of adverse decisions against established criteria should be provided, and clear public criteria for such review should be announced.

2. The *Guichet Unique* as an Informational Structure

The proposal for a *guichet unique* should be modified such that its function is informational and promotional. Its establishment as a private sector entity should also be considered.

3. Uniformity of the Investment Regime

The flexibility given to operators under the Code d'Investment should ultimately be made available to all firms. Similarly, anyone who produces for export should have the same rights and privileges as persons currently operating in the Zone Franche.

4. Uniformity of tax codes

Once a single regime for investment is established, a single tax code for all operators should be adopted. The code of exemptions allows excessive leeway for bureaucrats to gain rents by interpreting the codes in divergent ways. Since the legal system provides little recourse, operators often find they are asked to pay bribes to limit the costs of these divergent interpretations. Because the risk is higher for the foreigner, the existence of widespread illegality makes a non-resident more reluctant to invest in the country than a resident.

III. Governance:

Based on the structural and procedural problems undermining the effectiveness of government in Madagascar, the following simple, straightforward recommendations should be implemented:

·Conflict of interest must be explicitly barred.

·Government officials must not be allowed to engage directly or indirectly in private business in the same industries in which they have jurisdiction.

·Arrangements must be made so that all rules, laws, judicial decisions and industrial licensing are made public.

IV. Options for Moving Forward.

There are many ways of approaching the needed institutional reforms. We recommend a course of action which adapts useful ideas to the Malagache situation and leads to an understanding by Malagaches leaders of the function of the various institutions to a market economy. Development of a constituency for reform requires that key elements of society be involved in the discussion and development of new policies.

A. Roundtable discussion of Institutional Reform

We recommend that this report be shared with officials in government, members of Parliament and leading political parties, representatives in the private sector, lawyers and academics. We then propose that a series of roundtables involving these people be conducted with experts from the U.S. and perhaps Europe. These sessions would have several functions:

- to develop more specific information on the implications of the issues for economic life in Madagascar.
- to expose key Malagaches leaders to the role that institutions play in a market economy.
- to identify individuals with expertise from various sectors of Malagaches society and begin a process of interchange with experts from outside Madagascar.
- to assess the feasibility of action and develop priorities.

The roundtables could be organized in the same fashion as the report, one on legal and regulatory issues and one on the investment approval process itself.

We also recommend that a team conduct further interviews with persons previously visited during the first IRIS trip, and with others to continue the collection of specific and updated information.

B. Working Groups for Specific Problems

A next step would be to establish working groups of foreign and Malagaches experts to undertake specific projects. The composition of the working groups would vary by topic but ought to include representatives of the government, other political parties, legal and economic experts and the business community. Outside experts should be included in each group. In some cases, Malagaches experts might need to visit other countries where a particular institution functions effectively in other circumstances, outside experts might visit Madagascar to work with local experts in documenting the current practice and rules.

C. Enhancement of economic and institutional analysis capability of legislators and key policy leaders.

1. Policy Seminars: The fundamental principles of markets are not widely understood by policymakers in many countries undergoing the transition to markets. Similarly the functions of legislatures in making economic policy decisions in a democracy are not well established.

Sessions targeted for Madagascar and conducted either in the U.S. or in Madagascar would have the benefit of providing a solid grounding in the underlying rationale for various reforms that are needed, and developing shared expertise among a cross-section of interests.

2. Study tours: A less structured alternative to the above model is a study tour by various experts who have responsibility or expertise that is relevant to the topic under discussion. To be effective, such tours will require briefing of the persons to be visited on the situation and issues in Madagascar, preparation of materials and a senior representative of the organizing entity to provide context and continuity. IRIS has found that the seminar model, above, mixed with trips to relevant organizations, effectively builds indigenous capability.

I. INTRODUCTION: THE ECONOMY AND RECENT HISTORY OF MADAGASCAR

Madagascar, the pearl of France's colonial holdings in Africa, is now one of the poorest countries in the world with a per capita income of \$220. By comparison with other sub-Saharan nations, Madagascar's physical resources are considerable. They include: exceptional ecological and climatic diversity which can support the cultivation of a wide variety of crops; extensive mineral deposits; and a well trained, disciplined, and competitively priced labor force. Mining, fishing, agriculture, and textile manufacturing all offer abundant and obvious venues for investment.¹ Yet Madagascar's investment rate lies below the average for sub-Saharan Africa. Even the minimum investment needed to replace depreciated capital has not been achieved². The absence of new construction in Antananarivo, Madagascar's capital, makes it unique among African capitals.

Two principal reasons are generally given to explain why abundant natural resources accompany the direst poverty. The first is the weakness of physical infrastructure. Roads connecting the major cities are inadequate and telephone service between the cities and regions is absent. Any nation lacking such facilities will score low on a list of foreign investment options. Political instability is the second reason. The instability of the last two years combined with future uncertainty discourages would-be investors.

The seven-month strike that brought the government to a standstill ended in November 1991 with President Didier Ratsiraka yielding to a transitional government. The transitional government established by the opposition party and the old-style bureaucrats has not been able to revive an inert economy. At the end of August 1992, a popular referendum adopted a new constitution establishing a parliamentary regime. By the spring of 1993 Madagascar should have a new president and Parliament. Many in Madagascar doubt that the sixty-odd parties competing for seats in the parliament will easily agree on a prime minister. Comparisons are often made with France's Fourth Republic, a weak parliamentary regime remembered for its stalemated legislature. Conspicuous among the doubters are those who grew rich under the Ratsiraka regime. The recent unrest and doubt about future stability have reduced Madagascar's economic performance far below its potential.

In Madagascar, stability and poor infrastructure are the chief factors inhibiting investment. Once, Madagascar's political stability is restored, the difficult job of overhauling the infrastructure and institutions that govern trade and industry will begin. At present, the regulatory environment is inadequate to sustain long-term trade among strangers. Increasing the size and complexity of the economy will require building new institutions to

¹Glass manufacturing, bottles etc., food processing, furniture are all areas in which Madagascar has natural advantages that are under-exploited.

²Gross domestic investment averaged 10.6% of GDP during 1985-89 against 14.6 % for Sub-Saharan Africa. The minimum investment needed to replace depreciated capital is estimated at 13 % of GDP. Madagascar: Financial Policies for Diversified Growth; Choices for A Market Economy World Bank Report 9817-Mag. March, 1992:11.

sustain commerce. This work can begin immediately, regardless of which party or regime should prevail.

Madagascar is not alone in its predicament. The World Bank has noted that an insufficient return on investment has been one of the reasons for the disappointing GDP growth of African economies during the last twenty years.

"Viewed over the long term, falling per capita incomes for Africa as a whole since the late 1980s are explained largely by the declining level and efficiency of investment. Many countries, especially the poorer ones, did suffer severe external shocks. But the low return on investment is the main reason for Africa's recent decline. Africa's investment and operating costs are typically 5 to 100 percent above those in South Asia -- the most comparable region."³

Madagascar falls into the typical African pattern characterized by low returns to investment. The limits of infrastructure without institutions is evident. Public investment is too high a percentage of total investment. This is particularly harmful given that many publicly financed projects have failed. Ineffective public sector management, symbolized by loss-making public enterprises, over-investment in inappropriate technologies, inadequate infrastructure, price distortions caused by an over-valued exchange rate, subsidized credit and politically determined prices have resulted in inefficient resource allocation in Madagascar. Coupled with a dysfunctional judicial system and arbitrary decision-making by a highly interventionist bureaucracy, Madagascar scores low among developing nations in having the institutions to attract both foreign and domestic investment.

The nation's ability to cope with the needs of its fast growing population depends on offering more attractive opportunities not only to foreign investors, but as importantly, to domestic investors. Mobilizing the resources of local economic operators will be critical. Unfortunately, present programs to augment investment focus on attracting foreign investment, while measures designed to protect existing but inefficient industries often hamper local investment in the domestic economy. Rules that restrict citizenship and complex procedures for licensing and investment further reduce both foreign and domestic investment in the economy.

A first round of market-oriented reforms designed to reverse more than a decade of state-centered economic dirigism was instituted in 1985. "Getting the prices right: has been the theme of macro-economic adjustments, which since 1985 have transformed the economy of Madagascar."⁴ The macro-economic adjustments include foreign financing and debt rescheduling. In addition, internal and external trade, the financial sector, social policy and

³Sub-Saharan Africa: from Crisis to Sustainable Growth, The International Bank for Reconstruction and Development (1989): 3, Washington DC.

⁴An analysis of these reforms can be found in "Madagascar: Adjustment in the Industrial Sector an Agenda for Further Reforms" The World Bank, June 1989 and "Whither Madagascar", Frank Martin, USAID, March 1992.

public expenditures were all restructured; the exchange rate was devalued; a liberalized import regime was introduced in 1987; licensing requirements for exports were reduced, government export monopolies were eliminated, and the public sector was rationalized. Measures were also implemented to liberalize agriculture, trade and industry. The government removed controls from agricultural producer and consumer prices as well as on profit margins.⁵ Financial and public enterprise sectors were reformed. In the hope of attracting investment, a new investment code and industrial free trade zones were created.

These reforms created incentives which transformed the industrial sector. Producers responded favorably by launching new export activities in labor intensive industries. Most notably, French investors are returning to Madagascar. They have taken advantage of bank privatization by opening one new bank and buying shares in another. Many of the recently installed free zone plants are French financed and managed. Air France now runs two flights a week to the capital. However, the level of investment has not been sufficient to offset unemployment, population growth and increasing indebtedness. Negative growth rates persist and the scope for further adjustment is considerable. Thus, the attraction of greater domestic and foreign private investment remains urgent.

Although the macro-structural adjustments have increased the rewards of investing in Madagascar, institutional uncertainties continue to pose substantial risks to entrepreneurs. While, the government no longer runs the major industries, monopolizes trade in farm produce or randomly limits exports, investment has not burgeoned. Structural adjustments, a realistic exchange rate and other market oriented-policies do not seem to be enough to accelerate growth. The risk of confiscation, inefficiency of contract enforcing institutions and limited means of dispute settlement continue to deter investment. Foreign exchange controls and credit restrictions continue to restrain imports. Most importantly, in Madagascar, government does not provide adequate institutions for law and order, infrastructure or education. Moreover, Madagascar's economic potential will not be achieved without major steps to overhaul the basic institutional infrastructure -- to improve the rules or arrangements which govern commerce. Investors will not choose a nation where these tasks are neglected.

This report will outline the institutional reforms needed to alter the course of economic development and increase the pace of growth. It will offer prescriptions for improving the performance of those institutions which govern exchange in Madagascar and propose ways

⁵Liberalization of agriculture decree n. 86.092 Of April 2 1986; *La soumission des marges beneficiaries sous le regime de la libre concurrence arrêté # 986-89 February 20, 1989, liberalization of imports SILI arrêté n. 189-88, January 14, 1988.* Quantitative restrictions imposed for protection were eliminated, tariffs were lowered, price controls were removed, and flexible management of the exchange rate was introduced to increase the competitiveness of exports and to compensate for the elimination of trade obstacles. A cumulative devaluation of 52 percent in 1987 in trade weighted foreign currency terms was implemented. An open general license system for allocating foreign currency was introduced. At present 99 percent of total imports require no licensing. The maximum import duty was reduced from more than 1,000 percent to 90 percent. Industrial profit margins were liberalized in 1989.

that the liberal constitutional order established by the recent referendum can improve trade. We will discuss both how institutions shape the pace and direction of investment generally and which specific changes can channel economic forces into efficient directions. Institutional bottlenecks will be identified which inhibit the response of the private sector to market signals. A number of solutions will be offered which can be implemented at low cost.

The report is divided into three main sections:

Section II: Legal and Regulatory Environment

Section III: The Investment Process

Section IV: Governance

Section V outlines the actions that could be taken to implement the reforms detailed in the report. The identification of specific recommendations in this report is but an early step in a process which involves sharing experience from other economies and building consensus, as well as capability among a cross-section of Malagasy leadership.

While financial sector reform is necessary to improve the climate for foreign and domestic entrepreneurs, this topic is not covered because it has already received attention from the World Bank⁶ and others.

⁶Madagascar: Financial Policies for Diversified Growth: Choices for a Market Economy, March 16, 1992, The World Bank, Report No. 9317-MAG.

II. Legal and Regulatory Environment

Investors in Madagascar face an environment in which the security of private property, the enforcement of contracts, and the assignment of liability for wrongful damage are insufficiently specified by the judicial system. Effective judicial mechanisms for settling commercial disputes and enforcing judgments are lacking. The ability of the judicial institutions to generate the confidence of investors are a key determinant of sustaining growth. Transparency is lacking in the administrative practices, rules and institutions governing business transactions. To promote investment, the private sector and the government must work together to provide dispute settlement mechanisms which can sustain the confidence of the private sector. A judicial apparatus that can enforce judgments, as well as mechanisms of political choice that allow economic agents to define and agree on the rules of the game, must be created. A system of trade works best when the relevant players agree upon the rules. To address these problems effectively, Madagascar's reformers should be encouraged to seek out judicial and administrative practices which have been successful in other countries.

A. Description of Problem

Madagascar's legal system was largely inherited from its colonial period. Many administrative and legislative practices developed in France are inappropriate for present day needs. It includes price restrictions, political control over marketing institutions, and foreign trade regulations that were designed to cope with France's war-torn economy. Rules governing investment and finance were similarly adopted by France for war-time emergencies. Most of these laws were subsequently repealed in France, but not in Madagascar. Their continued operation provides bureaucracies with the means to export profits while protecting monopoly inefficiency and corruption in a peacetime economy.

The decade of socialist control that began in 1972 expanded state control over the economy further increasing the gains to bureaucratic rent-seeking.⁷ The legal tradition inherited from the French is now superimposed on a legal and institutional system designed to facilitate state control under socialist management. Mechanisms to settle disputes among private sector operators were not developed. Rather, rules and mechanisms to restrain competition and efficiency were expanded and placed in the hands of an underpaid and under equipped bureaucracy. Corruption often resulted.

Imposing capitalist macro-structural reforms on a polity designed to facilitate central planning and socialist control resulted in incoherence. The socialist institutions give the bureaucracy the ability to override the decisions of economic agents. Appeals to the judicial system are not possible because it served a political system designed to facilitate socialist control. The result is that commercial relations lack the support of an independent system of law. One minister explained, "Many of the socialist enterprises escape the justice system,

⁷Rent-seeking refers to activities which consume resources to achieve a pure transfer of wealth from one sector, group or individual to another. These activities are wasteful because they use up resources without creating additional value for society at large. Lobbying for a monopoly is a good example.

however they are not above the law. They were created by a social rather than economic or judicial motive. When conflicts arise they are resolved by the technical ministry responsible and not by the justice system. A private sector interviewee stated that "anarchy in the application of laws occurred when a socialist system was added to the French system. This assured that the political would always take precedence over the commercial."

Judicial procedures were not developed to assure the accountability of government officials. One government ministry can annul the decisions of a rival ministry⁸. One cannot predict in advance which rules or fiscal procedures will be imposed *ex post* on potential investors. Because the judicial system has been put at the service of the political system, there is no countervailing power to prevent state officials from using state power to serve their own interests. When laws are not enforced, individual ministers respond by constructing personal networks of influence. Public administration becomes personalized and patronage essential to maintaining power. Once high officials lose respect for the law, those underneath take their lead and follow their example. Because people are influenced by the values of others, especially those placed above them, the behavior of leadership is critical. When a nation's president uses his authority to become the country's richest citizen, fails to report his earnings, exports his profits and neglects to pay local taxes, others holding public office will attempt to do likewise. An unaccountable leadership inevitably loses its legitimacy. The end result is a demoralized population and a general loss of respect for the law.

1. Judicial System

a. **Independence of the Judiciary.** Under the 1975 Constitution, the judicial authority was not considered as a power of equal ranking with the executive and legislative branches of government. The so-called High Constitutional Court was designed to review laws and oversee elections, but had no substantive judicial powers. Under the 1975 Constitution, the independence of the Judiciary was guaranteed by having a *Conseil Supérieur de la Magistrature*, headed by the President, whose function was to recommend

⁸Legal texts formally in effect in Madagascar reflect these different periods of Malagasy history. Liberalizing statutes often took no account of the existence of prior and incompatible texts, or (especially) executive branch institutions. It was remarkable to note on many occasions that apparently progressive legislation was diluted by subordinate legal materials (decrees, "*Circulaires d'application*" which are merely executive interpretations of legislation but which in Madagascar often actually contradict legislation, etc.). As an example (among many others) of such a practice, Malagasy rules permit provisional enforcement of court orders even pending appeal). Apparently, a *circulaire d'application* was issued to courthouses prohibiting the issuance of the official copy of judgment a 'title' without which provisional execution is of course impossible. Since the October 31, 1991 convention, decrees by the Prime Minister have replaced legislation. Before this transitional period, and (presumably) after enactment of a new constitution, in administrative law decrees represent delegated power and are thus subordinate to legislation. We heard of executive civil servants applying decrees and *circulaires* which had not been published. The laws are rarely contested because the judicial system is inaccessible and because it is difficult to verify the publication of a given decree or *circulaire*.

promotion of judges. Despite this design, the *Conseil* was widely viewed as politicizing the judiciary.

The Project of the Constitution, the subject of the August 1992 referendum, may alter this situation if implemented. Articles 98 and 99 intend to establish two principles: judicial independence from the legislative and executive branches and the primacy of the Constitution and positive law in the actions of the judiciary. Three institutional devices are meant to guarantee the independence of judges:

1. Life appointment of "sitting" judges. However, this appointment is affected by the power of the executive to transfer judges without their consent.
2. "Standing" judges are free to express their opinions in court as to their understanding of the law. However, these judges are members of the Public Prosecutor's office and work under the supervision of the Minister of Justice.
3. A watchdog "General Inspection of Justice" has been established to enforce ethics among judges. The members are drawn from all three branches of government.

Despite their intended purpose, none of these measures will fully secure an independent judiciary. The extent to which the General Inspection helps insulate the judiciary will depend on whether legislation is passed to establish the General Inspection, whether resources are made available to it and who is appointed to serve on the panel. Steps to implement the Constitution had not been taken at the conclusion of the trip upon which this report is based.

b. Slow Processes. Discrepancies between Madagascar's written rules of procedure and practical litigation are common. Written procedure specifies quick and efficient justice in Madagascar. Work-place conflicts adjudged before the *Tribunal du Travail*, a subset of the *Cour d'appel* (the workhorse of the Malagasy judicial system) are supposed to be decided within three months. Commercial litigation is supposed to be resolved by the *Cour d'appel* within ten months of the suit's commencement before the *Tribunal de Commerce*. Bankruptcy proceedings must be closed within three months of a declaration of bankruptcy by this tribunal.⁹ However, attorneys interviewed confirmed that these deadlines are not respected. One attorney interviewee reported not having ever seen a case where a bankruptcy trustee finished liquidating the debtor company. Registration of property is time-consuming, taking as long as 10 years (during which credit for improvements is difficult to obtain).¹⁰

c. Conflicting Rules. Judges, lawyers and litigants must contend with different and frequently conflicting policy goals. Many pieces of legislation are motivated by conflicting

⁹Art. 511, Code du Commerce

¹⁰ Source: Banque Malagasy de l'Océan Indien, July 1, 1992.

policies. As administrative agencies expanded their domain, the legal system often became subordinated to bureaucratic discretion. Officials may resort to discretionary executive "authorizations" to override the legal codes.

d. **Training of Judges and Lawyers.** Under the socialist regime, members of the judiciary have not handled any commercial or economic issues of importance. Once, enterprises became public enterprises, they were outside the jurisdiction of the courts. Because the problems of these enterprises affect social and regional interests, their "legal" problems were decided by relevant ministries. As a result few judges have experience or training in commercial law. There is no "continuing legal education" for judges to help them adapt to the evolution of business law and practice. Their inability to consult legal expertise often exposes businesses to inadvertent infractions. Private sector actors operate under the constant threat of censure and ultimately confiscation if a ministry has the ability to arbitrarily decide they have broken some rule or law.

2. Property Rights

a. **Title of Ownership.** Ordinarily, a title of ownership should be based on registration or recordation of a title. In practice the title holders must take into account customary rules governing local collectivities. No mechanism for establishing individual ownership against a collective claim exists. Waves of confiscation and of poorly recorded land sales further complicate the picture. Independence brought one major wave of transferred titles. Confiscation by the socialist regime of 1972 brought another. We heard stories of investors who built on land they had leased only to learn later they had leased from the wrong owner. Naturally when the holder of the superior claim appeared a higher rent was requested. A method to establish the superiority of claims by conflicting owners needs to be established. Past confiscations should be redressed. This is a serious problem that has slowed economic progress from Nicaragua to the former GDR.

b. **Establishment of Clear Private Property Rights.** Almost all the private sector operators recommended that the government go further to establish private rights in property than it has gone. There may be good reason to believe that protecting small holders in agriculture is valuable, but the prohibition against foreigners owning land in Madagascar goes beyond such efficiency considerations.¹¹ At a meeting of *Chambre Economique Fianarantsoa* on the topic of acquisition of land by foreigners, the Prime Minister said "It is the investors that interest me, however there will be no speculation. The Malagasy will hold on to their land."¹² Curiously a law of Dec. 16, 1968 offered similar criteria, "good morals, economic but not speculative interest in the purchase, personal and direct utilization. The

¹¹The experience of Japan, Korea, and Taiwan suggests that state imposed land redistribution schemes may increase efficiency.

"Ce sont les investisseurs qui m'intéressent... Cependant, qu'il n'y ait surtout pas de spéculations: Les Malgaches tiennent à leur terre". Madagascar Tribune, Friday August 14, 1992 #1104, p. 7.

offer must not be made under a false name".¹³ A law of 1978 later prohibited foreigners from owning land.

The Prime Minister's phrase would be less troubling if the meaning of speculation was clear. How will government officials distinguish speculation from productive investment? It is a phrase charged with political passion and can easily be turned against private sector operators whose work is often little understood by the public, and hence, easily vilified by politicians. The laws that followed colonization were a response to the widespread ownership of land by the French. Considering the weakness of foreign investment in Madagascar, the persistence of those laws is much more difficult to understand.

Foreigners are allowed to lease property under three *ordonnances* relating to commercial property¹⁴, residences¹⁵, and emphyteutic leases.¹⁶ These rules permit foreigners to lease property for a maximum of 50 years, but they require authorization from the Minister of the Interior. Although a fifty year emphyteutic lease does confer much of the present value of the property to the lessee, the refusal to grant full property rights signals distrust to foreigners. Frequent tricks or legal fictions are used to circumvent the prohibition of land ownership, including the use of a Malagasy "partner" as formal owner with a concomitant *contre-lettre* establishing true ownership in the foreign entity. These tactics are costly to negotiate and risk being invalidated before domestic courts.

One potential foreign investor, after obtaining authorization to do business in Madagascar, chose not to do so because of the prohibition against owning its own buildings. Owners of buildings sometimes request payment in foreign currency outside the country, in violation of Madagascar law. External payments permit evasion of the surtax on rental income but can expose an enterprise to charges of malfeasance and compromise its integrity. While the Malagasy debate whether to allow foreigners to buy property, many potential investors place their capital elsewhere.

Economic operators made an additional observation concerning the inconvenience of not owning property. Those who build factories want to amortize their investments in four or

¹³The curculaire #3.202 of December 16, 1968 "bonne moralité, intérêt économique de l'acquisition, demande non faite sous le couvert d'un prêt-nom et non basée sur l'accaparement des biens ou la spéculation pure et simple." The article 11 de la loi 62.006 of forbids foreigners from owning land.

¹⁴Ordonnance 60-150

¹⁵Ordonnance 60-100

¹⁶Ordonnance 60-064

five years. Exorbitant rents then make products uncompetitive. For example rents in the free zone of Madagascar are the same as those of Auvergne in France.¹⁷

Property rights in mining deserve special attention because the development of Madagascar's mineral reserves requires significant foreign capital. Because that capital is asset-specific and cannot easily be moved once invested, it can easily be held hostage by an opportunistic government.

The mining code (law 90.017 of July 1990) allows mining authorities to classify mineral reserves according to their priority for national defense. Article 3 of the mining code gives vast powers to the Minister of Industry, Energy and Mines to classify minerals. A single command "arret" of a mining official can change the classification of a mineral if the mineral is defined to be of the general interest. A mineral that is not considered strategic

¹⁷Rental prices have skyrocketed in recent years, which detracts from the low cost of manpower. This escalation of rental prices is due both to the legal prohibition against vertical integration and to banking restrictions which make construction financing very difficult, thus increasing economic rents on existing lodgings. Unknown to most investors is that rentals are regulated by Ordonnance #60.060 and 62.112 (of 1960 and 1962, respectively...) establish the legal contours of the landlord-tenant relationship. According to these ordinances, the rent must be an "equitable rental value" (...), and once established can only be varied as a function of an economic index which incorporates variations in the cost of the labor and of the materials used in the construction of the building. The ordinances establish coefficients for location (corner locations have higher coefficients, basements much lower ones), etc. According to the law, for example, if a merchant wished to rent a space containing a shop, a store-room, accessory buildings in the rear and an unfinished basement space, the rent would be established as follows:

·Shop in Zone 1: 25 Sp. m. *1.2 ponderation for zone,	=	36.0
·Backroom: 35 sq. m. * .33 ponderation	=	11.55
·Accessory Bldg in courtyard: 75 sq. m. * .33	=	24.75
·Basement space: 20 sq. m. * .1 ponderation	=	2.0
TOTAL	=	74.3

If the "base price" (comparable worth of similar buildings, indexed as stated above) is now 120FMG per square meter, the new rent will be 74.3 (the adjusted area) * 120, or 8,916FMG. This law should be abolished.

Michael Krauss reported that attorney interviewees doubted whether anyone in the relevant ministry (and they weren't sure which ministry was relevant) was entrusted with or capable of making these calculations. Second, they noted that the ordinances created the "*délit de majoration illicite*" in case of violation, and that the judicial system was such that no prosecution was possible. [As far as rental rates are concerned, they would be better addressed by first-best solutions such as legal authorization of vertical integration, and speeding up of property dispute resolution so as to facilitate financing of the construction of immovable property.] This example illustrates the dilemma involved for the investor who attempts to determine his legal rights and obligations in Madagascar. Another example of fictitious regulation concerns Tana's taxis. In law, taxi fares were strictly regulated, Cabs do not have meters and odometers (necessary to calculate the distance travelled, and thus the 'legal' fare) are rare.

one day can be declared so the next by a simple administrative ruling. As with much Malagasy legislation, the criteria determining ministerial classification is not specified.

The basic mining law¹⁸ attributes ownership of all minerals to the State (which then grants concessions to certain minerals), regardless of the identity of the owner of the surface land. Hence, landowners can suddenly lose rights over land if the minister decides that the minerals which lie under it should be excavated. This basic rule was not modified by the new Constitution. One interviewee affirmed: "Mining resources are part of the collective national patrimony, and have cultural and religious (not just economic) value."¹⁹ He did mention that granting ownership of minerals to the state often means granting those rights to a select group of families or parties.

3. Business Law

The basic text regulating corporate and individual commercial, industrial and agricultural activity is the Malagasy *Code Du Commerce*. This Code consists of the four books of the 1960 French *Code Du Commerce*, and applies to everyone who exercises "acts of commerce and who makes a profession doing so." The Code has been amended on many occasions.

The main problems with the *Code Du Commerce* have to do less with official abrogation than with incompatible practices by the government over the last fifteen years. As one lawyer complained, "we have no business law here in Madagascar".²⁰ Decrees and "arrêtés" supplement and often contradict the *Code Du Commerce*. One example (among hundreds) is the 1987 *plan comptable*, which was designed to restructure the issuance of economic information in the country. This complex plan required a new accounting method, which in turn required recourse to an expert. The 1987 plan, enacted by a mere decree²¹, modifies an earlier article of the Code; this kind of irregularity occurs often in Madagascar business law.

Until the socialist innovations of the 1970's, Madagascar corporate law was identical to pre-1966 French corporate law. Thus, as long as they are registered with the *Tribunal de Commerce*, individuals or groups can do business. Partnerships could take the form of: *sociétés en nom collectif* (partners are jointly and severally liable for all debts of the partnership); *société en commandite simple ou par actions* (*commandités* are fully liable and manage the company; *commanditaires* have limited liability); and of course corporations. Presently, the following corporate forms exist in the country²²:

¹⁸ Loi #90-017, 20 juillet 1990

¹⁹See also "La loi minière à Madagascar", *Juréco Magazine*, April 1991, p. 8.

²⁰Interview with government official, Antananarivo.

²¹*Décret* #87-332, 17 sept. 1987.

²²Partnership forms are rare; most investment will take capitalized, corporate form.

a) *Société à responsabilité limitée*²³ [SARL]: simple-to-create, simple-to-run; permits limited partnership on the French model for firms with a minimum of FMG 500,000 in constituted capital. Management is centralized and non-managing partners have very little say. Also, credit is limited and lenders generally require personal guarantees from managing partners;

b) *Société anonyme*²⁴ [SA]: a more elaborate corporate form for firms with a minimum of 7 shareholders. It is modeled after the French, but in reality is more similar to the American corporation. The requirement of 7 shareholders poses a major problem, however, given other structural provisions of Malagasy investment law to be discussed below. The SA could be modified to allow for a sole proprietorship;

c) *Entreprise socialiste*²⁵ [ES]: these are essentially former private firms, of which the State has acquired (through purchase or nationalization) over 50% of the shares. Created by a decree, this sort of enterprise is officially favored by the legislation presently in force in Madagascar. The *Directeur-général* of this corporation is named by the Prime Minister and its management orientation council must follow State policies and priorities, thus politicizing the enterprise. Annual profits (which are rare...) are divided into the "entrepreneur's share, the workers' share, the State's share and the Nation's share...". Unfortunately, the shares of the last two partners often benefit the supporters and families of state officials;

d) *Société d'économie mixte*: a corporate form in cases where the State controls less than 50% of the capital of a corporation. Its management is similar to that of the SA. This type of corporation evolves into an ES if and when the State acquires the majority of shares;

e) *Entreprise publique à caractère industriel et commercial* [EPIC]: established by decree, an EPIC is a State monopoly in a certain area. Control is politicized;

f) *Société d'État*: an SA where the State is the sole shareholder. Control is politicized.

Referring to the overlapping of functions between these various corporate types, one attorney claimed that "there is no corporate legal system in Madagascar, only different perspectives".²⁶ Applicability of bankruptcy rules, of tax rules and of shareholder rights to the various forms of socialist enterprise is similarly inconsistent. The elimination of c, d, e, and f should be considered. Public offerings can substitute for state control.

²³Loi du 7 mars 1925.

²⁴Loi du 24 juillet 1867.

²⁵Ordonnance #78.006, 1 mai 1978.

²⁶Interview with government official, Aug. 3 1992.

4. Tort Law

There was a consensus among those economic operators to whom we spoke that the legal system did not provide adequate rules for assessing or remedying non-contractual damages caused by third parties fairly or objectively. The absence of protection from torts imposes unpredictable costs to those who want to set up businesses in Madagascar. It also means insurance for many types of contingencies is not available. The domestic insurance industry is weak. One operator explained, "what good is insurance if we don't know what we are being insured for or from". The largest private insurance company has assets that are valued at less than three million dollars. Foreign insurers are incapable of evaluating the risks of doing business in Madagascar and therefore do not enter the market to offer an alternative to domestic insurers.

5. Bankruptcy

The government relied heavily on parastatals to achieve full employment. Labor laws restrict the dismissal of employees without the approval of the Ministry of Labor. In a further attempt to protect the rights of workers and prevent the waste of capital, laws have been created that make terminating an enterprise difficult. These laws have had the opposite effect, however, as rules which protect the inefficient create unfair competition for efficient operations. The owner of a private business cannot just wipe the slate clean and start afresh. Scarce resources are drained into inefficient enterprises making it more difficult to create new ones.

Once an enterprise fails, its creditors have inadequate legal provisions to terminate operations in an orderly fashion. Hence, liquidation often leads to fraud. The slow treatment of dossiers by the courts further reduces the option of bankruptcy. The effects of keeping insolvent firms in operation are higher interest rates and unfair competition. The creditworthiness of new borrowers is diminished because the costs to lenders of sustaining bankrupt operations are passed along to borrowers in the form of higher interest rates. Investors are deterred by an environment in which capping their losses is made particularly difficult.²⁷

In addition, creditors are not assured of realizing their collateral when a borrower defaults nor is there any efficient way to pursue the author of a bad check. The inadequacy of the rules governing default of payment results in the necessity of having cash on hand for all transactions.

6. Legal Information

a. **The Lack of Legal Information.** The lack of information on laws and judicial decisions is another impediment to the rule of law in Madagascar. The judicial system languished during the period of socialist domination. Today the texts, statutes and codes that

²⁷Curiously, economic operators generally called for a bankruptcy code, which according to a representative of the Justice Ministry already exists, albeit written in a very confusing manner.

the courts should follow are either unavailable or contradictory. One magistrate told us that keeping a record of the legislation in force was impossible. Many old statutes, apparently still valid, are either unknown or unavailable. Even judges did not have copies of the code of commerce and bankruptcy. There were few materials available to courts of first instance since 1971. Because the systematic documentation of cases by the law school library stopped in 1975, judges find they are unable to contribute to the growth of a reliable, uniform and accessible body of judicial decisions. Judges can not rely on each other's research and opinions or weigh the merits of each other's reasoning because they do not have the basic tools to conduct even the most rudimentary network of communications among themselves. Because judges are poorly paid, they are tempted to take bribes, serve as consultants to public or private enterprises or do research for private law firms. As a result the magistrates and the laws they defend inspire little confidence. Even a director within the Justice Ministry reported an unwillingness to go before a judge, "because one can end up with a surprising judgment".

b. Ignorance of the Law. Lawyers confirmed that ignorance of the law is a serious handicap to law enforcement. Legislative and regulatory acts are often unrecorded. Orders issued by one ministry may not be known to another. Often only one copy of the law exists. The most striking example is the commercial code which has been out of print for more than twenty years. Judges, as a result, may not know the laws. This lack of access to and knowledge of the fundamental texts of law explain why it is not unusual for civil servants to disagree over which decree or, circulaire, is the law to be applied. A centralized system for the recording or collection of laws is needed to ensure widespread distribution and knowledge of the laws in force.

B. Options for Reform

1. Judicial System

Judges in Madagascar lack training in contemporary economic management and are untutored in contemporary international business practice as the country was cut off from the world economy almost twenty years ago. At that time, most decision-making in Madagascar was transferred to the bureaucracy. During that same period resources were allocated according to technical criteria established by bureaucratic initiative rather than by private economic agents freely contracting in a market. So long as economic decision making was technical and bureaucratic, the services of judicial authorities trained in commercial matters were not needed. An official in the Justice Ministry explained "There has been a gap of sixteen years in the development of the magistrature. Issues concerning commerce have been decided by the ministries, not the courts. The law has simply not played a role in the resolution of commercial conflicts". Hence the expertise of the judiciary did not evolve. Introducing a market economy creates a need for a commercially trained legal cadre.

a. Rules and Practices. The creation of an independent judiciary and the rule of law requires both rules and practices of the following sort:

- The judicial appointment process needs to be made open to public view and criteria for selection explained.

·The status of currently sitting judges must be reevaluated. If their terms are to be converted into lifetime appointments, a choice must be made whether their appointments should be reconsidered under new appointment procedures, or whether the simple act of extending their tenure will provide adequate independence and address questions of corruption.

·The statute establishing the General Inspection of Justice should specify minimum levels of staff and resources in order to free this body from dependence on the executive.

While contract cases may be amendable to private sector solutions (see below) the capability and independence of the judiciary are especially important for criminal and tort cases where there is no pre-existing contractual relationship between the parties. While parties to a contract may agree to a *clause compromissoire*, victims of crimes or torts obviously have no such advance option. Thus improvement in the environment for investment will be directly affected by progress in this area. Developing detailed recommendations for reform of the Malagasy legal system will necessarily require direct and regular consultation with Malagasy authorities over an extended period. Such a task would likely take several years so that interim measures are needed.

b. **Training.** Steps to train judges, as well as lawyers, in the fields of economics, business, trade and taxation, among others should be undertaken. This can be accomplished in at least two ways, including creation of a series of short (for example, two week) seminars for sitting judges and additions to the curriculum at the *Institut d'Etudes Judiciaires*.

2. Improvements in the Adjudication of Commercial Disputes.

Until an adequate judiciary can be established, institutions should be developed to encourage the private arbitration of commercial disputes. Nothing can substitute for a judiciary when parties fail to accept the judgment of private arbitrators, but the economy needs a strengthened dispute solving mechanism now. Steps to establish private arbitration of commercial disputes should be undertaken immediately and parliament should modify appropriate legislation to provide for the effective implementation of such mechanisms.

The private resolution of commercial disputes will allow for the quickest and most effective introduction of necessary legal recourse. For such a system to work awards made under arbitration must be binding. Corrupt behavior by arbitrators must be punishable. Judicial review of judgments reached by arbitration must concern themselves primarily with questions of law and procedure rather than those of fact.

Several of our interviewees expressed the concern that private arbitration impinges upon the prerogatives of the state and will produce a body of pseudo-judges who are better remunerated than their public counterparts, further demoralizing the public system. Competition among private arbitrators will help to resolve this issue. Arbitrators will gain business by earning a reputation for efficient judgments. An efficient judgement in contract

law is the issuance of awards that the parties would have themselves agreed to in the contract had the contingency been foreseen. Competition among arbitrators will reward the effort of those arbitrators who strive for efficient decision making. Private adjudication might not be an ideal form of conflict resolution, but it represents a badly needed, cost-effective alternative to the present system.

A court system based on private adjudication can serve an important function as a source of information needed to monitor the reputations of economic agents. It is difficult in an open economy for individuals to keep records of those merchants who cheated in the past. If parties to an exchange are matched only once, they know only their own experience. Therefore bilateral relations between strangers are rarely enough to prevent opportunism and sustain trade over time. An alternative court system can be a source of information about the reliability of potential trading partners. A private court system can serve as a multilateral reputation mechanism by controlling and disbursing information. The court's authority comes from its role as guardian of reputations, even if it does not possess coercive powers against those who commit infractions. A mechanism by which reputations can be established would increase confidence and reduce some of the contractual problems that arise during economic expansion.

The alienation of justice to the private sector need not be permanent. Once the public sector can offer more efficient judgments than can the private sector, cases could return to the public law courts for settlement. In English history the common law courts offering the king's justice, eventually superseded private or local jurisdictions by offering a more efficient alternative. The system is not optimal since it lacks real coercive authority, but as a transitional method it may help to sustain economic growth.

Lack of access to effective conflict resolution is a major obstacle to the promotion of interdependence in an open economy. Economic operators universally acknowledged that the sluggishness of the present system requires radical measures. The Parliament must be called upon to make the creation of private arbitration a priority. The judicial capacity to enforce and arbitrators findings should also be enhanced.²⁸

A second best option to a private system for commercial disputes would entail assignment of commercial disputes to a special commission or to the executive branch as an interim measure until the courts are established to handle such disputes more effectively. Alternatively, the French system of special jurisdiction commercial courts might be a target.

These solutions are risky. Most notably, reforms to separate the political and judicial spheres will be further retarded. Since members of the executive branch may have significant economic interests to defend, the selection and liberty of the judges could be compromised by their close association with executive power.

A third option is to establish quasi-judicial tribunals to settle disputes independently of the executive and judicial branches of government. The goal is to create recourse to a

²⁸A representative of the justice ministry told us that "If a private agreement is reached it will not have any judicial weight."

transparent impartial institution rather than a politically dependent judiciary or an anonymous civil servant, who avoids taking responsibility for his decisions. Instances of tribunals judging labor disputes and financial markets abound in several countries. Membership is usually drawn from a variety of professions, including the magistrature. Such tribunals work best when members serve lengthy fixed terms that allow them independence from the executive.

These latter three options are only half-way measures because their start-up costs are nearly as high as reform of the underlying judicial system and they would not produce the same beneficial incentives as a system of private justice.

It may be difficult to convince the Malagaches of the vital importance of these reforms. Therefore, first steps in the reform of the judiciary might beneficially include a trip by key Malagasy legal policy leaders, legislators and business leaders to learn about the workings of the independence-creating institutions in other countries and to observe the operation of non-government dispute settlement mechanisms.

3. Property Rights

The establishment of clear property rights is a prerequisite for promoting the development of an efficiently functioning market economy. Currently, in Madagascar property rights are unclear and many conflicting claims exist. As many other countries are discovering, this severely retards growth. In order to clear the confusion surrounding property rights in Madagascar, we suggest the following initial steps:

- Experts in land tenure and registration systems should research the current hodge-podge of customary, socialist and civil property regimes. Procedures for settling ownership among these competing regimes needs to be established and an administrative structure for taking on this formidable task created.
- While private ownership is expanded alternatives to state "ownership" might be considered. In certain areas, such as mining, specific attention to land use and environmental regulation might be tried.
- Laws forbidding "speculation" in land need modification. There is considerable difficulty distinguishing "*spéculation*" from productive investment.
- The ban on foreign ownership of land discourages long term investment and encourages the use of Malagasy "front" organizations. Such transactions are expensive to negotiate and are of questionable enforceability.
- The system of rent value regulation, especially for commercial property, is ineffective. A wide variety of mechanisms are probably used to avoid application of various rates ("*pondérations*") each of which carry their own risk of detection and enforcement. Such a system further undermines respect for the law and it would be better to eliminate it altogether.

·The property interests of landowners in minerals and their ability exploit these resources for profit need strengthening. Even in countries with limitations on the absolute freedom to extract minerals from land, a system of leases, property rights and administrative procedures insure that investors have greater confidence that their investments will not be confiscated.

4. Business Law

The problem of codification of Malagasy business law is formidable. A review of civil and commercial codes by a team of Malagasy, US and perhaps European experts is necessarily a first step. The team should contain at least one expert in comparative law. The reform should consider Malagasy customary law, all useful portions of modern French codes and relevant areas of law codes from different legal systems that are applicable to Madagascar. The legal academy of Madagascar has already begun work on such a project. Sweeping reforms will be needed to correct the problems relating to the confusion and multiplicity of the sources of legal authority. Customary law must be studied to determine its applicability.

The Malagache team should work in close collaboration with an outside team of experts so that they will be able to call upon lawyers specialized in the various sections of commercial law under revision. These experts can introduce concepts which give the Malagasy a broader perspective on possible approaches. It should be emphasized, however, that the fact that a group of Malagaches has decided to work on these issues is of enormous significance. Efforts such as these should receive support to establish a pattern of reform from within, rather than of reform imposed from the outside.

In the course of this *refonte* there are some items which came to the attention of the IRIS team that deserve more careful consideration. Their mention here does not necessarily suggest that they are the most important changes. Specific items to review include:

·Reduction to the absolute minimum of legal standards which establish minimum terms for contracts. Currently, *dispositions d'ordre public* often so reduce the capability of private parties to agree on terms of their bargain that there is very little freedom of contract at all.

·Reduction of the ability of administrators or courts to alter clear terms of contracts is a necessary part of this reform.

·The rate of interest applicable to legal judgements should be both positive and at a level such that it encourages enforcement of court decisions. With annual inflation running at about 17%, the current legal rate, apparently at 6%, encourages debtors to delay.

·Explicit recognition of the role of passive investment and elimination of provisions of the law which purport to wipe away "speculation."

·One interim measure might be to simply adopt in its entirety the 1960 *Code de Commerce* of the *Troisième République*. Stripped of conflicting interpretations, decrees and other modifications from the last fifteen years, the Code is clearer than the current confusion.

·In order to identify restraints on industrial opportunities in key investment sectors, a team of local and outside experts should conduct studies of the administrative rules, laws and decrees affecting these important industries. This should be accompanied by an economic analysis of industry structure and operation. Such a coordinated study will suggest reforms of both specific industrial policies as well as broader efforts.

5. Tort Law

The lack of effective mechanisms for compensating non-contractual damages requires increased understanding in Madagascar of the importance of liability-assigning institutions to a market economy. The investor's need for information and rules permitting risk assessment must be emphasized and understood. Exposure to systems used in other common and civil law countries will be useful. Tort law must be coordinated with customary rules regarding trespass and other harms to persons or property. A team of Malagaches and outsiders can begin to apply local concepts of torts while simultaneously addressing the needs of foreign investors. Ultimately, many forms of insurance will not be available until the risks of doing business in Madagascar can be adequately assessed.

6. Bankruptcy Process.

Bankruptcy procedures should be liberalized and made less costly for all parties. Procedures for liquidating an enterprise are a necessary component of business law. Keeping unhealthy enterprises afloat increases risks faced by financial institutions, which in turn increases the cost of credit. The absence of policies to protect creditors stifles credit and hence, the ability of Malagasy merchants to take risks. This results in an under-capitalized economy. Frugal merchants can not distinguish themselves from their spendthrift colleagues and the resulting lack of capital resources will produce a shortage of merchants.

In order to liberalize the bankruptcy law, a working group of outside and Malagasy experts should be established. The objective of this group would be to provide a basis for reform and to create an understanding of reform issues among a group of opinion leaders. Specifically, the tasks of the groups would include the following:

- Catalogue the specific laws, decrees and *arrêts* which affect the ability of firms to close operations and the rights of creditors in that eventuality.
- Document the economic and operational impact of the current system on firms.
- Introduce the working group to other approaches to bankruptcy emphasizing the principles and incentives inherent in various economic systems. The interaction of bankruptcy with contract enforcement, property rights, banking, credit and labor law should also be studied.

·Conduct a seminar for a wide spectrum of Malagasy society on the issues at stake and the implications of improvement for firms in Madagascar. A similar but separate session for legislators and ministry officials should be held.

·Draft reform proposals by the working group or a subcommittee.

·Support for Malagasy groups working to advocate adoption of such a reform.

7. Improved Information on Legal Rules.

a. **Collection of Information.** All existing sources of law, including statutory, regulatory or customary rules must be compiled, sorted and integrated. This fundamental exercise will support all the other legal reform efforts described above relating to torts, commercial law, property and bankruptcy.

b. **Dissemination of Information.** A group (possibly the same as in point a) is also necessary to systematically publish and circulate basic legal texts which are still unavailable, including statutes, codes, textbooks, decisions of key tribunals, etc.

c. **Legal Center.** The group or groups performing the above mentioned function could be located in a center for the administration of justice, which would perform information collection, creation and dissemination functions. Training could be centered here as well.

III. The Investment Process

A. Description of Problem

Foreign investors searching for a permit to start a business face many obstacles. They must first decide whether to channel their investment to the *Droit Commun*, *Code des Investissements*, or *Zone Franche*. In order to invest in the free zone or to take advantage of the investment code an *agrément* is necessary. Investing in the common law²⁹ sector also requires an *agrément* when more than twenty percent of the capital is foreign.

1. Ministerial Overlap

Obtaining permits for an enterprise can be difficult, costly and time consuming in Madagascar. Investors need the authorization of those government ministries claiming technical competence in the industry in which the investment is targeted. Rarely is only one ministry involved in the licensing procedure, but it is often difficult for the investor to know which ministry's approval is needed or where to begin the process. Government agencies were created without much attention to their inter-relationships so investors must navigate through a number of overlapping bureaus. This is a real challenge because the authority of one ministry is often unknown by the adjacent ministry. As one official put it, "the information available is always too vague, you have to pass through five or six doors before you find the good one". For example, benefits under the *Code des investissements* require submission of a detailed plan to the Ministry of Finance and to the sectoral Ministry or Ministries.³⁰ The sectorial Ministries may be one or more of:

- Industry, Energy and Mining (for manufacturing and energy distribution, including transformation and distribution of hydrocarbons)³¹;
- Agriculture (for food processing and handicrafts)³²;
- Transport, Meteorology and Tourism (for land, water, and port industries)³³;

²⁹Common law does not refer to the distinction between judge made and legislative or statutory law in the English tradition. The French term common law refers to normal practice established by the standard codes which apply to all parties.

³⁰Art. 15, Code des Investissements

³¹Arrêté # 4115/87, 10 sept. 1987, and 2160/90, 12 avril 1990. This section presents another example of the Malagasy legal swamp. Art. 2 of the loi 80-001 (6 juin 1980) gives the state a monopoly on the exploitation, transport, transformation and distribution of hydrocarbons. No text has abrogated this law, and SOLIMA is not due for privatization.

³²Arrêté # 2162/90, 12 avril 1990

³³Arrêté #2173/90, 12 avril 1990

·Livestock, Fisheries and Forestry (for large and small-scale ranching, slaughterhouses, forestry and fish farms)³⁴;

·Public Works; (for road improvements, buildings, real estate development, general construction).³⁵

·Health (for medical and dental care, laboratories)³⁶;

·Post and Telecommunications (for telecommunications and electronics)³⁷;

·Commerce (for refrigerated warehouses, and transport of agricultural products)³⁸

For example, if the project calls for raising chickens, the Ministry of Agriculture may get involved. If feed must be transported, Commerce and Transportation may get involved. If workers must be hired, four different bureaus of work may have to review the process. If foreign supervisors are needed, Interior's approval is required. If borrowing is required the approval of finance and the treasury may be necessary. Budget and Plan may have to be consulted to determine if the project fits long-term national economic objectives. Finally, tax and fiscal authorities wait at the end of every project.

There are thirty-six ministries in the present government. Four ministers have jurisdiction over labor. Most have no idea what their cohorts do or to which ministry a dossier is likely to pass before the process is complete. For example, one official in an economic ministry did not know what the Ministry of the Economy did. When we asked him his functions, he indicated that there were books of rules but we were not allowed to see them. He mentioned a brochure on investing put out by the Ministry of Industry but he had no such brochure for his own ministry. We asked for measurements of the impact of fiscal policies on the economy but he did not know how the existing fiscal code influenced the decisions of investors. When we asked how the various ministries that have jurisdiction over the economy relate to each other, he lamented that his colleagues did have "*attributions croisées*" (overlapping jurisdictions).

2. Unclear Standards for License Approval

We asked one government official, whose approval was often necessary in the *agrément* process, to provide a text explaining the rules governing the exchange of currency. He held up his hands to indicate that two feet of documents had to be consulted and no

³⁴Arrêté # 2163/90

³⁵Arrêté 2164/90

³⁶Arrêté 2165/90

³⁷Arrêté 2174/90

³⁸Arrêté 3238/90, 7 juin 1990

simple accessible summary of the rules concerning foreign currency transactions was available. He suggested that Tax (*Impôts*) and Customs (*Douanes*) might have a document that explains the tax codes. Yet, no such document could be provided by either agency. With the exception of Industry none of the ministries have produced a formula "plan type" indicating the kind of information they require. Several key ministries were unable or unwilling to give us a summary of their requirements. Industry assumed that the other ministries had a 'plan type' to offer investors but none did. One government interviewee was direct - "creating a dossier is an art".

Only one Ministry was willing to provide figures about the relationship of approvals to non-approvals. Nevertheless, we were told such figures would not be very helpful, because the government "never says no but does not always say yes." Commerce reported an approval process depending on a "point system".³⁹ If more than one Ministry is involved (which is usually the case), "*agrément*" is given "by consensus"⁴⁰. The risk that the process will be held up increases the probability that extra legal intervention will be necessary. One investor attributed delays in accepting his request for an *agrément* to his refusal to offer government officials shares in the company he wanted to create.

Getting reasons for refusals is difficult. One minister told us he refused a request for permission to purchase a luxury car which he determined was for the investor's private use. Operators have learned to ask for a jeep, as it seems easier to justify, although most never leave the capital city. Another rejection involved an exporter of sour pickles who requested a tractor. We later learned the tractor was needed to build a road so the merchant could get to his producers more easily. One General Secretary remarked, "Rejections occur when you are in textiles and you ask for a refrigerator or if you want to bake croissants and you ask for five ovens when only three are needed." One minister thought that the elimination of excessive competition caused by free markets should be one of the concerns of those reviewing dossiers. "*Libéralisation progressivement*" was a theme we were to encounter in various forms from both bureaucrats and bankers. "Advantages must be given to those projects designated as good for the nation" was one official's criteria. Another minister said the final decision must ultimately rest on whether the investor is honest and not practicing speculation. An apparatus allowing officials the latitude to invalidate normal competitive behavior is a license to discriminate among projects according to the ethnic origin or political connections of their backers.

³⁹The point system includes 40-60 points for value added, 25-40 points depending on the number of local jobs created and capital costs per job, 5-35 points for the use of local materials, from 10-25 bonus points if a new firm will increase exports, up to 5 bonus points for innovation. In the submission of the detailed plans differences of opinion will occur on the number of points which should be allocated for each one of these criteria. Extra-legal payments sometimes resolve these disagreements.

⁴⁰Interview with the Secretary General, Ministry of Commerce, July 26, 1992

3. Delays in Consideration of Licenses

A process that allows decisions to be arbitrarily delayed or offers inconsistent premises for approval increases business risk and delays investment. The foreign investor will go where the process is more transparent and predictable particularly when a delay of three to six months can change the original investment calculation. Moreover, it is not only the delay that an entrepreneur must take into account, but also the cost of missed opportunities while waiting to hear if one meets the criteria set by individuals whose basis for judgment is unpredictable. Because it once took five or six months to get an *agrément*, many of the administrators with whom we spoke expressed satisfaction with the present three month delays.

One economic operator spent five years in the pipeline. Another claims to have waited a year and half. Another had two acceptances after six months. One dossier was two hundred pages and cost thousands of dollars to produce. The other was two pages and was produced in a few days. Although he received both *agréments* in six months, reasons were not given in either case. If he had to apply for a permit again he would not know whether a 200 or 2 page dossier would do. The director of a foreign owned bank explained "there is no formula, each dossier is different, each decision shrouded in mystery". Because he sees only the dossiers that are successful he has no way to evaluate the criteria for refusals.⁴¹ The success stories often had the support of key individuals or investors. Because no government ministry was willing to discuss a single refusal or show us an *agrément* request that had been refused, we are not able to dismiss the claims of arbitrary treatment.

Once having chosen which ministry should initiate the authorization process, the choice of applicable laws is limitless. This is why most observers and participants in the process mentioned the importance of a sponsor or insider. For example, the complexity of the information demanded of the new *Code des Investissements* is such that civil servants were reported to be "sitting on" applications that they do not know how to examine. Projects are more likely to gain approval when a sponsor who knows both the laws that apply and the individuals who decide show an interest. How does one find such individuals? An outsider considering investing in the country for the first time will rarely have such connections. At the very least, a share in the project may be demanded for an offer of assistance by those capable of demystifying the regulatory maze. One banker told us that "one inspector applies the tax codes differently than another. Someone who would be able to understand the tax system would do very well but by the time he succeeded he would be too old to put his knowledge to work." The *agrément* process must become more transparent before foreign investment becomes significant.

4. Uneven Administration of Special Investment Régimes.

It is commonly assumed that the weakness of local savings in Madagascar offers little hope for investment; that low per capita output limits the possibility to create industries

⁴¹The Director of a rival Bank reported seeing the dossiers the same time they were brought to a ministry. We were unable to determine the reasons for the discrepancy between the two reports.

sustained by the local market and that domestic savings will be insufficient to meet investment needs for some time. In a country with a low per capita income of \$220, many assume that the most obvious industrial option is to invite foreign investment. *The Code de Investissements* (CI) and the *Zone Franche* (ZF), both adopted in 1989, were developed for precisely this reason. Among the obstacles that had to be addressed by the investment codes were that many sectors were previously reserved for parastatals (banks, insurance, mining), and that it was difficult to transfer funds.

The *Droit Commun* (DC) is the collection of statutes, decrees and other rules which establish normal company law. The main objective of the DC, according to authorities, is to assure full employment. The difficulties inherent in this system have been documented in prior sections. The recently created *Code de Investissement* and *Zone Franche* offer exemptions from normal company law, that is from the *Droit Commun*.

The *Code de Investissement* offers the following advantages over the DC: exoneration from taxes on profits, exoneration from the *taxe unique* on all transactions, exoneration from the tax on imports (especially of equipment). The tax advantages are held for two years, freedom from professional taxes for five years. Dividends can be transferred. However, transfers are permitted only of funds acquired in foreign currency. Free exchange of profits from investments made in local currency is still not allowed. Except for dividends and profits, transfers are limited by a ceiling. The ceilings inhibit investment and invite fraud, especially the over-evaluation of imports and the under-evaluation of exports. The undervaluation of imports is widespread in the CI.

Every economic operator we spoke with desired affusion of the DC and the CI. Most reported that the effort in seeking a CI was hardly warranted because they could get most of the advantages informally or through the DC. Nevertheless, most private sector operators believed that Madagascar would benefit greatly if rules facing investors operating in the DC of tomorrow were to enjoy benefits such as those offered by the CI of today.

Unlike the CI, which is a temporary zone of exceptions, the *Zone Franche* offers permanent exemptions. The ZF gives exoneration from all taxes on imported products including primary materials. Unlike the CI, which progressively joins the DC, the ZF maintains many of its exemptions. The tax on the salary of foreigners is limited. While the *Droit Commun* forbids the transfer of foreign currency and the CI allows transfers only when the original investment was in foreign currency, the *Zone Franche* allows free transfer.

The *Zone Franche* of Madagascar offers many of the advantages found in Mauritius with the exception of a reduced interest rate on loans to pay for primary materials. Mauritius also guarantees a maximum delay at customs of no more than 24 hours. Non-nationals must make their initial capital investment in foreign currency. This eliminates projects of a foreign resident wanting to invest local currency.

Free zones have worked well where they are supported by a dense network of services and products as in Korea, Taiwan and Malaysia. They are considered useful especially when the advantages of the zone are extended to the entire economy. For the Zone to work well the exchange levels must be realistic and the measures must be effectively enforced. But

Madagascar is handicapped by a lack of administrative capability and inflated exchange rates. Madagascar's regimes of exceptions open many avenues for rent seeking while offering few rigorous measures of control. Positions in the civil service were often political payments disbursed to sustain and expand networks of clientage. However, salaries are too low for the recipients to make a living so they seek salary supplements in the form of bribes or shares in the operations they supervise.

Although, the *Zone Franche* helps to increase employment, it does not help to develop local industries when *Zone Franche* manufacturers import their materials from abroad. To improve their products local producers will need fiscal exemptions like those received by the *Zone Franche*. Mauritius introduced favorable fiscal and tariff schedule for local producers who supply the free zone. This helped integrate its free zone and the rest of the economy.

The *Zone Franche* will work best if the government has the capability to live up to its commitments, but there is no sign that this is the case in Madagascar. The ministries with whom we spoke had no capability to insure that rules were followed. *Zone Franche* operators who try to remain entirely within the bounds of their original *agrément* complained about the time consumed to report every deviation from the original *agrément*. The *Zone Franche agréments* are too narrow and do not allow operators to adjust easily to changing conditions.

One of the benefits of the *Zone Franche* is the ability of producers working within it to import materials necessary for production without import restrictions and taxes. This, of course, entails a government capable of controlling its borders so that the exemptions are meaningful. Unfortunately, the government of Madagascar exerts only very limited authority, thus ensuring that customs officials control what they can, not necessarily what they should. The following are some examples:

·A tariff secretary admitted that he lacks the capacity to supervise the coast even 2 1/2 miles from the principle port. His officers do not have cars or even a change of uniform. They lack typewriters, computers or secretarial support. Considering the means at their disposal, they can only enforce the law in an arbitrary fashion.

·One minister similarly explained that "When someone asks for permission to buy a truck I have no way to determine if he uses the truck to cart machines or tourists. One does not know what enters or what really leaves. The control required opens us up to all kinds of abuses".

·A tariff official told us his bureau has no way to prevent a ship from disembarking an entire load of contraband several miles north of the nation's principal port since the customs officials were too poor to own a car. We were able to confirm his observation since during our visit to Tamatave we observed a ship disembark its entire contents on a beach several miles north of the Tamatave airport.

·One *Zone Franche* operator confirmed these impressions of the administration. This French investor reported that, "...there is no control in the Free Zone. One can do anything one wants to do. The tax collector at Tamatave told me he has no right to

intervene in a *Zone Franche* installation. I have not paid taxes since beginning production one year ago. Two containers of goods came in without inspection or taxes being paid."

Not all free zone operators with whom we spoke had the same luck. One operator in Antananarivo claimed to have had his container taxed two times and had to bribe the tax collector to reduce the amount.

The CI and the ZF do not guarantee the liberty of commerce or exchange because the rules and administrative arrangements that restrain free trade have never been annulled. The authority rests in the hands of the various ministries to annul or override any of the provisions of the CI and ZF.

As might be expected given the above rules, existing ZF's have brought little capital to the country. Operators are engaged in labor-intensive operations, utilizing machinery that will be amortized by the end of the tax exemption period. The prohibition against foreign ownership of property has, perversely, increased the chance of a "take the money and run" in-and-out investment. ZF's are typically risk-free ventures, because investment is typically minimal and relatively immune to nationalization and revolution.

Evaluating the impact of the CI and the ZF, the Ministry of Industry general secretary told us that his agency could not be more pleased. Since January of 1992 his ministry has been asked to approve 360 *agrément*s of which 60 were for Zone Franche installations. The bureau has been averaging about three months per approval. Longer than three months for an approval would be too long, the minister thought. By the standards of his ministry's administrative capability, the response to the exemptions codes has been overwhelming since his administration is working at full capacity. Yet for a population of twelve million, 350 requests for permission to invest in the manufacturing sector is feeble. At such a pace the investment codes have added little increase in employment to the economy. Even more disappointing is that the administration would not have been able to cope had there been a stronger response.

The results of investment code offerings in various other parts of the world have been similarly disappointing. Less investment than expected often results because investors are deterred by the red tape and uncertainty they must encounter in seeking the approval of concessions. The multiplicity of agencies, the potential delays, the possibility of having to pay bribes, all rebuke potential investors, sending them home in frustration that is then communicated to other would-be investors. A high-ranking official from one of the nation's four banks told us that after having read the *Code de Investissements* three times he could make no sense out of it. The reader is constantly referred to the *Droit Commun*, where for every exemption there seems to be some condition that can modify it.

While some governmental discretion over investment is needed, Madagascar must present potential investors with a set of concessions that are standard, transparent and predictable so that corruption is reduced and investors will not worry that they are missing out on some special advantage that rivals with better connections may have secured. As one public official who often participated in the granting of an *agrément* explained "the *Code de*

Investissements motivates all operators to seek out exactions and advantages. I am constantly being asked to say that so and so does not have to pay this or that. I get nothing but requests for exemptions. A common law for all businesses would be best."

5. Over-emphasis of Impact of a Proposed *Guichet Unique*.

To overcome the hazards of jurisdictional overlap, one solution most often suggested has been to create a *guichet unique* through which all demands for business licenses would pass. Although most ministers agreed that a "one-window" solution would be an improvement over the present system, the consensus ended there. Legislation calling for the creation of the *guichet* in the Finance Ministry has languished for three years. The *guichet unique* had still not been established as of the writing of this report. Evidently, the various ministries have different assessments of where the *guichet* should be situated and who should control it. One minister called for a *guichet unique* in which a member of each ministry would be represented. He also claimed that Budget, Finance and Economy should be in one department under the obvious tutelage of Finance, as in France. Another minister, assuming the *guichet* would end up being one more hurdle, commented "what can it add to what we already have?" Yet another government representative was equally blunt "I see no point having an investment code or a process to determine who is worthy, there is no reason for the entire process". He added "*plus il y a d'administrations, plus il y a de pouvoirs créés*"⁴².

One argument, placing the *guichet* directly under the tutelage of the prime minister, was for the *guichet* to be strong enough to override the opposition of the other ministries. This would mimic the reputedly successful *guichet* that was installed in Senegal, directly under the president's authority. Another minister thought the prime minister's office would be too busy and overloaded with responsibilities. One minister defended the present system, noting that if the prime minister was dishonest, the situation could be even worse than the present. Nevertheless, big payoffs made to a single source might be more economically efficient than the present system.

It seems that everyone assumes that each ministry operates according to the same criteria in granting *agrément*s: reward friends and family and keep the fiefdom unified. As a result, the view is that it is best to have as many decision makers as possible so that one group of ministers does not get all the contracts for their clients. One student of Malagasy public administration wrote that "the ministries are political fiefdom's competing for foreign resources. The ongoing philosophy is "*débrouillez-vous*", or "manage for yourself".⁴³

⁴²Roughly- "Another ministry, another force."

⁴³The feudal character of the Malagasy administration is demonstrated in the insularity of each ministry's operations. And it is reinforced by the fact that unlike many strong Presidential regimes in Africa and other developing countries, the ministers tend to have long tenure in their positions. Each has considerable reign within the fiefdom. Even as their administrations have been stung by fiscal austerity and reduced operating budgets, each has tried to shore up its "sector" by crafting donor supported projects and programs under the investment budget." Mimeo USAID report: 19.

One of the larger economic ministries argued that the Ministry of the Economy was the best place to put the *guichet* because, as a new ministry, it could be viewed as a disinterested interlocutor between the various ministries whose expertise would be encroached upon. "Everyone wants to be the chief of the *guichet*," they told us. "The Ministry of the Economy is most neutral. While the Ministry of the Economy is presently not strong enough to overcome the opposition of the more powerful ministries, progressively it could get stronger so it could take over the task of the other ministries." Economy is a newly created ministry. Industry, which presently has 13 technical officials, a number of executive officers as well as various secretaries and computers is able to clear dossiers after three months. Economy has a fraction of the resources presently in the hands of Industry to implement a much greater percentage of work. When presented with this anomaly, the minister's response was that its resources would grow as its activities grew. Industry noted that the creation of a *guichet unique* that is poorly managed would be a disaster for everyone. Several of the ministers we questioned, however, did not believe Economy would have the ability to override the opposition of stronger ministries.

We could not find a single operator in the private sector who had enthusiasm for the construction of a *guichet unique*. Most officials believed "a *guichet* would only perpetuate the present system"; that the *guichet* would just be another hurdle and that the young Ministry of the Economy would never be able to prevail over the already established ministries. Their preferred solution was to let investors and their banks determine which industries could be profitably implanted into Madagascar. "Let those who have the most to lose have the most to say in the process". This opinion, expressed consistently by private sector operators, was rejected with the exception of one minister.

A measure must be established whereby those whose investments have been denied or delayed can appeal to a higher authority. A branch of the Supreme Court must be given authority to examine such complaints. Because many in the business community have experienced arbitrary behavior by the administration, they mistrust the administration to regulate access to the market. For a *guichet* to be credible it might have to be a judicial or quasi-judicial tribunal staffed by persons in which the business community has confidence. Obviously, the *guichet* should not be staffed entirely by political appointees. A method of selection must be found in which the business community participates.

B. Options for Reform

1. Consolidation, Simplification of Investment Approval

Four different types of screening mechanisms are generally found in developing countries:

- a. A single ministry that centralizes and makes all screening decisions;
- b. A permanent ministerial board that coordinates all decisions;
- c. An *ad hoc* ministerial committee that refers cases to the various ministries;

d. Various administrative units making decisions in a diffuse manner.

A centralized structure that approves most investment applications without input from other governmental units is most effective. Only this solution will prevent the development of a discrepancy between policy statements and implementation.

Creating a screening body that represents the various ministries is preferable to a structure that simply reroutes applications directly to the ministries. Nevertheless, institutions comprised of department representatives rarely end up making decisions expeditiously. The real screening decisions often continue to be made by the executive level boards of the various government units. A window which only reroutes the requests for approval will not prevent subunits from making independent decisions and exposes the process open to bureaucratic rent seeking and bribery.

One step investment units will usually work with investors to expedite the approval process. But after approval, the investor often must request additional permits from the different ministries. To avoid this danger, all necessary permits should be provided at the time of the original authorization by the screening board. The success of a liberal investment policy requires a structure preventing subunits from having veto power.

A structure which allows the final decisions to be made by the various heads of departments should be avoided. The time wasted in arriving at unsound screening decisions is time Madagascar cannot afford to lose.

The process of foreign and domestic investment approval should be simplified and consolidated in fewer ministries. In addition, the following recommendations should be implemented in order to improve the investment climate in Madagascar:

·Conflicting and overlapping statutory requirements should be systematically identified and eliminated.

·A single text describing requirements for registration should be prepared and published.

·The same text should specify the steps in the review process and the criteria for approval. Screening should be requested only of those investors seeking investment incentives. A negative investment list can be adopted that specifies certain sectors from which foreign investors are barred, as long as they are provided the same access as natives in all other sectors. Restrictions on equity ownership should be removed so that all investors can freely transfer equity in their own companies. Investors should also be free to use expatriate employees.

·The criteria for approval should preclude bureaucratic second-guessing of the investment decisions of entrepreneurs. Except for a very narrow list of investment areas (for example, in arms production), approval should be automatic. Information collected should not compromise competition by demanding confidential information.

Several of the operators with whom we spoke claimed their ideas, sources of supply or methods of distribution were expropriated by a rival investor while they were waiting for an approval. Because the information was highly specific they suspected leakage had occurred. In effect, the screening process allows officials to confiscate new ideas and projects.

Time frames for approval should be established with automatic approval at the expiration of that time. In addition, the texts of the agreements should be published within a specified number of days after issuance.

Many investment decisions depend on circumstances such as interest or foreign exchange rates that vary over the short term. Several investors complained that after receiving a license they were later denied authorization to buy the foreign currency needed for the project. Presently, banks or companies cannot hedge or secure their foreign currency exchange needs because companies receive the exchange rate on the notification day in an export transaction or application day in an import transaction. A request for an *agrément* should trigger immediate permission to acquire the foreign currency needed.

A process for review of adverse decisions against established criteria should be provided.

2. The *Guichet Unique* as an Informational Structure

The proposal for a *guichet unique* should be modified such that its function is informational and promotional. Its establishment as a private sector entity should also be considered.

There are many good reasons for investors to come to Madagascar, but the process of registering a business discourages many from looking carefully at the nation's potential. Once the codes of exemptions are eliminated the need for a *guichet unique* will also be eliminated. The *guichet's* function can then be performed by a private organization whose primary function will be to provide precise information to potential investors about the costs of doing business in Madagascar and the steps needed to embark on such a course. There is presently no reliable statistical information on the Malagasy market. A *guichet* that collects and distributes accurate information would be a significant asset. The *guichet* in Mauritius presently provides such information and in doing so makes investment decisions easier. A *guichet unique* that answers all of an investor's questions is useful. On the other had, a *guichet* which questions the technical competence of the individuals bearing the risks of the investment and which seeks complex technical analysis of projects hinders investment.

Ultimately, the *guichet* should be a source of information and not a licensing agency. Why would technical experts in a government ministry have more technical know-how than the investor who specializes in the field? How can a technical expert whose academic training may already be dated have superior insight to an investor? A *guichet* will be helpful if it assists investors in evaluating the costs of producing in Madagascar. What will be the

role of related public sector investment? What real rate of taxation will be imposed and what legal recourse will be available in case of disputes both with the government or with other private operators? A *guichet* that can answer questions such as these will be a valuable asset to a nation that hopes to attract foreign investment.

The riches of Madagascar should not remain a secret. In the early 1960's a report was prepared detailing the many natural resources of the island. That report should be revised and made available to potential investors. A private organization or a privately run industrial development authority modeled on the Irish example could be considered to undertake the study and to serve as *guichet*. The authorization function of the *guichet* should be transferred to one of promotion and information distribution under private administration.

3. Uniformity of the Investment Regime

The flexibility given to operators under the Code d'Investment should be available to all firms. Similarly, anyone who produces for export should have the same rights and privileges as persons currently operating in the *Zone Franche*.

There are numerous reasons for eliminating the regime of exemptions. As noted, free zones and investment codes work best when political and administrative officials can effectively enforce them. Madagascar presently lacks the administrative capacity to do so. Hence, the report of one operator in the *Zone Franche* who had to pay double tariffs on goods he believed could be imported duty free. In the same vein we met small operators who produce for export in the *Droit Common* because they can wiggle their way around the codes and end up with the same *defacto* exemptions they would have obtained had they gone through the costly process of seeking an *agrément*. However, the many small operators who do not want to incur the costs of applications, legal fees, and out-of-pocket expenses to gain the authorizations provided by the investment codes, find it necessary to trade on a smaller scale and in a more transient manner. Those exporting without proper licensing will not elicit the confidence of their trading partners, they will invest less, incur higher unit costs and contribute less value added to their products. The reports of small operators suggest that the costs of registration and licensing in the CI and ZF may be greater than the social value created by the exemptions.

Madagascar should not bank its economic aspirations on the necessity of attracting foreign funds through the *Zone Franche*. At best the ZF will only be a small part of the total economy. Much investment can be unleashed from within the country once the judicial environment is reformed. If the institutions necessary for the emergence and enforcement of capital market contracts are strengthened we should expect the level of domestic savings to increase dramatically. The increased leverage of enterprises would allow for greater domestic investment. The capital markets are in such a state that credit is expensive and rationed because of agency problems. Removing these credit constraints could allow for substantial capital formation even in the absence of foreign investment.

The domestic economy does not receive the full benefit of the *Zone Franche* because domestic entrepreneurs are forced to buy more expensive local or imported products. Another

perverse effect of the exemption codes is that competitive advantage is given to foreign nationals over indigenous Malagasy investors. The exemption codes favor new investors, rather than addressing the concerns of existing (mostly indigenous) business people. The latter often have depreciated capital which is difficult to renew because of high import and purchase taxes (from which Code investors are exempt).

In sum, because of the complications in the process of business licensing many practitioners decide to practice without permits. Although they do not incur the costs of application and registration, they often must pay protection money to tax collectors and other officials. They must often operate at a smaller scale and in a more transient manner than is optimal. The economy will benefit greatly from greater transparency and lower cost access to business licensing. Private sector operators now in the informal sector will be able to seek out capital for investment and expand their network of distribution and production. One of Madagascar's most experienced international traders warned "The *Zone Franche* gives all of its advantages to foreigners while nationals are locked into the domestic economy. If liberalization does not create Malagasy capitalists it will fail. Why can't Malagasy invest elsewhere for instance? If liberalization does not create Malagasy capitalists we will recreate the situation that led to the first revolution".

Consider the recent misfortunes of Perlin, one of Madagascar's most successful export enterprises entirely managed by a local entrepreneur Monique Ramahay. Ramahay began in 1983 with five sewing machines and a workshop in ruin that could shelter thirty workers. By 1987 sales to France of fashionable children's clothing had reached 142,000 FF; by 1991 sales passed 6,5 million. In 1990 Perlin was the first Malagasy firm to gain *Zone Franche* exemptions. But 1991 ended with a loss of 300,000FF. Two restrictions are responsible. Malagasy law prohibits nationals from investing overseas. As a result, Perlin was unable to create a network of distributors in France. Neither could it get credit in France because Perlin has nothing to offer as security or collateral for a loan. Monique Ramahay explains, "It is the problem of those firms that produce for export but who do not have a partner overseas. One has no shelter against greedy intermediaries." Another problem is that Ramahay's single source of fabric, Cotona, is partly under the control of the state. Cotona's status keeps other producers of cotton out of the Malagasy market. Cotona is reported to lose money but benefits from cheap credit which competitors would not be assured of getting. Perlin and the other producers of clothing in Madagascar cannot get supplies from the outside because the lack of infrastructure prevents prompt and regular deliveries. Products for the fashion market cannot tolerate delays. A delay of a month may be too late for the fashion season. Monique Ramahay has to struggle with regulations that non-native firms in the *zone franche* do not have to surmount because they can own distribution networks overseas. Perlin's hope is to become the first native firm with permission to invest overseas.

4. Uniformity of tax codes

Once a single regime for investment is established, a single tax code for all operators should be adopted. The code of exemptions allows excessive leeway for bureaucrats to gain rents by interpreting the codes in divergent ways. Since the legal system provides little recourse, operators often find they are asked to pay bribes to limit the costs of these

divergent interpretations. Connections to powerful people sometimes help reduce such annoyances but not all operators have such connections. Operators that are new in the country or who belong to ethnic minorities are most likely to lack such resources. As one lawyer put it "only foreigners pay taxes". However, even one firm recently established in the *Zone Franche*, with investment from the president's family found itself being asked to pay bribes to avoid the imprecations of a persistent customs agent. The prevalence of practices contrary to written law constitutes a much greater cost of doing business for a foreigner (who does not know how likely or unlikely detection and penalty is) than for the indigenous merchant who can estimate enforcement probabilities more accurately. Because the risk is higher for the foreigner, the existence of widespread illegality makes a non-resident more reluctant to invest in the country than a resident.

A tax code that is too complicated to be enforced effectively invites bribe taking by officials. To avoid arbitrary behavior by tax and customs officials a *code des investissements* that offers different exemptions to different investors should be avoided and replaced by a single regime. Then an effective tax code should be developed taxing all operators equally in an open and transparent manner to reduce the costs to the government and the private sector of tax collection. Once a single regime for investment is established it should be complemented by a single tax code which treats all operators equally.

IV. Governance

A. Description of Problem

1. Unchecked Executive Branch Authority

A theme often referred to by our interlocutors was the complete unaccountability of officials. In fact, it is among the most commonly cited causes of weak domestic investment.

One interviewee remarked "the economy of Madagascar always depends on politicians who run the regime. All the projects which pass for authorization by the state are always blocked by members of the Old Regime. Either they ask to become shareholders or they take your project and implement it themselves". We have no way of verifying these assertions that government officials have used public office to stake an important claim in the economy of Madagascar. Nevertheless, because of the lack of openness, these charges influence the investment environment. If the charges are incorrect, greater openness would quickly refute them.

Businesses are frustrated by the lack of transparency in the privatization process. For example, we heard that information was withheld from the public about the condition or capacity of the factories that were for sale so that only insiders would be able to buy. *Le Groupements des Entreprises de Madagascar* wrote the following letter to the prime minister "nous avons déploré l'opacité dans laquelle se sont effectuées les opérations de désengagement de l'Etat et avons suggéré un certain nombre de mesures, entre autres, la publication de la liste des privatisations effectuées avec les conditions d'exécution." They went on to "exiger la définition précise des règles du jeu et la transparence à tous les niveaux. A l'expérience de certains cas, dont ceux de la SOMALC, de l'Hodima et de la SMPL, le GEM regrette de constater que la notion de transparence continue à poser des problèmes en ce qui concerne la procédures de dépouillement des soumissions, l'analyse des offres et l'adjudication du marché."⁴⁴ It was also reported that the process for authorization to exploit national forests was arbitrarily assigned and that open bidding for lumber rights did not exist. Overall, openness should be welcome by the government and ownership should be made public information. No one wants to compete with firms that have political advantages.

2. Conflicts of Interest

The president of Madagascar has set the pattern of public officials engaging in business activities on their own account. It is a pattern that bodes badly for the development of competitive markets. The accumulation of market power is inevitable when a ruler or cabinet minister enters into a business. Illegal or unfair practices will go unreported by officials. When an enterprise representing the interests of government officials seeks to make an acquisition at a price it determines is fair or affordable, it is essentially issuing an irresistible administrative decree. The prevalence of firms with associations to the president discourages private investment. No one can sue the president for canceling a debt or for unfair business practices. Legal remedy for unlawful business practices by individuals

⁴⁴Letter form GEM to the Prime Minister July 22, 1992, signed by Augustin Rafidison and Madeleine Ramaholimihaso.

connected with the president is unavailable because the executive controls the legal system. Investors will not choose to compete with government insiders who not only own the businesses, but also control the regulatory apparatus of the state. At the very least, investors will demand special immunities or concessions or they may offer shares in their firm to key members of the government to assure special treatment.

High inflation and poorly paid civil servants open the way for conflicts of interest. Poorly paid civil servants will find it difficult to avoid the opportunity costs of not pursuing supplemental income. Civil service reform is imperative. Reform would concentrate on creating a higher paid but smaller bureaucracy that will behave more like an elite. Obviously, officials who can barely afford bus transportation to the office are unlikely to inspire confidence or behave independently. With an honest bureaucracy everyone knows that the rules of the game are the same for all players. By contrast, unfair advantage breeds unfair tactics throughout the system. When it begins with the president it quickly spreads to the lowest level of public service. Constitutional restraints that prohibit conflicts of interests are necessary. One highly placed official, told us "the first republic worked well. But now everything is politicized. Everyone feels themselves protected by some kind of higher authority and may feel above the law, and unpunishable. Depoliticization is necessary. We must apply the law to everyone without distinction". He assured us that "conflicts of interest must be eliminated". However, it seems the new constitution does not go as far as it could to restrict the possibility of presidential conflict of interest.

Article 49 of the new Constitution makes a welcome addition by confining the President to his role as Head of State. According to this article, the functions of President are incompatible with "all... other professional activity... in addition to any elected public function or activity with a political party." Yet we could find no mechanism in the Constitution specifically designed or capable of being used to enforce such a prohibition. Article 103 does not give the *Inspection Generale de la Justice* the power to investigate the President. Neither does Article 121 hold the President responsible for his acts other than those performed in the course of his functions.

3. Dependence on Closed Networks of Personal Relationships

Involvement by officials in the economy may represent an anti-competitive force, but it also represents the only force capable of overcoming the obstacles to investment when the judicial system is dysfunctional. Overall, it is a force that keeps investment horizons low and keeps many investors out.

Without effective commercial laws, the circle of parties among which one is likely to transact is limited to those whose reputations can be ascertained by personal networks. Since contract enforcement mechanisms are usually achieved outside the legal system, operators shun engagement with strangers. This restricts economic activity. Because verification is difficult and there is no recourse in the case of a dispute with a stranger, one contracts with those with whom kinship or other social ties can be called upon to enforce the contract. As one private businessman put it "one needs to ascertain the family history of each individual with whom one interacts". One factory owner told us "One does business only with those you know because if there is a problem you have no recourse. You work only with

those whose reputation you can verify. You are very careful with strangers." So long as the Malagasy depended on informal contracts, and an informal code of conduct to govern exchange, and so long as disputes are resolved informally, foreign as well as domestic investors will be repelled from investing in anything but the most certain projects.

To create an open society one has to create a functioning legal system. Our interviewees made it clear that neither exist in Madagascar and that many were unfamiliar with the relationship between the two concepts. One investor, commenting on the insignificance of rules, told us rules or institutions do not matter here since without accord "*entre le Malagasy rien marche*" (i.e. nothing works without agreement among the Malagasy). Another government representative made a similar point when he explained why it was unimportant that he did not know where the competence of his recently created ministry ended and another began. People, not the institutions, mattered most. One elder statesman deplored the emphasis on rules because it would only entail more lawyers. He explained that "normally one enters into deals with partners that are confirmed as reliable, who really want to work together and are genuinely interested in the project."

This perspective is sincere and well intentioned but it fails to account for the fact that people and plans change. What seems like a good decision today seems less good tomorrow. Investors may decide to restructure their portfolios as their interests change. When relationships are purely personnel such alterations are difficult. Renegotiating or calculating the value of a business or project is difficult when personal ties constitute a large portion of a project's feasibility. The primacy of personal linkages reduces the liquidity and hence the value of an enterprise. The introduction of a commercial society permits relationships among strangers. This is sometimes difficult for individuals, who are accustomed to the primacy of familial relations, to conceptualize. A functioning legal system will allow trades among strangers to become quantitatively significant. Without such a system the level of investment will be limited to courageous individuals rather than large firms. An individual investor can more easily wiggle his way around the obstacles and establish a personnel relationship with his or her clients. Similarly, someone starting their own business may be willing to sacrifice their personal life to assure the success of their enterprise. A typical career employee in a large firm will not be willing to make the same sacrifice. To operate effectively, a large firm requires a much higher level of impersonal standardization of the legal environment.

Compliance with contracts has been assured through informal means in Madagascar because of both tradition and the lack of an alternative. This dependence on informal enforcement mechanisms predates socialism, but socialism did not encourage the development of broader economic ties. The economic history of Western Europe suggests that formal organizations help society gain from the division of labor and anonymous exchange. Private order institutions can help but are by themselves insufficient; private order institutions do not support the optimal amount of trade or investment. Anonymous enforcement of anonymous exchange is critical for economic growth.

The dependence on informal enforcement of contracts is one of the reasons why Madagascar's economic operators often expressed a concern over the general absence of liquidity. For example, a representative of the nation's only venture capitalist firm reported that when one does not know the management personally one would not invest, so that the

market for shares in companies is limited. When the value of a relationship with people well placed in the government becomes decisive in determining the value of a right or an asset, those rights and assets cannot be easily traded. Liquidity is a problem when investments are privately placed.

4. Citizenship Rules Limit Legal Rights

Many of Madagascar's leading economic operators have been considered foreign even though they were born in Madagascar to parents that were also born in Madagascar. Not possessing citizenship, many fear expulsion if political and economic conditions deteriorate. Since there is no law to appeal to in order to protect their rights, they kept much of their capital out of the country. If their rights as citizens were secure, many claimed they would bring their money back into the country. Under present circumstances it was thought unwise to do so. It does little to expand investment horizons, having many of the nation's most experienced business people living in fear of expropriation and intimidation in the absence of citizenship.

Many economic operators refused to allow us to take notes or be cited because they feared retaliatory measures by various ministries they appeared to criticize. The greatest fears were expressed by those who were not citizens of Madagascar and who feared the loss of residency permits if their remarks were perceived to have a political content. Foreign investors feared participating in meetings which could be viewed as political and many expressed concern that their residency permits would be revoked if they were too vocal.

A story was told to us by several of the private operators with whom we spoke to characterize the insecurity they experienced. Several years ago a German national was given a mining concession. As soon as he found the minerals he was authorized to mine, his concession was removed by the Ministry of Mines claiming the mineral was necessary for national defense. Then, the Ministry of Interior denied him permission to remain in the country. The German filed suit. Nevertheless, he was not able to attend his trial because his entry visa was denied. A local firm took over the concession. This story had its analogue in tales we heard of investors who were delayed in their request for an *agrément* only to find a competitor opening up precisely the kind of operation they had proposed. The legacy of such stories linger. Madagascar must make every effort to convince investors that their rights will be protected by laws which apply equally to natives and foreigners. The rules governing mining that made this investor's nightmare a reality have not been altered.

5. Constitutional Arrangements

"State capitalism" was the motto of the transitional 1972-75 regime. Creating a welfare state was the theme of the 1975-85 Socialist Revolution. One of our interviewees explained that the problem in Madagascar is not the socialist tradition of centralized control but that socialism allowed the economy to be dominated by a single party. "The monopolies of the state became the monopolies of a single party. The state was transformed into a party that monopolized the economy. The tissue of the economy was destroyed because one cannot compete with firms of the state. Once the monopolies of the state are established the others cannot evolve. The effect of state control of the economy is instability because whoever

controls the state controls the rents⁴⁵. In Africa this has meant leaving little behind for groups other than the party running the government. Since whoever control the state controls the rents, taking over the state is a way to gain shares in the economy. A comparison with the Asian Newly Industrialized Countries is pertinent. There bargains were generally struck with all the major interest groups so that each receives a piece of the economic pie. Relative political stability was a consequence of the bargain which assured all the major players a share of the gains. Stability in turn created investor confidence, increasing the percentage of long term to short term investments. The bargain in Asia was institutionalized by the creation of links (for example, deliberative councils) between the political leaders, the technocrats and business groups. Japan is the primary example. Cooperation between the private and public sectors is highly institutionalized. By comparison with Asia the lack of coordination between private sector and government groups appears as one of the fatal flaws of the political economy of Madagascar during the past twenty years.

Deliberative councils of commerce and industry could be developed to increase the communication between business and government. These councils or chambers of commerce should be independent of government and of political or administrative influence. Membership on the councils must not, however, be a privilege of only a few industries or firms.

Methods by which private sector operators could collaborate with the government and agree upon the rules of the game have not emerged, so that coordination is lacking between business and bureaucratic practice. Most business people deplore their inability to organize or to present their concerns to the government. Institutions must be developed to allow systematic consultation with organized business groups. It is here where bureaucratic practice in Madagascar differs most sharply from that of the Asia NICs, where interactive contact is continual between private and public sector representatives. The creation of chambers of commerce and industry can strengthen accountability and responsiveness of the government. But such chambers must be completely free of political or administrative influence. The proposition now under consideration, to create a Chamber of Commerce in the French model, does not provide sufficient independence from the government.⁴⁶ Our discussions with economic operators suggest they are willing to pay the costs for the creation of organizations that can represent business interests. Such organizations eventually could be linked with or endowed with a conflict resolution mechanism.

⁴⁵Public expenditures were more than 27 percent of GNP as compared to 19 percent in low-income countries outside of Africa. Sub-Saharan Africa: From Crisis to Sustainable Growth: 27

⁴⁶Projet D'Ordonnance Portant Resructuration de la Chambre de Commerce D'Industrie et D'Agriculture, La Haute Autorite de l'Etat, vu la constitution et la convention du 31 Octobre 1991.

6. Political Reforms

The coordination of political and economic liberalization is the great challenge faced by Madagascar. The new constitution offers a unique opportunity for an open economy to develop along with a democratic culture. The challenge of uniting a democratic constitution with a liberal economy should make the next few years of Madagascar's political history of more than passing interest to those who closely follow world events.

The new constitution should reduce the cost of entry into the political system and the ease with which legal institutions can be established. A parliament can help liberalize the economy by bringing the holders of different economic rights together in a forum in which they can openly trade. This should allow for the public placement of rights that are now privately placed.

Bringing the holders of rights together will make it more difficult for private groups to obtain monopolies or privileges that come at the expense of other groups represented within the parliament. This should mean that without converting individuals to the ideology of free trade and competition, the existence of a strong parliament should make the process of gaining economic rights more transparent.

B. Options for Reform

Based on the preceding description of the structural and procedural problems undermining the effectiveness of government in Madagascar, the following simple, straightforward recommendations should be implemented:

- Conflict of interest must be explicitly barred.
- Government officials must not be allowed to engage directly or indirectly in private business in the same industries in which they have jurisdiction.
- Arrangements must be made so that all rules, laws, judicial decisions and industrial licensing are made public.

V. Options for Moving Forward

There are many ways of approaching the needed institutional reforms. We recommend a course of action which adapts useful ideas to the Malagache situation and leads to an understanding by Malagasy leaders of the function of the various institutions to a market economy.

These reforms all relate to and reinforce each other. No single recommendation by itself is offered as the key that will unlock a flood of investment into Madagascar. Instead, the main conclusion one should draw from this report is that there are a series of institutions which exist in successful market economies and which do not exist in Madagascar. Building those institutions is not an automatic or particularly easy process. Action in all areas will ultimately be important to create an investment environment which makes Madagascar a more attractive investment opportunity than the many others which currently tempt both foreign and Malagasy investment.

Beyond the specific suggestions there is a larger point: reforms suggested here must be specified in light of Malagasy needs and views. Reform requires more than simply adopting an outside model of law, policy or practice. Development of a constituency for reform requires that key elements of society be involved in the discussion and development of new policies. Key officials in government, leaders of the private sector, economists and lawyers - all those who contribute to the shaping of new ideas and opinion in society --have a role to play.

A. Roundtable discussion of Institutional Reform

We recommend that this report be shared with officials in government, members of Parliament and leading political parties, representatives in the private sector, lawyers and academics. Allowing time for the report to be digested, we then propose that a series of roundtables involving these same people be conducted with experts from the U.S. and perhaps Europe. The function of these sessions would be several-fold:

- to develop more specific information on the implications of the issues for economic life in Madagascar.
- to expose key Malagasy leaders to the role that institutions play in a market economy.
- to identify individuals with expertise from various sectors of Malagasy society and begin a process of interchange with experts from outside Madagascar.
- to assess the feasibility of action and develop priorities.

The roundtables could be organized in the same fashion as the report, one on legal and regulatory issues and one on the investment approval process itself.

At the same time these sessions are conducted, we also recommend that a team conduct further individual interviews with persons visited during the first IRIS trip, as well as others not yet conducted, to continue the collection of specific and updated information. This information will be of use at the roundtables and in any further work.

B. Working Groups for Specific Problems

A next step would be to establish working groups of foreign and Malagasy experts to undertake specific projects. The composition of the working groups would vary by topic but ought to include representatives of the government, other political parties, legal and economic experts and the business community. Outside experts should be included in each group.

For example, if one priority is the reform of the commercial code, the working group would undertake several tasks:

- catalogue the specific laws, decrees and arrets which affect the ability to create firms and to invest and trade in Madagascar.
- document the economic and operational impact on firms of the current system.
- introduce the working group to commercial transactions used in other economies, as well as the interaction of a commercial code with other institutions such as contract enforcement, property rights, banking and credit and labor law.
- conduct a seminar for a wider group of Malagasy interests on the issues at stake and the implications of improvement for firms in Madagascar. Perhaps a similar, but separate session for legislators and ministry officials.
- drafting of reform proposals by the working group or a subset.
- support for Malagasy groups working to advocate adoption of such a reform.

This basic model should be adapted for work on other topics. These topics include:

- The creation of institutions to protect the rule of law and an independent judiciary,
- clarification of property rights,
- reform of the Bankruptcy system,
- establishment of private dispute settlement mechanisms,
- establishment of a liability or tort system,
- simplification of the investment and company registration approval process,

-establishment of an informational guichet unique.

In some cases, Malagasy experts might need to visit other countries where a particular institution functions effectively in other circumstances, outside experts might visit Madagascar to work with local experts in documenting the current practice and rules.

C. Enhancement of economic and institutional analysis capability of legislators and key policy leaders.

1. Policy Seminars: The fundamental principles of markets are not widely understood by policymakers in many countries undergoing the transition to markets. Similarly the functions of legislatures in making economic policy decisions in a democracy are not well established. IRIS has conducted a successful program of two-week seminars for leaders of the Mongolian legislature, government ministries, political parties and private sector entities. These sessions take place in the U.S. The first week emphasizes basic economics of the transition and the institutions central to successful markets (those which secure individual property rights and facilitate transactions). In the second week, a specific current policy topic is addressed, such as land law, tax and budget policy, foreign trade and investment institutions or price and competition policy. Follow-up visits to the country by experts are aimed at helping the participants implement the principles covered.

Sessions targeted for Madagascar and conducted either in the U.S. or in Madagascar would have the benefit of providing a solid grounding in the underlying rationale for various reforms that are needed, and developing shared expertise among a cross-section of interests.

2. Study tours: A less structured alternative to the above model is a study tour by various experts who have responsibility or expertise that is relevant to the topic under discussion. To be effective, such tours will require briefing of the persons to be visited on the situation and issues in Madagascar, preparation of materials and a senior representative of the organizing entity to provide context and continuity. IRIS has found that the seminar model, mixed with trips to relevant organizations, is most effective in quickly building capability to address issues such as those faced by Madagascar.