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EIGHTH CONSULTATIVE GROUP FOR MOZAMBIQUE

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INTERAGENCY REVIEW PAPER

EIGHTH CONSULTATIVE GROUP ON MOZAMBIQUE

I. OVERALL GOAL

The U.S. should use the opportunity to make clear that our goals are to ensure that Mozambique achieves both democracy and development. The international community invested a billion dollars to get Mozambique to and through the elections and has invested billions to bring about its development. At present, Mozambique has only taken the first step toward democracy and has inadequate foundations for development. Both these factors are, in part, due to government policies and priorities. Much more needs to be done by the GRM to assure that democracy is institutionalized and that development is realized. We should also make clear that failure to lay out and implement a significant reform program will lead to reductions of our aid program.

II. ADMINISTRATIVE ARRANGEMENTS

The World Bank (IBRD), at the request of the Government of the Republic of Mozambique (GRM), has called the Eighth Consultative Group (CG) meeting for Mozambique on March 13-15, 1994, in Paris, France. Ms. Catherine Marshall, the World Bank's Director of Programs for Southern Africa, will chair the meeting. The U.S. Delegation will consist of: Ms. Carol Peasley (Head of Delegation), Deputy Assistant Administrator for Africa; Ambassador Dennis Jett; Mr. Roger Carlson, Director, USAID/Mozambique; and Margie Rauch, U.S. Treasury. The GRM delegation will be led by Mr. Pascoal Mocumbi, Prime Minister.

The IBRD is distributing the following three documents for the meeting:

- IBRD, *Impediments to Industrial Sector Recovery*, January 1995;
- GRM, *The Poverty Reduction Strategy for Mozambique*, February 1995; and
- GRM/Donors, *Establishing the Basis for Economic and Social Development, Key Policies*, February 1995.

III. BACKGROUND INFORMATION

A. Political Background

From independence in 1975 until the mid-1980s, the GRM's domestic and external political orientation was toward the Soviet Bloc. About 1984, the GRM began a shift to a more market-oriented economy and a more democratic society. Outwardly, this shift manifested itself in the establishment of relationships with the West and a shift toward a non-aligned position on international matters. Internally, one manifestation was the adoption of a new constitution in November 1990. Concomitant with the more significant progress in economic reform and opening up of the political system in the early 1990's, the GRM and the Mozambique National Resistance (RENAMO) began serious peace negotiations which culminated in the signing of a General Peace Accord in Rome on October 4, 1992.

In October 1994, multi-party national elections for the presidency and National Assembly were held for the first time in Mozambique's history. Thirteen candidates contended for the presidency and fifteen political parties for the Assembly. The FRELIMO candidate and incumbent, Joachim Chissano, won the presidential contest with 53% of the vote and the FRELIMO party managed a slim majority in the new National Assembly with 43 percent of the popular vote. Turnout was high, the number of spoiled and blank ballots were relatively low (under 10%) and the international community deemed the process free and fair. However, political tension remains as the FRELIMO party has neither created a government of national unity nor has RENAMO been included in any position in government at the national or provincial level. RENAMO, the other major political party, won solid majorities in all five central provinces, including the two most heavily populated in the country, which gave them 112 seats in the 250 seat parliament.

These elections were the concluding phase in a process, that began with the signing of the General Peace Accord in October 1992, to end 16 years of civil war and introduce multi-party governance to the country. The elections, by being based on universal adult suffrage, were also a major step in reversing the historic tendency towards centralized and statist governance. Political power is concentrated in the hands of the executive branch with weak and underfunded legislative and judicial branches and a largely government-owned media providing no effective counterweight.

Over the last two years, but particularly between mid-1993 to mid-1994, one of the world's largest mass movements of people took place. About 1.7 million Mozambican refugees from six neighboring countries returned to their home areas, about 3.4 million of the estimated 4.5 million internally displaced also returned to places of origin, and about 200,000 demobilized former combatants and their dependents returned home.

B. Economic Background

1. Pre-independence

Before independence, economic activity centered around five activities: 1) subsistence agriculture; 2) the processing of agricultural commodities for export; 3) migrant labor; 4) transport of goods between Mozambican ports and the landlocked areas of southern Africa; and 5) tourism services. Traditional subsistence agriculture was focused on growing food crops, primarily maize. Production for export centered around four commodities: 1) cashew nuts; 2) prawns; 3) cotton; and 4) tea. Migrant labor mainly went to South Africa to work in the mines. Transit trade from the Transvaal province of South Africa, Zimbabwe and Malawi was an important source of foreign exchange. In addition, tourism receipts, primarily from the above countries and Portugal, also constituted an important source of foreign exchange.

Prior to independence, private commercial farming in Mozambique was largely defined by concession agriculture, with the exception of cashew and, to a lesser extent, cotton which were grown by smallholders. Subsistence farming on traditional lands dominated food production as it does today. In theory, an African farmer could obtain clear title up to two hectares. However, financial capability had to be demonstrated, and demarcation and survey of the land were also required. The process was expensive and complicated. Large concessions displaced native Mozambicans from large areas of the country's best agriculture land and effectively denied them future access. During the colonial period, less than 15% of the land was under cultivation. Over 50% of the cultivated land was in the hands of a few large European-controlled farms which produced cotton, sugar, tea, sisal and processed cashews. Another 25% was occupied by small commercial farms (greater than twenty hectares) and managed by Portuguese settlers and a few African farmers. The large majority of the population farmed traditional communal lands or worked on large plantations.

Industrial production in Mozambique was initially based upon agroprocessing of locally produced goods such as sugar and sisal. Small-scale manufacturing began to emerge in the 1930's in products such as cement, bricks, soap, beer and cigarettes--with the market for these industries being largely provided by the small settler community. This process of industrial development continued for the next thirty years with diversification into other consumer and intermediate manufacturing, including food processing, garments, footwear, furniture, glass and metal products. After 1965, the Portuguese opened the economy to foreign investment, particularly from South Africa. This forced new enterprises to be internationally competitive and avoided the development of inefficient industries. This open door policy, up to 1974, included a series of incentives such as tax holidays and profit repatriation entitlements. The rate of growth of industrial output, between 1957 and 1970 according to available information, averaged between 6% and 7% per annum. The metals and engineering industry subsectors recorded annual growth rates above 30%. In 1973, total manufacturing value added per capita was estimated to be the sixth largest in Sub-Saharan

Africa and by 1974, Mozambique was the tenth most industrialized country in Sub-Saharan Africa.

2. *Post-independence*

After a long period of armed warfare in the fight for independence from Portugal, Mozambique became independent in 1975. A substantial exodus of Portuguese settlers at the time of independence in 1975 severely depleted the pool of skilled labor. Estimates of the exodus are put at 200,000 people (90% of the skilled and semiskilled labor force). Up to the time of independence, little emphasis had been put on development of social or physical infrastructure. The effects of the withdrawal pervaded the economy. The impact of the exodus was further exacerbated by the sabotage by departing Portuguese of productive resources. Due to damage and losses from attacks on the railways by RENAMO, transit trade from the Transvaal in South Africa, which had been an important source of income for the port of Maputo, was diverted during this period to other South African ports rather than through Mozambique. Changes in South Africa which reduced the job opportunities for Mozambican mine workers in the South African mines led to an important decline in remittances. Tourism receipts fell substantially as the number of tourists visiting Mozambique declined dramatically due to the civil strife between FRELIMO and RENAMO. Mozambique entered its immediate post-independence period facing severe economic strains.

At the time of independence in 1975, Mozambique was a relatively prosperous country with an economy built on a strong agricultural and industrial base and provision of transport and labor services to neighboring countries, particularly South Africa. However, several factors were in place which led to a substantial deterioration in economic performance, including: 1) a colonial legacy of very low investment in human resources; 2) inappropriate Marxist economic policies; 3) weak civil service capacity, exacerbated by the emphasis on centralized planning; and 4) the emerging civil war which devastated much of Mozambique's countryside and infrastructure.

The GRM implemented Marxist policies that centralized economic planning. Physical controls over production, allocation and prices were instituted and resources were concentrated in large capital-intensive agricultural and industrial investments in the public sector. Mozambique inherited an economy largely geared to service the raw materials requirements of Portugal and the manpower needs of neighboring countries (which, of course, meant that it was neither physically nor economically integrated). Few Mozambicans were employed in the modern sector, especially in managerial positions.

Immediately post-independence, high priority was assigned to social services, particularly health and education. The GRM committed itself to the establishment of an expenditure program with emphasis on poverty alleviation, including a massive program of expansion of social services with an emphasis on primary education, adult literacy and primary health care. However, the combined effects of macroeconomic mismanagement (thereby reducing real resources available to the social sectors), population growth (augmenting service demand) and widespread destruction and disruption caused by the war, led to a substantial decline in service delivery capability and jeopardized its sustainability.

After a brief recovery in 1977 and 1981, the economic situation deteriorated under the combined effects of the civil war and a misguided development strategy based on central planning and heavy government intervention in the productive sectors. In agriculture, state farms and production cooperatives were established on the large estates abandoned by their pre-independence owners and on communal lands. Communal villages were established and in some cases people were forcibly relocated. The Government accumulated a substantial external debt to finance inefficient and nonsustainable mechanization and irrigation schemes on state farms while the smallholder sector, which accounted for almost all of the country's food production, was deprived of basic agricultural services and penalized by the GRM's macroeconomic policies and the inefficiencies of parastatals. Also, smallholders were gradually isolated from markets by the disruption of the private marketing network and the destruction of road infrastructure brought about by warfare in the region and growing internal conflict.

As a result of civil war in neighboring Zimbabwe, and due to unpopular Marxist policies internally, the Mozambican National Resistance (RENAMO), initially created and financed by external sources, was able to mount an increasingly effective war of sabotage and destruction in Mozambique in rural areas from the late 1970's until 1992.

3. *Economic Collapse: 1981-1986*

In the early 1980's the Mozambican economy experienced a marked and sustained decline in output, increasing economic distortions and financial imbalances, largely as a result of widespread insecurity in rural areas, periodic natural disasters and the application of inappropriate economic policies. In the decade to 1986, overall production fell about 30 percent, exports declined by 75 percent, and imports fell by 30 percent. External imbalances, aggravated by an increasingly overvalued exchange rate, led to substantial arrears in external debt service. Domestically, large fiscal deficits and unconstrained bank financing of enterprise losses led to a tripling of the money stock (within the context of shrinking output). Centralized control of prices and distribution further hindered the efficient allocation of resources, leading to shortages, inflation and a widespread movement to barter and parallel market activities for goods and foreign exchange.

Production dramatically collapsed between 1981-1986. Real GDP declined at an average annual rate of 3.5% per year with a similar decline in real per capita consumption. The steepest decline occurred in the industrial and transport sectors. Although the subsistence sector proved rather resilient, the decline in the agricultural sector was also severe, with a fall in agricultural GDP estimated at about 5% per annum. By 1985, cotton and sugar production had collapsed to 9 and 16 percent, respectively, of their 1980 levels. The production of tea and cashew nuts, which together contributed a third of the country's total exports, fell to around 30% of their 1980 level. Between 1981 and 1986, the marketed production of maize and rice declined by about 50%. Although it is difficult to assess the production of subsistence agriculture, it is estimated that climatic problems and the massive displacements of populations led to a substantial decline in food production and that per capita food production in the subsistence sector may have fallen by as much as 30% between 1981 and 1986. As a result, the country became heavily dependent on foreign aid to guarantee a minimum level of food security to its population in urban centers but also in some rural areas. Although the endemic lack of basic security since independence and multiple natural disasters contributed to this poor economic performance, a clearly inappropriate policy regime also made a major contribution to this performance. For example, over the 1980-1986 period the GRM's total fiscal deficit, including grants, averaged 13.7% of GDP, while the total deficit, excluding grants, averaged 16.3% of GDP. An average 52% of these deficits were financed through expansion of the money supply (domestic bank financing). Based on a conservative estimate of the "appropriate" exchange rate, the average degree of exchange rate overvaluation for this period was 81%, i.e., a devaluation of 81% would have been required to reach the appropriate rate.[1] Real interest rates were negative, averaging a negative ten percent (-10%) for the 1980-1986 period. With the exception of monetary growth, policy performance worsened significantly during the 1984-86 period. The fiscal deficit (including grants) increased to 14.9% of GDP and almost 76% of this increased deficit was financed through the domestic banking system. Combined with the reduced growth in the money supply, these fiscal developments severely constricted credit to other sectors of the economy. The metical's overvaluation worsened, requiring an average 85% devaluation to reach an "appropriate" rate. Due to the increase in the rate of inflation, real lending rates fell to a negative 18.7% (-18.7%). By 1986, it was clear that economic policy reforms had to be implemented if there was to be a turnaround from the deteriorating conditions which characterized this period.

4. *Economic Adjustment: 1987-1994*

By 1987, 60%-70% of the population was absolutely poor and Mozambique's social indicators were among the worst in the world. Much of the rural infrastructure had been neglected or devastated by more than ten years of civil war. A third of all health units and half of the primary schools had been destroyed. Much of the service networks were inoperative or barely functioned. Most enterprises had been nationalized or taken over by the state as "intervened" companies. The industrial sector was paralysed (output was only one-third of the 1973 level). The agricultural sector had reverted to subsistence levels. The consequence was a sharp fall in Mozambique's import capacity as exports fell by over two-thirds. Aid dependency had become extreme: because of the sharp decline in production and

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[1]As an indication of the conservative nature of the estimated appropriate exchange rate, the parallel market rate, expressed in meticais per U.S. dollar (MT/US$), was approximately 40 times the official rate in 1984, while the "appropriate" rate used in this calculation was only 4.5 times the official rate. The appropriate rate is based on a purchasing power parity projection using the exchange rate initially established when a market-based system was introduced in Mozambique.

exports, 90% of marketed grain in the country had to be provided through emergency assistance. External debt was unmanageable with Mozambique's debt stock equal to 3.5 times GDP and 45 times its exports by 1986.

In 1987, the economy was a morass of interlocking problems. Even understanding the situation was difficult, let alone disentangling the issues and implementing remedial action. Enterprise profits and losses meant nothing because domestic prices were all out of line with world prices and there was no incentive to improve profitability. Profits were handed over to the Ministry of Finance (MOF), while operating losses were covered by subsidies and investment was financed by grants. The Bank of Mozambique, the central bank, was a typical mono-bank in a centrally-planned economy, ostensibly performing both central banking and commercial banking functions, but in reality acting as the accounting arm of the MOF. The exchange rate was grossly overvalued. Moreover, the information base was abysmal. Enterprise, banking and government accounts either did not exist or were in disarray. While Mozambique's economic problems were among the most difficult in the world to resolve, the country's human and institutional capacity to design and implement remedial action was among the weakest in the world, with very few graduates in the country and no possibility of adding to national capacity except by training a new generation of Mozambicans.

In order to stop the country's economic deterioration, the GRM adopted a comprehensive Economic Rehabilitation Program (ERP) in 1987, which represented a dramatic change in the country's economic development strategy. Under the ERP, and the subsequent Economic and Social Rehabilitation Program (ESRP) of 1989-1990, major reforms were introduced to move toward a market-based economy. Macroeconomic imbalances were reduced through a realignment of the real exchange rate, a reduction of the fiscal deficit and movement toward elimination of deficit financing by the banking system; the comprehensive administrative controls over prices and marketing that characterized the early 1980's began to be dismantled; major steps were taken to improve the terms of trade in favor of agriculture; and measures were taken to start removing the structural bottlenecks inhibiting a supply response, e.g., rehabilitation of the transportation network, availability of inputs and consumer goods.

In the initial period of adjustment (1987-1989), priority was given to making a start on reducing financial distortions (prices and the exchange rate), decreasing administrative controls over economic activity, rehabilitating state enterprises and mobilizing domestic resources. These actions required progress towards improved transparency (sorting out the accounts and information so that it would be possible to know what was going on, and rationalizing prices to provide better information on performance and desirable investments and to provide incentives to improve efficiency).

In the next five years (1990-1994), the GRM established a more market-oriented foreign exchange system, initiated financial sector reform, freed domestic trade and controlled prices, continued enterprise reform and strengthened public expenditure (incorporated more off-budget items). The GRM's implementation of the program was complicated by a number of deep structural problems and severe external shocks. Aid from and trade with the former Soviet Union collapsed in 1991 and Mozambique lost key markets, particularly textiles, in Eastern Europe. The civil war worsened which caused an increase in the percentage of displaced households from 30% in 1988 to over 50% in 1992. To further exacerbate the situation, the agricultural sector was devastated by the most severe drought of this century in 1991 and 1992.

The economic collapse of the 1981-1986 period was arrested under the ERP and ESRP. Real GDP growth averaged 9.8% during 1987-1991. However, real GDP growth contracted by 0.8% primarily because of the drought and a slowdown in industrial activity. All GDP expenditure components fell in 1992 except for public consumption which increased by 8.9 percent, largely as a result of the emergency expenditures related to the drought. In 1993, real GDP grew by 19% in response to the end of the war and the drought and increased the demand for goods and services created by the establishment of the U.N.'s third largest peacekeeping operation in the world. Real GDP growth in 1994 is expected to be a respectable 5.2% (7.7%, excluding trade).

Trade reform was undertaken including a rationalization and reduction in some tariffs, with specific taxes replaced by ad valorem rates, a significant reduction in the large number of rates, a lowering of rates and the dismantling of quantitative restrictions. Mozambique is continuing to simplify its foreign trade regime. It has gradually reduced the number and spread of import tariffs since 1991 and has authorized import licenses automatically (except for products included on a negative list). All export retention schemes have been abolished. A package of measures was implemented in late 1993 to promote exports, including a further simplification of licensing procedures, elimination of remaining export tariffs, and a reduction in import tariffs. The external account deficit after grants reached $316 million in 1993 (85% of exports of goods and services). In 1994, merchandise exports only increased to $148 million, while imports were $1 billion (75 percent of which was financed by donor import support funds). Mozambique will continue to need substantial foreign aid over the short to medium-term, as well as additional debt relief on highly concessional terms from Paris Club and other official bilateral creditors.

Mozambique concluded all bilateral agreements with creditors under the March 1993 Paris Club agreement (its fourth) except with Italy and Japan. Mozambique made substantial efforts to obtain agreements with non-Paris Club creditors on terms comparable to those granted by Paris Club creditors. Rescheduling agreements were reached with both Paris Club and non-Paris Club bilateral creditors in 1994. Despite significant debt relief, Mozambique still has an external debt of over $5 billion, mostly owed to bilateral creditors. Debt rescheduling on concessional terms helped lower Mozambique's debt service ratio to 21% of exports of goods and services in 1993 but this still represents a heavy burden on the country's budgetary and external resources.

The official exchange rate was devalued by about 76% in real terms between 1986 and 1990 but foreign exchange and credit allocation remained administratively managed. The foreign exchange system moved toward a market-based system and regular devaluations reduced the premium on the parallel exchange rate from 150% in 1990 to less than 10% by the end of 1993 and averaged 13% during 1994. The metical (MT) only depreciated by 26% against the dollar in 1994 (compared to 81% during 1993), largely as a result of the infusion of funds under the World Bank's Second Economic Recovery Credit. Convergence of the official and parallel rates has proven difficult, partly because of Mozambique's extensive borders which, exacerbated by the current tax and customs regime, invites smuggling (particularly to and from South Africa). By operating on the parallel market, importers evade payment not only of tariffs but other taxes.

Significant progress was achieved in improving financial incentives. Products with fixed prices accounted for about 30% of GDP in 1989 compared with 70% in 1986. A more significant breakthrough occurred in July 1993 when the GRM decreed that prices on a large number of food goods were liberalized in the pursuit of "development of free competition in the market." Maize meal, cooking oil and rice were among the goods covered in this decree. Prices of 22 more products were freed in August 1993. Administered consumer prices are now limited to two basic foodstuffs (wheat flour and bread), rents, fuels, utilities, newspapers and certain hotel tariffs and transportation fares. The conditioned price system which applied to eight goods produced under monopolistic conditions was eliminated in April 1994. The GRM is planning to revise urban residential and commercial rents in 1995 which have been basically frozen since 1991.

Considerable fiscal adjustment was carried out and fiscal performance was better than targeted under the IMF Structural Adjustment Facility (SAF). The revenue base was strengthened with fiscal revenues increasing from 13% of GDP in 1986 to over 22% in 1990. Some progress was made in prioritizing public expenditures. The budget slowly became more transparent and coherent with national development priorities. Budgetary coverage was widened by including previously off-budget items amounting to about 10% of GDP in 1990. A rolling three year investment plan was formulated which led to a reallocation of investment towards the social sectors, agriculture and transport (away from large-scale capital-intensive projects in agriculture). To raise the efficiency of existing investment in the social sectors, recurrent expenditures were increased. The inefficient National Food Distribution System was phased out, food subsidies were virtually eliminated, and a safety net targeted to a segment of poor urban households (those without earning potential) was established in 1992.

Fiscal policy aimed at mobilizing domestic and external resources while reducing monetary financing of the budgetary deficit. The fiscal deficit before grants remained at nearly the same level (29%-30% of GDP) in 1990-1993 but the fiscal deficit, after grants, fell from 12.3% to 3.4% of GDP during the same period. However, in 1994 the fiscal position considerably weakened with the fiscal deficit, before grants, reaching 30% of GDP and, after grants, 9% of GDP.

Enterprise reform succeeded in privatizing about 370 small and medium-enterprises from 1987 to September 1994. However, reform of large enterprises moved much slower. The main burden of reforming the financial and enterprise sectors lay ahead. The main focus in the enterprise sector was on creating a clear legal and institutional framework for privatization (even if this slowed down privatization). All state enterprises with the exception of strategic enterprises that provide essential public goods and services were to be privatized, transformed into commercially-oriented public enterprises or liquidated. By the end of 1993, most state farms had ceased production or had been privatized. Progress on privatization of large enterprises, however, was extremely slow and no major enterprises were privatized during this period. The gross value of output of enterprises sold prior to 1994 was only one percent of total gross industrial output. By mid-1994, approximately two-thirds of gross industrial output remained under the control of state-owned enterprises. Loss-making operations of many state firms have been covered partly through direct budgetary transfers (less than one percent of GDP), but mostly through indirect transfers. Large state industrial firms account for a high percentage of the non-performing loan portfolio of the banking system, in particular the Commercial Bank of Mozambique (BCM), the largest state-owned bank. Inevitably, this transfer of resources to loss-making state enterprises has crowded out access to credit by the private sector, further constraining industrial output recovery. However, there was an increased effort on the part of the GRM in the latter half of 1994 and early 1995 regarding privatization of large enterprises. As of February 1995, 19 large enterprises had been privatized and 10 more were in the process of privatization.

In contrast to other areas, implementation of financial sector reform in the first few years of adjustment moved much slower than expected. Separate legislation was developed with a new Central Bank Act in 1991 and a Banking Act in 1992 which established the legal and institutional framework for prudential regulation and supervision of the banking system. The separation of the central banking functions and the commercial banking functions of the Banco de Moçambique (BM) was achieved in 1992 (as opposed to the 1990 target date). A separate commercial bank, Banco Comercial de Moçambique (BCM), was established and the staff from BM were divided between the two institutions. Regulations and procedures were issued for licensing of new banks and two private banks were licensed and began operations.

Progress towards enhancing transparency of the financial system, however, revealed that severe distortions existed and there were greater imbalances in the financial and enterprise sectors than had been initially realized. Explicit budgetary subsidies to state enterprises were reduced from 8.5% of GDP in 1986 to less than one percent of GDP by 1992. However, implicit subsidies have proven more difficult to eliminate. Stricter explicit credit rules were imposed and the GRM adopted the principle that bank loans would not be granted to cover operating losses of public enterprises (following its assumption in 1987 of financial responsibility of bad loans of public enterprises--which amounted to 14% of GDP). Nevertheless, the publications of BM and BCM's accounts in 1993 revealed that substantial additional credit to public enterprises had in fact been provided from 1987-1992, with the accumulation of non-performing loans assigned to BCM (roughly 7% of GDP).

In addition, the GRM failed to effectively control monetary expansion. Part of this was related to the separation of BM and BCM, including the final assignment of certain foreign exchange assets and liabilities and the fact that BCM could not comply with the requirements of the adopted banking regulations. Other issues include the increase in interbranch assets liabilities of the two state banks and an expansion in inter-enterprise liabilities. This occurred as tighter lending criteria were adopted in 1993 and explicit credit to public enterprises was effectively stopped. Imbalances in the financial sector reflect underlying real problems in the enterprise sector. Large information gaps still exist on critical variables of enterprise behavior and efficiency. Savings mobilization has also been very poor. Financial repression has forced a great deal of financial activity into the informal sector as a result of the lack of implementation of banking system reforms, the lack of banking services and the poor returns on financial savings.

The GRM has had partial success in stabilizing the economy. The rate of inflation decelerated from 163% in 1987 to 33% in 1991, in line with tighter fiscal and monetary policies. In 1992, inflation accelerated and peaked at 55% in December 1992, mostly on account of the drought. Despite normal rainfall and efforts to eliminate various financial leakages, inflation reached 43.6% by December 1993 (well above the program target of 30 percent). The situation deteriorated significantly in 1994 with inflation reaching 70.8% by the end of December (again, as in 1993, above the program target of 30 percent). The program target for inflation in 1995 is an ambitious 24 percent.

Despite the initial gains of the ESRP, deep structural problems continue to hamper Mozambique's economy. With a per capita income of about US$80, Mozambique is one of the poorest countries in the world. Mozambique remains heavily dependent on external aid inflows and has requested $1.5 billion in assistance at this Consultative Group meeting. The tables below summarize Mozambique's socio-economic position.

Table 1. Social Indicators of Development

Indicator	Mozambique	Sub-Saharan Africa	Low-income Economies	Middle-income Economies	Upper Middle-income Economies	High-income economies
Life Expectancy at Birth (in years) 1991	47	51	62	68	69	77
Adult Illiteracy (percent) 1990	67	50	40	21	14	4
Female	79	62	52	26	17	5
Infant Mortality Rate (per 1000 live births) 1991	149	104	71	38	34	8
Infant Child Mortality Rate 1991						
Female	265	167	96			
Male	294	186	104			
Primary School Enrollment Rate (%) 1990	58	68	105	103	106	104
Primary Pupil/Teacher Ratio 1990	58	41	38	25	25	17

Source: World Development Report 1993, World Bank.

TABLE 2: MOZAMBIQUE-- SELECTED ECONOMIC AND POLICY INDICATORS

Indicator		1990	1991	1992	1993	1994
Real GDP Growth Rate		1.0	4.9	-0.8	19.2	5.2
Inflation Rate (end of period)		47.0	35.2	54.5	43.6	70.8
Current Account Deficit (% of exports of goods and services)	Including Grants	106.0	64.8	66.0	85.1	NA
	Excluding Grants	255.6	202.2	204.0	220.4	NA
Fiscal Deficit (% of GDP)	Including Grants	11.8	5.5	5.7	3.9	9.0
	Excluding Grants	28.7	24.9	26.5	20.8	30.0
Net Domestic Financing (% of GDP)		1.7	-1.0	5.1	5.9	NA /1
Debt Service Ratio	Before Rescheduling	162.3	134.2	144.5	133.4	NA
	After Rescheduling	90.7	84.7	88.3	30.5	NA
Net Domestic Assets		37.2	13.1	40.2	100.1	NA /2
Money Supply Growth		37.1	35.7	59.3	78.7	NA /2
Gross Domestic Savings (% of GDP)	Public Sector	2.0	3.3	2.0	2.0	NA
	Private Sector	7.2	9.2	10.6	13.2	NA
Gross Investment (% of GDP)		59.0	60.8	64.5	65.5	NA

Source: Bank of Mozambique, IMF and USAID Estimates.
/1 Was less than the 1994 program target level.
/2 Exceeded the 1994 program target level.

5. *Statistical Note*

The quality of statistics in Mozambique is truly appalling. GDP is compiled only in terms of uses of resources (consumption, investment and net exports). Intermediate consumption data is not available which precludes any estimates of value-added. Private consumption is compiled on the basis of the estimated private sector wage bill and autoconsumption. Gross investment excludes changes in stocks because of the lack of reliable data. Data for savings and investment are essentially residuals calculated from other numbers that are problematical. Gross output merely measures the gross value of transactions as opposed to value-added. The Consumer Price Index (CPI) is based on a 1984 Maputo household expenditure survey with 10% weight given to two vegetables: cabbages and tomatoes. Although efforts have been underway to improve data collection, unless significant improvements are made in the near future, the efficient economic management of Mozambique's economy will be very difficult, if not impossible.

IV. WORLD BANK AND HOST GOVERNMENT EXPECTATIONS FOR THE CG

The GRM's principal theme for the CG meeting will be to mobilize pledges from donors to support the post-election economy. The World Bank's and GRM's expectations for the CG are to generate sufficient donor pledges to support the adjustment program, and continued economic growth as well as the democratization process. The financing to be requested in support of the adjustment program totals approximately $1.5 billion.

While the specific discussion of the GRM's economic policies will depend on the points raised by various donors, the Bank expects that three areas will receive special attention, all of which are inter-related. First is the question of transparency and accountability. Related to the first area, underlying this broader discussion should be: role and capacity of government, the budgetary process, civil service reform, decentralization, and governance in general, including the need to reduce corruption.

The second area is the policy and regulatory impediments to private sector activity and investment, in particular the industrial sector. Key components will be the slow pace of privatization, the formidable constraints to investment and establishing a business as well as the tax and customs regime.

The third area will be fiscal policy, particularly regarding the expected budget reduction as the level of counterpart funds falls as donor resources decline (due to overall reductions in donor foreign aid budgets and increasing requirements for other regions). In particular, the Bank is concerned about the effect of this decline in donor support on the investment and recurrent budgets, the lack of transparency and accountability in the budgetary process and the urgent need for tax and customs reform.

V. RECOMMENDED U.S. POSITIONS FOR THE MEETING

A. General U.S. Position

The U.S. wishes to join with other donor countries in applauding the efforts of the newly elected Government for its apparent commitment to setting a new course for the development of Mozambique. However, our praise for these first efforts must be tempered with a realization of the substantial issues which remain to be addressed if Mozambique is to sustain its economic recovery and achieve sustainable economic growth.

As a result of intensive donor pressure led by the U.S., the 1995 budget contains some important first steps in realigning the country's spending priorities. A real increase of 46% in health and education and a real decrease of 37% in defense are to be applauded, although expenditures in the social sectors remain far below the proportion devoted by other governments in the region. The decrease in defense is also somewhat offset by a 29% real increase in security expenditures. There is an overall 15% decrease in defense and security combined. These changes are significant but the GRM's commitment and ability to accelerate economic and social development remains in doubt. As a consequence, the U.S. should attempt to continue its assistance program at approximately the current levels of assistance or higher only if measurable progress is achieved both politically and economically.

As discussed below in greater detail, the GRM faces a number of difficult challenges in its attempt to accelerate economic and social development. The outcomes for two critical macroeconomic variables in 1994 are warning signs of insufficient economic stability and unproductive resource use. As the IMF has reported, inflation and money creation are far too rapid and, if not brought under control, will choke off economic growth. Donors will be watching for indications midway through the year that the GRM is achieving greater discipline in this aspect of macroeconomic management and meeting IMF benchmarks with respect to both fiscal and monetary targets.

If the GRM achieves lower rates of inflation and money creation, and if progress is made in defining a substantial economic policy reform program, the U.S. could consider an increase in its economic assistance program for FY 1996. On the other hand, if the GRM fails to achieve greater economic discipline, the U.S. should not consider increasing aid and may decide not to maintain its investment in Mozambique's economic development at current levels.

This post-election time period presents Mozambique with a unique opportunity to redefine the government's role and bring about greater social and economic development. From the point of view of structural adjustment, three variables will affect the definition of that new society. One, with the successful completion of last October's elections, there is an opportunity for more participation and consultation in decision-making, be they political or economic. Two, Mozambique will, as will most other countries receiving donor assistance, operate in a context of declining foreign assistance. Budget support through donor assistance to balance of payments will suffer a sharp decline. Three, the role of investment, both domestic and foreign, will be increasingly important. The currently stagnant to falling levels of investment need to be reversed. To do this, Mozambique needs to address the lack of confidence in the private sector, the slow rate of privatization and severe constraints in the business environment, including taxation, tariffs, licensing requirements, and customs.

Mozambique needs to redefine the roles of government, the private sector, non-governmental organizations, and individuals.

Maintenance of assistance levels will be strongly influenced by transparency and accountability for public funds, progress in implementation of policy reforms, and the results of programs and projects on the ground. Despite the results of the ESRP, most Mozambicans are only marginally better off today than they were when the program was initiated. Now that the war is ended and various emergency programs come to a close, the GRM needs to effectively use its resources, including those from donors, to alleviate the extensive poverty that exists in Mozambique. A significant acceleration in the pace of reform is needed. A clear presentation of a strategy for economic growth and development, based on a realistic assessment of available resources and Mozambican human resource capacity will enable the donor community to improve the effectiveness of its resource transfer and mobilize in such a way as to be more responsive to domestic concerns. Such a strategy will need to include a redefinition of the government's role and an indication of consultation with the private sector, nongovernmental organizations, local communities, and donors. To facilitate the assessment of resources and absorptive capacity, the level of donor coordination, despite great progress made in 1994, needs to be continually improved and broadened.

While the GRM and the donor community have made significant responses to overcome the effects of war and periodic natural disasters, conducting the first-ever, multiparty national elections and mounting other special programs, deep structural problems still exist. Of particular concern to the USG are the issues discussed below.

B. Specific Issues

Mozambique has a generally good, but very uneven, record in implementing its economic adjustment program. The U.S. delegation should indicate our support for the adjustment program. However, while expressing appreciation of the dilemma faced by the GRM in addressing the myriad of critical short and medium-term problems, the Delegation should urge the GRM not to allow the multitude of issues and requirements to divert their attention from the continued necessity to implement the adjustment program. In the interim, while Mozambique is redefining the role of government, the private sector and other participants in the economy, the U.S. delegation should stress the importance of the GRM continuing reforms in the following areas. We recognize that many of these reforms will take considerable time to formulate and implement fully. Some, however, can be accomplished more swiftly, i.e., within the next few months. The GRM should set as its twin goals meeting IMF fiscal and monetary targets and immediately beginning the implementation of other needed reforms.

The areas for critical attention are:

- reduce inflation and accelerate financial sector reform;
- budget reform;
- improve land tenure security for smallholders and improve the transparency of the land concessions;
- tax and customs reform;
- improve the business and investment climate, including privatization efforts; and
- implement civil service reform and create a transparent environment for decentralization to take place.

Issue 1. Inflation/Financial Sector Reform

Discussion: Inflation continues to be the major source of macroeconomic instability. Inflation for 1994 reached 70.8% by the end of December. Money and credit expansion led to a significantly higher than programmed target for inflation in 1994. By the end of December, the accumulated rate of inflation was 70.8% (versus the program target of 30%). The rapid expansion of monetary aggregates adversely affected price performance in early 1994 as it did in 1993. High rates of inflation pushed the Central Bank nominal rediscount rate up to 69.7% in November 1994. Unlike inflation in previous years, this could not be blamed by the GRM mainly on the devaluation of the metical and the consequent increase in the price of all imported goods. The metical/dollar rate on January 1, 1994 was 5,406 to the dollar. By the end of October, the rate had only depreciated to 6,517, an accumulated devaluation of only 21 percent. Furthermore, there was no longer any vast differential between official and parallel rates (the differential was maintained at around 13 percent, on average, throughout the year). Part of the cause of inflation was the rise in prices that took place in early 1994, which reflected the effect of the rapid growth in the money supply at the end of 1993. In addition, there was the announcement of the Concertaçao Social in April 1994, an agreement between the GRM, the trade unions, and the main traders, which tried to set maximum prices for basic foodstuffs[2] which created considerable concern about future scarcities. In the second half of 1994, there was a further increase in the amount of money in circulation, partly due to the increase in the minimum wage decreed in June and the demobilization payments made to tens of thousand of soldiers returning to civilian life. Political parties, particularly FRELIMO, also spent large amounts of money during the electoral process. The presence of the U.N. peacekeeping force in 1994 (as in 1993) also played a role as they spent more than $1 million per day, much of which entered the local economy.

However, as in 1993, the increase in net domestic assets was significant, particularly in other items net (unidentified assets and liabilities) of the banking system. The significant increase in monetary aggregates in 1994 will put the GRM out of compliance with the IMF program targets (for, inter alia, net domestic assets, money supply and the bank-by-bank credit ceilings) and will further exacerbate the current liquidity crisis. Inflation remains a primary

[2] Although officially announced, it was never put into practice as evidenced by prevailing prices in the markets. The action, to which the GRM was only a "signatory" agent, was primarily done to appease labor unions, who have seen their purchasing power significantly erode over the last five years, before the elections.

concern and the reform of the central bank as well as reforming instruments of monetary policy, financial policy and enterprise reform are important steps in addressing the root causes of inflation, which has been a major source of macroeconomic instability for several years.

Commercial banking is dominated by the BCM, one of two state-owned banks. BCM holds 70% of the assets in the commercial banking system and is the principal financier of the enterprise sector which is the principal source of formal employment in urban areas. Fifty percent of BCM's loan portfolio is non-performing and is primarily to state enterprises. BCM, the bank with the largest credit ceiling, accounts for 65% of total commercial bank credit. As a result of the reform process, BCM now competes with private banks for foreign exchange business but still utilizes 97% of donor import support funds (which finance 75% of total imports).

Management of BCM is a major source of macroeconomic instability. In 1994, it significantly exceeded its credit ceilings. During the first eight months of 1994, its overdraft position at the central bank went from 0 meticais (MT) to MT447 billion (its position improved somewhat by the end of the year thanks to the infusion of donor import support funds), the level of credit extended increased by 50 percent, its liquidity decreased by 32%, and other items net (OIN) increased by 67 percent, particularly as a result of inter-branch debts which almost doubled. BCM has already been recapitalized twice with donor import support funds: once to deal with pre-1987 debts and again in 1993 to deal with pre-1992 debts. It appears that its continued poor performance may require a third recapitalization.

Recommended U.S. Position: The GRM, especially the Bank of Mozambique, should implement the existing monetary and financial conditionalities under the World Bank and IMF programs. In particular, the following should be observed:

- Make sure the bank-by-bank credit ceilings are implemented and observed;
- Remove implicit subsidies to non-performing public enterprises through the banking system;
- Immediately privatize or liquidate BCM.

Issue 2: Budget Reform

Discussion: The lack of transparency in the budgetary process has become a major concern for virtually all donors. The GRM has not closed its budget books since 1977 and has not published an executed budget since 1991. Although the GRM and major donors established a budget working group in 1994, progress has been relatively slow. The executed investment budget for 1993 is still not available. Shifts in budgetary priorities are inadequate, in particular the importance of defense and military current expenditures compared to health and education expenditures. The announcement in late February 1995 of a 50% cut in defense salaries and 30% cuts in goods and services for the military and a 50% increase in education and health is a step in the right direction. The executed budget showing the implementation of those cuts will be equally important.

Fiscal policy in 1994 continued to aim at decreasing the underlying budget deficits (before and after grants, in terms of GDP) as well as reducing the GRM's outstanding debt to the banking system. Although the program envisaged substantial special expenditures related to demobilization and elections, the GRM was expected to repay at least MT151 billion (2% of GDP) to the banking system (compared to the MT51 billion recourse to the banking system in 1993). Early indications are that this did not happen in 1994. The fiscal deficit, before grants, increased substantially to 30% of GDP in 1994 (the target was 25% of GDP) and 9%, after grants, of GDP. There was a $150 million shortfall compared to expected grant financing in 1994, leading to a marginal increase in the fiscal deficit to a total of $512 million. Revenues declined below programmed levels and expenditures significantly increased, particularly investment expenditures.

Net proceeds from the privatization program are targeted to help finance the budget. There has not been much revenue generation to date, given the slow pace of privatization. The GRM's policy has been to minimize subsidies by only providing budgetary transfers to those enterprises that were adversely affected by the war. Explicit enterprise subsidies were targeted not to exceed 0.4% of GDP in 1994. However, there is some evidence that significant implicit subsidies to enterprises has occurred as evidenced by increases in other items net in the monetary accounts. Such implicit subsidies are acting as a significant drain on budgetary resources and creating problems in monetary policy. It has been extremely difficult to impose hard budget constraints on public enterprises operating in 'strategic sectors,' because there are so many subtle ways of extending or tolerating indirect fiscal transfers, giving rise to soft budget constraints (negotiable subsidies or taxes, non-payment of dividends or counterpart funds, delinquency on debt service, credit reschedulings, enforceability of suppliers' contracts, fungibility between investment and current expenditures). Regardless of when the inevitable cleanup operation is implemented, significant pressures will be placed on the GRM budget as the unliquidated non-performing assets of public enterprises will have to be transferred from the commercial banks to the treasury. This will obviously place further pressure on an already overstrained budget, especially if the level of donor funding declines.

Defense and security expenditures, including special payments such as those made to demobilized soldiers, were 41% of total current expenditures in 1994 (31%, excluding the special factors). Health and education current expenditures accounted for 11.5% and 6.5%, respectively, of total current expenditures.

Given the pressing needs of the country, this continuation of high levels of expenditure on defense and security is quite simply indefensible. For the first time in its history all of Mozambique's neighbors have democratic governments who are interested in Mozambique's economic success and political stability. There is therefore no external threat. The war is over and if democracy functions as it should, any internal threat should be no more than a police problem. In addition, donor funds are declining overall especially as the emergency/transition phase comes to a close. Mozambique's *current expenditures* on defense and security represented 7.6% of GDP in 1993 compared to the Southern Africa regional average ratio of total military expenditures to GDP of only 3.7 percent[3].

In 1994, health received 16% of total investment expenditures. Education received only 12%. As a result, over half of the primary school age children will receive no education this year because of the lack of funds, teachers, facilities, and material. Agriculture received 16 percent. Donors finance 70% of the total investment budget, over 90% of the health investment budget and 71% of the education investment budget.

The implementation of the National Reconstruction Program (PRN) is placing further constraints on the budget, especially because external financing is not sufficient. The PRN has two tracks: 1) reintegration of refugees and the internally displaced and the demobilization and reintegration of the armed forces into civilian productive life, while concurrently establishing a framework for rural development at provincial and district levels which incorporates all emergency activities; and 2) redirecting the thrust of the public sector investment plan toward a sectoral program, rather than a project, approach to address fundamental problems, and shifting and encouraging greater private sector investment in sectors which address these same fundamental problems, including the expansion of employment and income opportunities (especially in agriculture). These additional financing requirements must involve compensatory domestic measures rather than recourse to bank financing in order to stay within the IMF/GRM fiscal targets OR greater private sector financing of necessary investments. Given that 70% of the investment budget is financed by external aid, sustainability comes into question, unless the government redefines its role in the productive sectors. In addition, the level of recurrent expenditures to cover the maintenance and operating costs of priority sectors are grossly inadequate to meet minimum quality standards, particularly in the social sectors. A basic weakness of the PRN as an investment strategy for the GRM and the donors is the lack of clear priorities which include a realistic assessment of financing limits.

Recommended U.S. Position:

- in 1996 no more than 10 percent of the budget should be allocated to defense and security expenditures;
- continue in 1996 with further significant increases in the level of health and education expenditures, including a major shift from tertiary to primary levels;
- continue to increase the transparency of budgetary operations, including the development of a timely public debate. In particular, the previous year's executed budget should be published no later than June of the following year;
- improve coordination among GRM ministries and between donors, particularly regarding the development and implementation of the investment budget; and
- establish country priorities based on a clearly articulated strategy, a realistic appraisal of available financing, and redefined roles of the participants.

[3] This is based on the latest available data. The regional average excludes Mozambique and Angola.

Issue 3: Land Tenure

Discussion: Security of land tenure, including buildings and land in urban centers, is essential to encourage private sector investment, domestic and foreign. An agriculturally based growth strategy is highly dependent on secure tenure by all participants--smallholders, small and medium farmers, large agricultural enterprises, and agribusinesses. Over the last seven years, land access, land rights and land tenure security have become serious points of contention between various social and economic groups throughout Mozambique. The resulting conflicts and tensions have the potential to undermine economic and political stability. Mozambique has approximately 80 million hectares of land, with roughly 36 million hectares of arable land. Preliminary research indicates up to half of this has been granted as concessions to parties other than smallholders, squeezing smallholders out. There are essentially two different mechanisms for land concessions, i.e., legal and extra-legal concessions. Legal concessions are being granted by a variety of government agencies, the central government, individual ministries and provincial authorities. In some cases, the different levels of government have granted the same or overlapping concessions to different parties. Extra-legal concessions involve tracts of land granted by government agents without authority or by occupation by the "owner." Similar patterns are occurring in all provinces. There appears to be no mechanism for the government to track or monitor the land concessions that are being granted. There is some evidence that private interests receiving land concessions are speculators rather than private investors, which has economy-wide implications. Smallholders will be unable to compete for productive land and will become further marginalized. Given the structure of the agricultural sector, this implies a scenario of weakening food security.

Recommended U.S. Position: The GRM should immediately develop and implement a comprehensive land tenure policy that includes an adequate monitoring process, in order to ensure that all parties, especially smallholders, who have an equitable and participatory stake in the allocation of productive agricultural land.

- o The GRM should reactivate a Land Commission that is not ad hoc, reporting to the Prime Minister.
- o The Land Commission should define its objectives and an action plan to achieve those objectives for presentation at the next CG.

Issue 4: Tax and Customs Reform

Discussion: While the GRM is facing severe budgetary pressures as it seeks to redress the devastation caused by the war, periodic natural disasters and inappropriate economic policies, by its own admission fully half of customs and tax revenue is not collected due to corruption and inefficiency. The deficit, after grants, has been overwhelmingly financed by foreign borrowing. The lack of own resources to finance development is painfully obvious. Donors finance 70% of the investment budget, 75% of imports and over 40% of the current budget. Gross official development assistance is well in excess of 100% of GDP. The international donor community provided over $9 billion worth of support to the economy in grants, credit and debt relief during 1987-1994.

The Mozambican business community has been increasingly vocal in calling for tax and customs reform as the current structure is prohibiting them from being competitive. Many local producers face negative effective protection in the domestic market. This results from the inability of Customs to control and enforce duty payments on competing imports while authorities seem more successful at collecting duties on inputs imported by manufacturers as well as the consumption tax and turnover tax on final output. This uneven tax collection performance is partly explained by the fact that formal sector firms are easier targets for tax authorities, particularly for the consumption and turnover tax which are collected at the ex-factory gate level. Registered companies in Mozambique are obliged to pay a number of direct (corporate, payroll) and indirect (consumption, turnover, import duties, etc.) taxes, plus assorted stamp duties associated with specific transactions. While progress has been made in rationalizing the tax regime through reductions in the level and number of tax rates, the tax burden in Mozambique remains quite heavy and constitutes a strong incentive for informal sector activities, particularly for import smuggling. Massive tax evasion has occurred because of the cascading nature of the tax system and the associated ad hoc requirements.

Leakages through Customs are particularly egregious. A recent World Bank study did a rough comparison between the revenue collected by Customs in 1993 against what should have been collected if statutory duties had been charged on recorded imports. The analysis revealed a shortfall of 55%. About one-third of the shortfall ($27 million) was accounted for by official exemptions granted under various exemption programs (donor-financed projects, diplomatic cargo and the investment code) while the remaining gap ($60 million) reflects tax evasion. However, this gap probably underestimates the shortfall because it excludes the effect of underinvoicing of imports, which is a major source of tax evasion, and because it is based on the value of imports which was reported by Customs ($598.8 million), which is well below the value of imports estimated for the balance of payments ($878 million, excluding emergency aid). The effective domestic tax burden on industry is proportionally much higher than that on imports: the value of the turnover tax collected from industry was comparable to that collected on imports ($17 million and $20 million, respectively), despite the fact that industrial output is less than half the level of imports. Finally, price comparisons between imported and locally produced goods sold in the local market confirms that many imported goods, mostly consumer goods, are actually entering the country duty-free[4].

According to the latest tax package adopted in December 1993 (described above), the corporate tax in Mozambique has been reduced from 50% to 35-45%, depending on the type of economic activity. Provisions have also been made to reduce import duties on raw materials and to exempt industrial inputs from the turnover tax. However, overall indirect

[4] The price of imported beer is a good example. Beer imported from South Africa is actually cheaper in Maputo, in spite of protective measures described above, than it is in South Africa (after the application of the 14% VAT in South Africa). The local beer industry cannot compete.

taxation on finished products is still high, particularly for consumer goods imports. While the level of import duty alone is not unreasonable at 35%, the total import tax on consumer goods amounts to a minimum of 65% when other taxes are included.[5] In addition, any move through the distribution chain would add a further 10% to the sale price. For an economy with a very low purchasing power and which is highly dependent on imports, this level of taxation is certainly too high.

Producers for the local market are therefore faced with high levels of negative protection, ranging from 35% to 439%. While the situation persists in which domestic industries pay taxes on their inputs and output, and importers of competing goods enjoy de facto tax-free status, it will not be surprising if domestic industry continues to atrophy. In addition, on account of the payment of duties and import charges, the cost of imported inputs has been estimated at 16% to 33% above world market prices for many exports. As a result, the manufacturing cost for these products is estimated at 10-22% over world prices.

Many of the taxes in the current structure are mainly nuisance taxes, e.g., the turnover tax and the stamp tax. Special forms for the turnover tax must be submitted monthly in five copies for each sale and product unit. Even minor transactions require stamp taxes. While the monetary cost of the stamp tax is modest (MT100 each), compliance costs are high as they involve time and resources for both the private and government agents. A more serious problem results from the methods used to calculate the stamp duty liabilities for specific transactions, e.g., stamp duties payable for notarization of collateral in credit transactions can be high as 7% of the value of the asset.

The high level of indirect taxation creates incentives for negotiation of ad hoc exemptions with the Ministry of Finance. This is also the case for many tax exemptions/deductions provided under the tax law (see above for details). Even in the case of tax breaks provided under the investment code, companies must undertake additional paperwork to make the benefits effective, despite the fact that the investment registration at the MOF already indicates eligibility. In addition, the high level of exemptions and deductions is heavily tilted toward civil service employees and the FRELIMO political party and related organizations, a practice that should no longer be relevant after democratic elections held last October.

Recommended U.S. Position: The delegation should recommend that by the next CG meeting that the GRM adopt and implement the necessary reforms to rationalize the structure and broaden its revenue base. This need includes continued improvements in:

- implementation of comprehensive tax and tariff reform, including implementation of a value-added tax and removal of nuisance taxes, to encourage private sector investment;
- complete overhaul of the current customs administration, including privatization; and
- the establishment of a National Commission, with public and private sector participation, to review the considerable analysis done by the IMF, World Bank and

[5] Including a minimum consumption tax (20%), a turnover tax (5%), and a customs handling fee (5%).

other donors, and recommend a comprehensive, detailed plan of implementation for tax and customs reform by the next CG.

Issue 5: Business and Investment Climate

Discussion: As part of the dialogue on the future role of the government, the role of the private sector also needs to be defined. Privatization of the remaining state enterprises needs to accelerate to help mobilize private investment, promote greater efficiency in production, and enable the industrial sector to make the needed adjustments to the new international and regional economic context. As of February 1995, UTRE, the state agency concerned with the privatization of large enterprises, had privatized 19 enterprises. However, the privatizations that took place prior to 1994 only accounted for one percent of gross industrial output. The overall business and investment climate and the severe disincentives it creates for the private sector are clearly laid out in the World Bank's CG report on the industrial sector.

Recommended U.S. Position: That the GRM, together with the private sector, define the role of the private sector, eliminate critical policy and regulatory constraints to increased investment, identified under the World Bank study, and speed up the implementation of privatization, including increasing the transparency of the process. In addition, the GRM should:

- establish a National Commission to define an action plan to address investment climate issues.
- urge the GRM to complete its privatization program by the end of next year.

Issue 6: Civil Service Reform/Decentralization

Discussion: Over the last several years, a number of issues related to the civil service and decentralization have been discussed both within and outside the CG forum. The GRM has been struggling to deal with the flight of qualified civil service employees to the private sector or outside the country. A donor initiative to supplement salaries of competent, senior, essential personnel in order to retain them within the civil service has been compromised by the GRM's extension of the program to all civil service employees. While donors recognize the intrinsic inequity of the program and the eroded purchasing power of salaries, the subversion of the program has resulted in no impact on the senior levels, and an unaffordable expansion of the budget. Unfortunately, the original proposal was inherently flawed. Retention of all employees should not be the goal of any such program. Retention of employees critical to the effective functioning of government is.

The new Government will face enormous challenges in establishing its priorities for fulfilling its mandate from the electorate. Part of the process of establishing those priorities will be to determine--from financial, human resource capacity, and management perspectives--for what and to what extent the Government can and should be wholly responsible. As a continuation of the efforts the Government has already made to broaden participation in the democratic process, a logical next step would be for the new Government to explore ways in which a broader selection of civil society can be effectively and appropriately involved.

The well-started decentralization process and the passage of the municipality law also raise issues related to respective roles, responsibilities and size of various levels of government to its citizens and between the several levels. In the period leading up to the next Consultative Group meeting, this newly elected government could begin an ongoing dialogue with its constituents on what the government can realistically be expected to deliver and what citizens can be expected to directly contribute to helping the government meet its constitutional responsibilities. The new government will have an outstanding opportunity to take advantage of the decentralization process, as demonstrated by passage of the municipality law, for instance, to seriously increase the participation of all Mozambicans in fulfilling the role of the government by boldly devolving a greater role to local communities and structures to mobilize local resources to meet their own development needs. In redefining the role of government to include developing public-private-community-nongovernmental organization partnerships, the government can place itself in the position of accessing the untapped energies and resources of its partners. The synergistic effects of tapping such resources also empower people to be responsible for their own development and not be dependent on the government for everything. This would have the double impact of significantly increasing Mozambique's contribution to its own development, thereby reducing the country's dependence on foreign aid, and enabling the country to more rapidly meet its priorities.

Recommended U.S. Position:

- the establishment of a National Commission, with public sector, private sector, and independent citizens' participation, to review the considerable analysis done by the IMF, World Bank and other donors, and recommend a comprehensive, detailed plan of immediate implementation for civil service reform and decentralization with this process to be well underway by the next CG.

C. Conclusion

Without a redefinition of government's role, based upon realistic assumptions of resources and absorptive capacity, Mozambique will be unable to effectively utilize its domestic and external resources. With declining foreign assistance, Mozambique does not have the luxury of trying to maintain the status quo. To take maximum advantage of its very real potential, the GRM must be persuaded to immediately take the steps required. For the economy that means empowering the private sector to become the real engine of growth; for absorptive capacity, that means structuring government according to available resources, both human and financial, and facilitating the greatest possible participation by Mozambicans.

VI. The U.S. Pledge

A. The U.S. Assistance Program

In November 1994, Mozambique's first ever free and fair elections were held. This landmark event transformed Mozambique from decades of war and civil strife to an era with the potential for peace, security and economic growth. The challenge is to encourage the GRM to take the bold steps required to transform the uncertainties of the present into a more secure and stable future.

The 1994 Consultative Group meeting is a watershed event. At peace with all its neighbors, and with a high degree of domestic tranquility if not consensus, the GRM should set its sights now on completing the dismantling of state management of the economy and boldly set the stage for economic freedom through open markets.

Our aid program should set as its principal goal, over the long-term, the achievement of sustained political and economic freedom in Mozambique. Only such an environment will contribute positively to increased growth, trade and economic cooperation in Southern Africa -- an important objective of U.S. foreign policy in this region.

For FY 1995, U.S. assistance retains important elements of our 1992-94 transition program, e.g., demobilization/demining support, rehabilitation of rural infrastructure, reintegration of displaced persons and emergency aid. We are also putting in place new activities to be launched later this fiscal year, e.g., rural road construction, and expanding rural production, markets and incomes through programs implemented by PVOs and Mozambican NGOs.

Under the currently budgeted program, the USG will provide approximately $59 million to Mozambique. This total includes $39 million from the Development Fund for Africa, $9 million of Title III food aid, and $11 million of emergency food aid. Of the $39 million of DFA, the Mission will apply $16.4 million to the transition program, and $22.6 million to its proposed new strategy.

1. *Transition Program*

In FY 95, the Mission will continue support for demobilization, mine clearance, and reintegration/rehabilitation. Through the Demobilization and Reintegration Support Project (656-0235), the Mission will continue assistance for the reintegration of demobilized soldiers and their families and mine clearance. Reintegration and rehabilitation assistance will continue its focus on rural communities, largely funded through the existing PVO Project ($11.8 million). In addition, USAID is completing the Rural Access Activity Project (656-0237) ($600,000) which is rehabilitating roads and bridges critical to the return of refugees, the movement of humanitarian/relief assistance, and the development/expansion of marketing networks for agricultural production.

2. *Emergency Program Phase-down*

Although national food production has increased significantly, localized serious shortages are expected in areas where insufficient seeds were available, rainfall was inadequate, and/or large numbers of internally displaced and returning refugees returned too late for planting or had inadequate amounts of seed. In FY 95, an estimated 1.8 million people will need targeted food aid. Because of the localized nature of the vulnerable population still requiring food aid, we urge even better coordination and targeting of food aid in order to begin significant phase-down of emergency and commercial food aid.

3. New Strategy

Although the proposed new strategy will not be fully implemented until FY 96, certain components which build upon activities financed under the Transition Program and core program will begin in FY 95. The Rural Access Project (656-0232) ($8.1 million) will support a strategic objective of increasing rural household income through improving market access by producers, traders and consumers. The PVO/NGO Support Project (656-0229) ($2 million) will finance grants to PVOs and Mozambican NGOs to support initiatives in increasing household income, improving maternal and child health, and strengthening civil society. The Democratic Initiatives Project (656-0227) ($3.2 million) will provide assistance for the national assembly, municipal elections and the technical secretariat for elections, as well as support for civil society, legal sector reform and decentralization of government through examination of the role of traditional authorities. Additional funding will be provided for both long-term ($800,000) and short-term ($500,000) capacity building. Based on available resources, the Market Food Aid Program ($9 million of P.L. 480 Title III resources) for FY 95 will continue to strive for policy reform while balancing food security concerns and concerns about disincentives to domestic production. The Mission will also provide a moderate ($5 million) addition to the Private Sector Support Program (656-0208), a policy-conditioned commodity import program. Three policy initiatives related to food security, land tenure security, and restoration of cashew production in the cyclone Nadia-affected areas of Nampula, will be financed through the Private Sector Support/Technical Assistance Project (656-0218) ($1.8 million). A modest $500,000 will be used for strategy completion, program monitoring and program and project development.

In summary, U.S. development assistance for FY 95 is expected to be:

- $11.8 million for rural communities for reintegration;

- $600,000 for completing the rehabilitation of selected roads and bridges which are critical to the return of refugees, the movement of humanitarian/relief assistance, and the development/expansion of marketing networks for agricultural production

- $3.2 million for civil society, legal sector reform and decentralization of government through enhancement of traditional authorities

- $8.1 million for the rehabilitation and upgrading of roads and bridges essential for the recovery and development of market networks

- $5 million for the reintegration of demobilized soldiers and their families into their communities

- $5 million will be available for the commodity import program but will be deferred until a determination is made that agreed upon policy reforms have been achieved

- $1.8 million to provide technical assistance in support of policy research related to food security, land tenure security and recovery of cashew nut production in the cyclone Nadia-affected areas of Nampula

- $2 million for improving maternal and child health status

- $1.3 million for human resource development in both the private and public sectors

- $500,00 for strategy completion, program monitoring and program and project development

We anticipate providing food aid to Mozambique during FY 95 at the level of $9 million of P.L. 480 Title III resources and $11 million of P.L. 480 Title II.

B. Planned U.S. Assistance for FY 1996

In April 1995, the U.S. Mission will submit a proposed six-year strategy for the FY 1996-2001 period. In order to achieve sustained political and economic freedom in Mozambique, we propose to concentrate our assistance on increasing production and incomes in rural areas, expanding the process of democratization and strengthening social services which contribute to productivity, e.g., health. We will continue important training programs in the areas of leadership development and technical skills training. Commercial food aid and humanitarian assistance will decline but continue as necessary. Commodity import financing will be expanded only if the government achieves measurable results in bringing about the policy changes and shifts in budgetary priorities necessary for economic development and political stability. Beginning in FY 1996 we are planning $60 million annually in development assistance and $20 million annually in food aid. Whether this program is sustainable will depend upon the actions taken by the GRM on economic reform and the availability of U.S. funds given pending U.S. budget reductions.

Drafter: Sallen:P:\PPA\ECON\CG\CG95c.PAP

Clearances:

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