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BOTSWANA EXPORT INCENTIVES STUDY

Prepared for

The Ministry of Commerce and Industry

and

The Botswana Development Corporation

Final Report

The Services Group

for

Deloitte Touche Tohmatsu (ILA) Group Ltd.

under USAID Contract 623-0253-C-00-2014-00

April 29, 1994

Acronyms and Abbreviations

BoB	Bank of Botswana
BDC	Botswana Development Corporation
BPED	Botswana Private Enterprise Development
EPZ	Export Processing Zone
ESZ	Export Services Zone
FAP	Financial Assistance Policy
GATT	General Agreement on Tariffs and Trade
GSP	Generalized System of Preferences
GOB	Government of Botswana
ITC	International Trade Centre
LPS	Local Preference Scheme
MFA	Multi-Fibre Arrangement
MFDP	Ministry of Finance and Development Planning
MIC	Ministry of Industry and Commerce
MUB	Manufacturing Under Bond
PTA	Preferential Trade Agreement
RSA	Republic of South Africa
SACU	South African Customs Union
SACUA	South African Customs Union Agreement
SADC	Southern Africa Development Community
SPRDP	Selebi-Phikwe Regional Development Project
sq.m.	square meter
TIPA	Trade and Investment Promotion Authority

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Executive Summary

Introduction

This study has been co-sponsored by the Ministry of Commerce and Industry and the Botswana Development Corporation (BDC) under the auspices of USAID's Botswana Private Enterprise Development Project. The purpose of the study was to design an export incentives program, based on Botswana's advantages and disadvantages as well as the experience of other developing countries, without violating Botswana's current treaty obligations under the Southern African Customs Union (SACU) and General Agreement on Trade and Tariffs (GATT).

Regional Export Promotion Programs

There are a wide variety of export incentives and programs used within the region. These include:

- duty drawback/exemption schemes;
- manufacturing under bond;
- export processing zones;
- partial export regimes;
- investment codes;
- foreign exchange export retention schemes;
- investment and export financing;
- investment facilitation; and,
- other tax and cost incentives.

The programs listed above have had varying degrees of success. In most cases, export incentives are most effective when implemented in economies that are severely distorted; a key example is the use of export retention schemes for exporters in countries characterized by foreign exchange shortages. While there is certainly room for improvement in Botswana's investment climate, the country's economy is clearly not subject to the massive economic, fiscal, and administrative distortions found in most countries embarking on the design of an export policy framework.

Current Investment Policy

The most important incentive program in Botswana is the Financial Assistance Policy (FAP) which provides grants and subsidies to both new and expanding businesses, whether locally or foreign owned, or engaged in exporting or import substitution activities. An extensive study of the FAP is currently underway.

The only export policy program currently offered in Botswana is the Selebi-Phikwe Regional Development Project (SPRDP) which has created 2,000 jobs in six firms. While this is in the range of revised targets, these jobs have been created at a high cost of US$6,400 per job. Managers of the program note that the program is economically justified at a maximum cost of US$4,000 per job.

Botswana's Constraints and Opportunities

There are a number of policy issues which affect the design of a non-traditional export development program in Botswana. One of the country's important advantages is the availability of foreign exchange and the freedom to repatriate capital, dividends, and profits. Other advantages include:

- political stability;
- reliable infrastructure;
- simple business establishment procedures;
- efficient import/export procedures; and,
- the overall high quality of life.

Constraints include:

- low productivity standards;
- relatively high minimum wage for manufacturing;
- high utility prices;
- Botswana's landlocked position translates into higher road and sea transport costs;
- shortage of serviced industrial plots;
- high construction costs; and,
- raw materials and intermediate components which are generally more expensive than those available outside of SACU.

Botswana clearly has a comparative advantage in terms of political and economic stability, foreign exchange access, and the quality of infrastructure. Unlike most countries embarking on export promotion policy frameworks, Botswana's constraints are more related to costs than to policy (although it must be noted that high costs are sometimes a reflection of policy, e.g. minimum wage levels).

Botswana has a comparative disadvantage in terms of labor, utility, and transport costs. The country also lags far behind its regional competitors in the area of productivity. Owing to these factors, the study team believes that Botswana's comparative advantage lies in capital-intensive -- rather than labor-intensive -- activities.

Treaty Limitations

The design of export incentives is constrained to a large extent by Botswana's membership in SACU and GATT. The main difficulty in designing an export incentives program without violating SACU is the Government of Botswana's lack of control over domestic prices for imported material inputs used by exporters. The rates of Customs duties and the ability to receive rebates or exemptions on these tariffs is determined by South Africa. Moreover, tax incentives are not applicable on exports to South Africa under the provisions of SACU. This is a critical limitation on the design of an export policy, as there is a growing recognition that South Africa is Botswana's natural export market.

Botswana's recent membership in GATT precludes the use of many typical export incentives. Under GATT, for instance, preferential tax rates and costs for exporters are countervailable. While Botswana would be unlikely to face challenges from GATT authorities in the near future if it was to introduce such incentives, the trend is clear from the most recent Uruguay Round that these types of incentives are likely to be challenged over the medium-term -- even for small developing countries such as Botswana.

Applicability of Standard Incentives

In order to determine what types of export incentive policies are applicable, it is useful to examine the relevance of the most common export policies in terms of Botswana's current obligations and situation.

Tariff Relief

The GOB has little say in the determination of tariff policies which are established in South Africa by the Board of Trade. As a result, Botswana cannot establish a less complex tariff schedule, an important and commonly used export incentive which is allowed by GATT.

Tax Relief

Tax relief can include outright tax holidays, low flat taxes, or special deductions for export marketing, accelerated capital depreciation, and training/labor deductions. While these benefits have clearly played an important role in attracting investors to some countries, tax relief for exporters is considered countervailable under GATT. Moreover, sales to South Africa would not be eligible for this incentive under the SACU agreement.

Export Sales Subsidies

In Zimbabwe, exporters receive a payment from the government equivalent to 9 percent of FOB value. Manufacturers like this kind of program because it is simple and straightforward; however, export sales subsidies are countervailable under GATT, and World Bank and IMF officials have made strong efforts to eliminate the use of this type of export policy. Under pressure from these organizations, Kenya recently terminated a similar program and the Zimbabwean and South African equivalents are due to be phased out.

Foreign Exchange Retention

Foreign exchange retention schemes have had a tremendous impact in a number of African nations and is not countervailable under GATT. Although a few foreign exchange controls remain, foreign exchange access is not a problem and this policy is not appropriate for Botswana.

Simplified Regulatory Policies

Easing regulatory constraints and accelerating bureaucratic processes are key elements in many export programs and are legal under both GATT and SACU. While Botswana clearly has a need to improve regulatory policies and procedures with regard to the allocation of land access and work permits, the study team heard far fewer complaints about the regulatory environment than is common in most developing countries. As such, work in this area is likely to be needed, but is relatively less important than in countries such as Ghana, Kenya, or Uganda.

Preferential Rates

A few export programs offer preferential or subsidized rates on items such as transport, electricity, factory rentals, and finance. These are countervailable under GATT if offered solely to export firms. Subsidizing high costs is generally not recommended in any case as such a measure is both distortionary and politically difficult to terminate.

Export Promotion Activities

This includes everything from individual firm assistance to trade show participation and is allowable under both GATT and SACU. Although export promotion programs have recorded some successes, their performance has generally lacked the proper focus to be effective. These programs should be considered to be of secondary importance; a firm must first produce competitive products in order for an export promotion program to be successful.

Export Finance

Export finance programs have been important in a number of countries, although they are typically not critical in the first stages of export development. This activity is allowable under both GATT and SACU.

Training

Training activities for export-oriented firms are allowed under GATT and SACU but, unfortunately, the performance of training activities in stimulating non-traditional exports globally has been disappointing. Botswana already offers an attractive training incentive under FAP which has not been extensively utilized.

Botswana's Competitive Position

Botswana suffers from a number of inherent internal constraints which are difficult to address in the design of an export incentive framework. High labor, utility, and transport costs and low productivity will make it extremely difficult for Botswana to significantly reduce its unemployment rate. Botswana's overall lack of competitiveness is also evidenced by:

- productivity actually declined in the apparel/textiles and leather industries in the 1980s -- two sectors which are widely considered "the future" of export manufacturing in the country;
- Botswana captured little of the disinvestment in South Africa despite its proximity, stability, and liberal foreign exchange regulations;
- local manufacturing investment is small and the level of local investment is often an important symbol to foreign investors; and,
- firms are having severe difficulties competing with South African imports which makes it extremely unlikely that they will be able to compete in more developed country markets.

Consequently, it is unlikely that Botswana will be able to compete successfully in attracting highly labor-intensive industries such as t-shirt and uniform assembly. While Botswana can offer quota access for the next few years, it cannot provide a low-cost operating environment. To the degree that Botswana is successful in encouraging exports, it is likely to be in small niche industries. This is already evidenced by the fact that some large apparel and textile firms are suffering, but smaller niche specialty exporters are doing well.

Botswana is also more likely to find success in service-oriented sectors such as offshore informatics, regional corporate headquarters, and perhaps offshore financial services. These sectors are more compatible with Botswana's higher cost structure, current pattern of education, strong exchange rate, and liberal exchange control system. Furthermore, Botswana's comparative assets -- political stability, high quality of life for expatriates, reliable infrastructure -- have greater importance to investors in these sectors than they do in lower-end industries such as apparel where labor costs are paramount.

Recommendations

Botswana's situation is more difficult than many African countries where significant reforms remain to be introduced; in these countries the use of export incentives is often appropriate in order to offset deterrents to investment and export until significant liberalization takes place. In contrast, the Government of Botswana has already introduced a wide number of important liberalizations. In addition, the country's uncompetitiveness in cost and labor-intensive activities eliminate the source of growth that has typically fueled export expansion in other developing countries.

As a result, no single incentive or reform is likely to attract significant investment to Botswana. A comprehensive package of measures will be necessary to maximize the attractiveness of the investment environment to the broadest range of firms and industries. Given the country's comparitive disadvantages, no single industry sector, no single source of investment, and to a lesser extent, no single market is going to provide the basis for export-oriented growth. Botswana has enough advantages to attract some firms in a variety of areas, many of which will be niche areas exploited by innovative or entrepreneurial companies. As a result, it is not a realistic option to tailor the investment climate to certain types of firms or industries. Instead, it is only through the creation of a thoroughly liberalized, market-oriented economy that Botswana can maximize the country's attractiveness to the broadest range of firms.

Implementation of the following core measures is recommended to maximize Botswana's comparative advantages and improve the country's relative competitiveness as an investment site without violating treaty obligations:

- abolish the current system of exchange controls;
- examine the potential for the establishment of an offshore informatics sector;
- examine the potential for the establishment of offshore financial services;
- allow for the private provision of international telecommunications service in order to reduce telecommunications costs for exporters;
- address the constraint imposed by high wage levels;
- further reduce the non-mineral corporate income tax rate as permitted by budget constraints;
- make Trade and Investment Promotion Agency (TIPA) into an autonomous agency which focuses on investment facilitation;
- establish an export marketing support program;
- guarantee expedited access to expatriate work and residency permits.

In addition to these core recommendations, a number of supplemental measures are recommended:

- allow the private sector to compete with the BDC in industrial estate development;
- consider rural utility provision as a development expense;

- provide hands-on technical assistance to selected firms to enter export markets;
- create a government and private sector advocacy group to foster export development; and,
- increase government efforts to resolve unfair regional trade policies.

Economic growth is not static, and it is not possible to predict with precision what types of industries are likely to invest under the recommended reforms contained in this study. While Botswana may have a greater comparative advantage in attracting more capital-intensive or service-related investment, this does not preclude the establishment of a variety of other industries. Since future economic growth is difficult to target, however, a liberalized investment climate which is free of distortions and subsidies; which is supportive of investment and export activities; and which is administratively simple to implement and monitor, provides the best possible enabling environment for all types of economic activity. Most importantly it lays the basis on which to attract industry and investment which is viable without subsidy and which can provide the economic diversification that is essential for sustained economic growth and employment generation.

Section 1

Introduction

Study Rationale and Objective

This study has been co-sponsored by the Ministry of Commerce and Industry (MCI) and the Botswana Development Corporation (BDC) under the auspices of USAID's Botswana Private Enterprise Development Project (BPED). The research and preparation of this report has been undertaken by Robert Rauth and Karen Hendrixson of The Services Group, and Maurice Thorne, an independent consultant under subcontract to Deloitte Touche Tohmatsu (ILA) Group Ltd. Specific oversight and direction for this work was provided by Richard Wolfe, of the Ministry of Commerce; James Eaton, of the BDC; and the BPED Export Incentives Design Reference Group, comprised of members of the public and private sectors.[1]

The primary motivation for this study was the Government of Botswana's (GOB) recognition of the need to diversify the economy and create employment through the expansion of non-traditional exports. To this end, the GOB is currently considering redesigning its industrial policy. This report is undertaken to provide information and analysis to that review and redesign effort.

The scope of work for this study had four primary objectives.[2] They were:

- to identify the specific objectives of an export incentives package for Botswana, taking into account the country's factor endowment and the historical experience of other developing countries in promoting the growth of non-traditional exports;

- to analyze Botswana's current multilateral and bilateral treaty obligations to determine what types of export incentives could be introduced without violating those obligations;

- to design an export incentives program, taking into account the above analyses, containing specific incentives, eligibility criteria, and designation of

[1] The members of the Reference Group are listed in Annex A.

[2] This study's terms of reference are included in Annex B.

institutional and administrative oversight and responsibility; and,

- to estimate the types of industries, investment, and levels of employment that could be expected to result from the successful implementation of the program.

In addition, the consultants were directed to design an export incentives program which addressed the needs of both existing and potential exporters, existing and potential investors, and domestic and foreign firms.

Report Structure

The remainder of this report is structured as follows. Chapter 2 focuses on export promotion programs currently in use in Sub-Saharan Africa. Following a brief overview of the components of a successful export promotion program, the chapter examines the types of export incentive policies and programs used in the southern and eastern Africa region, including manufacturing under bond, export processing zones, investment and export financing, and various tax and cost incentives, among others.

In Chapter 3, the current constraints and opportunities affecting the development of non-traditional exports in Botswana are examined. Five key areas are addressed: policy issues, institutional and administrative factors, infrastructure quality and cost, labour productivity and wage rates, and the availability of export and investment finance. The nature and design of Botswana's key trade accords -- the South African Customs Union (SACU) and the General Agreement on Tariffs and Trade (GATT) -- are assessed to determine their implications for the design of an export incentives program.

The key constraints affecting the design of an export incentive program are addressed in Chapter 4. The applicability of the various types of export incentives are weighed, and the economic models suggested by other countries' experience in export development are reviewed. The chapter concludes with an examination of Botswana's competitive position in three key sectors: apparel, offshore informatics services, and offshore financial services.

Chapter 5 recommends a strategy to promote both investment and exports. The proposed measures are divided into core recommendations, essential to the successful implementation of an export promotion scheme, and additional recommendations, which are supplementary to these key policy measures. Finally, this chapter estimates the potential impact of the proposed strategy in terms of the program's costs and anticipated employment and other gains.

Section 2

Export Promotion Programs In Sub-Saharan Africa

Components of a Successful Export Promotion Program

A successful export promotion program is comprised of a competitive set of policies or economic incentives to improve the economic feasibility of export production; a favorable administrative and regulatory environment; and low factor production costs. These elements are reinforcing and complementary in nature, and the more competitive a country is in each of these three areas, the greater the likelihood of success for export manufacturing.

The overall policy environment affecting investment, both domestic and foreign, is critical to the success of any export promotion program. This policy environment consists of those policies at the "macro" level which create the enabling environment for successful export development. They include the overall investment, trade, labor, exchange rate, and other policies which influence the competitiveness of the host country as a whole.

In most developing countries the enabling environment for exporters is seriously flawed. The adoption of import protection and other barriers set up to promote import substitution-based producers has created substantial disincentives to export.[1] Since the effect of import restrictions and other barriers is to place an implicit tax on export production, countries adopt specialized export incentives in order to counterbalance this inherent anti-export bias. While the most straightforward way to deal with these distortions is to eliminate them, most countries for political reasons have chosen a second best approach by using export incentive policies to offset the anti-export bias found in their trade regime.[2]

The most common form of export incentive is some form of tax incentive. It is often assumed that generous tax incentives are critical to successful export development. Generous incentives per se,

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1 These barriers include high direct and indirect tariffs and taxes on imports; sales taxes; quantitative restrictions; overvalued exchange rates; poor monetary policy and high rates of inflation; high rates of taxation; limited foreign exchange resources; and structural rigidities in labor markets that raise the cost of labor above its opportunity cost.

2 There are clear limits as to what can be independently achieved through export promotion policies. First, free trade status for exporters is administratively difficult to achieve, especially when effective rates of protection are still high. Second, the creation of an enclave export sector with free trade status will limit the efficiency effects that could be achieved for the economy as a whole. Finally, export incentives directed at specific industries or non-tradeables (e.g, subsidized utility rates) are countervailable under GATT regulations.

however, do not guarantee a successful program. While the tax incentives offered to exporters in Malaysia, Hong Kong, Mauritius, and the Dominican Republic are less generous than those of Egypt, for example, foreign investors have found that the former countries are more attractive investment sites owing to their predictable and standardized treatment of foreign private investors, political stability, low factor costs, and sound infrastructure.

The basis for successful export promotion lies not just in the types of incentives offered but depends as well on the program's implementation. While many countries offer attractive export or investment incentives, poor implementation commonly undermines the competitiveness of export regimes. Although not commonly considered an export incentive, investment facilitation is a critical component of export success. Faced with a number of alternative investment sites, foreign investors will select the country that offers the most streamlined and transparent investment approval and business establishment procedures. Countries with lengthy and burdensome procedures, where investment approvals can require anywhere from six months to a year or more, will frustrate and deter investors. Similarly, countries with simplified regulatory operating environments -- including rapid customs approvals procedures, simplified hiring and firing procedures, and eased foreign exchange access -- have found this to be a valuable incentive to investors.

Successful exporting countries have used this positive enabling environment as a powerful promotional tool in attracting export-oriented investment. In many countries, investment promotion consists almost entirely of advertising and other image-building activities; by itself, this approach is rarely effective. In fact, experience worldwide has shown that the provision of both pre- and post-investment services is the most effective form of investment generation. Countries characterized by a simplified investment approval and business establishment process and an investment promotion agency which focuses on investor facilitation have typically been highly successful in attracting investors.

Finally, factor costs play an important role in successful export development. Of the various factor costs, however, it is the cost and productivity of labor that is by far the most important. As labor costs have risen in industrialized countries, manufacturers have sought low cost offshore manufacturing sites for the assembly of highly labor-intensive goods such as apparel and footwear for export to developed country markets. This search for low cost manufacturing sites has been the principle factor fuelling successful export growth in developing countries worldwide.

In addition, export growth has been stimulated by the increasing imposition of quotas by industrialized countries on imports on certain types of goods. As a number of developing countries have become increasingly successful exporters, developed nations have imposed quotas and other restrictions to protect their domestic producers from lower cost imports.[3] In response, developing countries not subject to quantitative export limits have been specifically sought out as investment sites by manufacturers facing such restrictions.

In sum, successful export development results from a combination of policy, administrative, and cost factors. No country's export program is flawless, since all countries are characterized by some comparative disadvantage. Some of these disadvantages, however, such as policies and administrative procedures, are under a government's control and can be changed or modified. Other factors, such as transport costs, are less easily modified by government policy. Those developing countries which have become successful exporters have adapted their policies and practices to successfully offset to the greatest extent possible those comparative disadvantages which cannot be easily changed or modified.

Regional Export Incentive Programs Policies and Impact

A wide variety of export incentives and export promotion mechanisms are used -- with varying degrees of success -- in the southern and eastern Africa region. They range from duty drawback/exemption and manufacturing under bond programs -- whose single purpose is to enable exporters to obtain inputs free of duty -- to export processing zone programs which introduce a comprehensive policy package comprised of economic incentives and a streamlined investment approval and regulatory environment. Alternatively, some countries in the region have adopted investment codes which equally give incentives to both import- and export-oriented activities.[4]

Finally, a variety of other measures have been used to promote exports, including compensatory subsidies, investment facilitation, export and investment finance, and various types of tax and cost incentives. This section will highlight the major provisions of these export incentive and promotion packages and the impact they have had on jobs, exports, and/or investment.

3 In particular, the Multi-Fibre Arrangement (MFA) governing apparel exports has established maximum export levels for a number of countries, primarily in East Asia.

4 See Annex D for a detailed discussion of the characteristics, advantages, and disadvantages of various types of export incentives used worldwide.

Duty Drawback/ Exemption Schemes

One of the most important policies that can be enacted is to ensure that exporters have access to inputs at internationally competitive prices. Many governments, however, are unwilling to implement low tariff regimes owing to both their dependence on customs revenue and the political need to protect domestic industries. As a result, most countries offer some type of duty drawback or exemption scheme. The performance of duty drawback schemes has not been impressive within the region, however, mainly because of the long delays exporters generally encounter in receiving refunds for the duties paid on imported inputs.

In Zambia for example, delays of up to nine months are reported. While a slow payment process is detrimental to cash flow, the several month delays experienced by Zambian firms was disastrous given the country's high inflation rate. One of the reasons underlying Zambian Customs' slow payment procedures is its requirement that notification be received from Customs in the country of destination before payment can be made. Not surprisingly, providing such notification to Zambian Customs is typically not a high priority for regional Customs authorities. In Zimbabwe, six month delays are typical, despite regulations that payment must be made within 14 days. Similarly, a drawback regime exists on paper in Uganda, but even the Minister of Finance has stated that the program does not work and is used by only a handful of firms.

Within the SACU region, a drawback program is in place but is not extensively used. In Namibia for example, no firms made use of the drawback mechanism in 1992. In South Africa, 380 firms are registered under the program, but it is not widely utilized.

A duty drawback system is working well in Mauritius. In the early years of its operation, severe criticisms were raised owing to the long delays encountered in receiving refunds. The administration of the system has now been significantly improved, and refunds of import duties are normally now made within two to three weeks.

Kenya established its duty exemption scheme due to problems with its Export Compensation Program (discussed below) and the long delays associated with its duty drawback program. The Duty/VAT Remission (DVR) program was recently established to enable exporting firms to receive exemptions on inputs imported export production.. Firms must take out a security bond (or insurance for bond) equivalent to 75 percent of the duty and VAT which would be payable. The monitoring process is carried out using audit control methods. To date, the DVR has been primarily used by exporting firms that had previously operated under the Export Compensation Scheme. Approximately 60 firms have applied for DVR and the amount of exports that have received remissions was four times greater in 1992 than in 1991.

Manufacturing Under Bond

Manufacturing under bond (MUB) programs are offered in several countries in the region. In Kenya, MUB firms are exempt from paying import duties and value-added taxes on imported inputs and capital equipment. Firms are also allowed to deduct 100 percent of investment expenditures against corporate income taxes. To be eligible, however, firms must export 100 percent of their production. Security bonds equivalent to 75 percent of the dutiable value of the goods must be posted. Facilities are bonded by the Customs Department and Customs officers are physically present at all premises. This physical control system has caused problems, particularly when Customs officers are unavailable, resulting in delays in shipment and production. Documentary control is also used which is considered redundant by many observers in light of the required physical Customs presence. In general, MUB firms have greater locational flexibility than do EPZ firms in Kenya (see below), but receive a less attractive set of incentives.

In early 1993, Kenya's MUB program included 19 operational firms, with another 25 expected to begin operations. Approximately 55 percent of the investment has been Kenyan in origin, and many of the firms are subcontractors involved in the manufacture of garments for export to industrialized countries.

Zambia's MUB program is less extensively utilized ,but is used by two major textile and apparel exporters. In theory, the program relies upon the use of physical controls to prevent fraud, using a double-key system; this is the least complex system for Customs to administer, but is the most cumbersome system for the manufacturer. In practice, however, Customs has been more flexible in administering the regime. As a result, controls are primarily exercised through the use of audits, although physical inspections are undertaken regularly. Unlike some MUB programs, Zambia's system does allow for sales to the local market.

Export Processing Zones

The best known export program in the region is probably the export processing zone (EPZ) regime in Mauritius. Established in 1971, the Mauritian EPZ program has transformed an economy that was overdependent on a single commodity export (sugar) and suffering from high unemployment.

The current incentives offered under the EPZ program include a 15 percent corporate tax rate; a 20-year tax exemption on dividends; duty-free importation of equipment, raw materials, and spare parts; and free repatriation of capital (including appreciation), profits, and dividends. In addition, the government tries to reduce bureaucratic red tape to a minimal amount (one of the underappreciated aspects of EPZ programs, is that they generally provide regulatory relief in addition to the more prominent tax and tariff relief).

The Mauritian EPZ program is highly unusual in that the entire country has been declared an EPZ, and firms approved as EPZ manufacturers may set up operations anywhere on the island; Togo is one of the few other countries worldwide which places no restrictions on the geographical location of EPZ companies.[5] EPZ programs in most countries limit EPZ operations to licensed industrial estates or to specific geographical regions; in some countries, such as Cameroon, single factory EPZ operations are permitted, but only for agro-processing firms which must locate near the source of their raw materials.

Mauritius' highly attractive incentives package -- combined with low labor costs and fears in Hong Kong about China's eventual takeover in 1997 (the GOM gave passports and permanent residency status to interested investors) -- allowed Mauritius to experience explosive economic growth in the 1980s. Within five years, the unemployment rate dropped from 23 percent to less than four percent. Consequently, Mauritius is currently facing a labor shortage and some companies are now being permitted to import low-skilled labor from China and India.

The EPZ program has become the engine of growth for Mauritius. Interviews with Mauritian manufacturers demonstrate that the EPZ regime was a critical element in their decision to locate in Mauritius, and it is unlikely that the country would have experienced its substantial rates of investment and economic growth without the incentives introduced by the program. EPZ exports in 1992 were US$718 million, accounting for approximately two thirds of the country's exports. In a population of slightly over one million, the EPZ program employs nearly 87,000 workers. Unlike most EPZ programs worldwide, Mauritians also hold approximately 50 percent of equity in EPZ enterprises.

Following its torrid development in the 1980s, Mauritius has since discovered that the second step of the economic ladder is more difficult to climb. While foreign investment reached Rs. 900 million (approximately US$60 million) in 1989, it has dropped significantly in subsequent years. Since peaking in 1989, new investment levels have fallen to Rs. 690 million in 1990, Rs. 630 million in 1991, and Rs. 560 million in 1992. Employment in 1992 was approximately 87,000, the lowest level since 1986, and 4,000 fewer jobs than the level reached in 1991. Moreover, despite GOM efforts to diversify into other sectors, the main areas of investment continue to be in the knitwear and apparel sectors. Many sectors which the GOM has targeted as future areas of economic growth -- jewelry, informatics, footwear, toys, and optical goods -- have received little investment.

5 Although Costa Rica and Jamaica restrict the geographical location of EPZ firms, bonded manufacturing firms -- which receive the same incentives as EPZ firms -- are allowed to establish operations anywhere.

In 1981, Mauritius introduced the Export Service Zone (ESZ) Act to stimulate the export of services and the re-export of manufactured goods. It was also hoped that the program would provide employment to white collar workers in marketing, consulting, financial, and export services. ESZ firms are entitled to the same incentives granted to EPZ firms. One difference between the regimes is that foreign equity in ESZ firms is normally restricted to 30 percent of the total investment. This requirement has limited the program's appeal to investors and has lessened the potential impact of the regime. The results of the ESZ program have been disappointing to date: only Rs. 1 million in foreign investment was realized in both 1990 and 1991; in 1992, the figure doubled, but still reached a relatively unsubstantial Rs. 2 million (US$110,000).

EPZ programs have also been established in Kenya, Togo, Cameroon, Madagascar, and Burundi. In all but Kenya, EPZ firms have the flexibility to establish operations throughout the country. The Kenyan EPZ program offers a typical incentive package which includes a ten-year corporate income tax holiday and exemption from duties and taxes on imported raw materials, components, and capital equipment. In addition to the program's attractive incentives, the regime's relatively quick investment approvals, improved Customs procedures, and accelerated work permit registration system represent significant improvements over previous practice. The program currently has 16 approved firms and the operational firms employ approximately 1,600 workers. Sources of investment have been diverse, with equity coming from Kenya, Hong Kong, Korea, the United Kingdom, Germany, and Tanzania. A wide variety of activities take place in the zone, including the production of garments, paper products, pet food, cosmetics, and hotel safes, as well as the assembly of computers and motorcycles. The majority of sales are to neighboring PTA countries.

Togo has one of the most attractive EPZ incentive frameworks in the world, and the program has brought about the first significant job creation and new investment in the industrial sector in many years. Within two years of operation, the EPZ regime represented 15 percent of formal private sector industrial employment. By 1992, the program had attracted investments by nine firms, employing 900 workers and representing around US$11 million in investment. Like Kenya, much of Togo's EPZ exports are destined for the region rather than to developed countries -- a pattern which is unique among EPZ programs worldwide. Because the CFA franc was overvalued until recently, investments have tended to be in more capital-intensive industries; only one of the operating companies is producing apparel or textiles. Despite its past accomplishments, however, the future of the Togo EPZ is at risk due to on-going political unrest in the country.

Cameroon's EPZ program attracted eight firms representing US$250 million in investment and over 3,200 jobs in its first year of operation. In addition, indirect employment from four firms alone is expected to reach 7,000 jobs. Of the eight approved firms, seven have some level of Cameroonian ownership. The average share of local ownership is 48 percent which is greater than the local equity participation of any free zone program worldwide at such an early stage of development. The evidence so far indicates that Cameroon's EPZ will be dominated by natural resource and agro-processing activities in reflection of Cameroon's rich resource base and high labor costs. These activities are largely capital-intensive in nature.

Although its status after recent political troubles could not be ascertained, Burundi's EPZ had 12 operational firms in mid-1993. These firms were predominately European, principally Belgian, and all were exporting to Europe (taking advantage of the low-cost air freight between Burundi and Europe). An EPZ program has also been established in Madagascar which has attracted more than a dozen firms with links to Mauritius.

Partial Export Regimes

In a move designed to encourage existing import-substitution firms to shift their orientation to export markets, the government of Mauritius instituted a special tax policy for partial, non-traditional exporters. Companies benefit from a graduated tax reduction of two percent for every ten percent of turnover exported. As a consequence, any company exporting 100 percent of its turnover would pay tax at a rate of 15 percent, the same as that paid by EPZ firms (instead of the normal rate of 35 percent). This system was revised in 1991 so that firms exporting 10 to 30 percent of turnover would pay a 25 percent tax rate; those exporting 31 to 50 percent would pay a 20 percent tax rate; and firms exporting 51 percent of their turnover would pay a 15 percent rate of tax. Although theoretically countervailable under GATT, this type of incentive has not yet been attacked internationally.

Investment Codes

In countries such as Uganda, Zambia, and Ghana, there is no specialized export incentives regime. Instead, these countries have investment codes which are applicable to a wide range of activities, including manufacturing, services, tourism, and agricultural investments; mining activities, however, are governed by separate investment codes and incentives. Within these investment codes, incentives or other advantages are granted equally to a diverse number of activities.

In Ghana, for example, investments in "priority areas" -- which includes both export and non-export manufacturing, and agricultural activities, among others -- qualify for a 100-percent customs duty exemption on plant, machinery, and equipment; accelerated depreciation allowances; guaranteed expatriate quotas; and guaranteed transferability of profits, dividends, royalties, and other payments. These benefits apply to both export-oriented and domestic market-oriented manufacturing enterprises. Some additional incentives are available for exporters -- for example, non-traditional exporters are automatically eligible for 100 percent foreign exchange retention -- under other pieces of legislation.

Ghana's investment regime, therefore, is "neutral" in that it does not specifically favor export-oriented activities.[6] Rather, Ghana relies primarily on the fact that the reforms introduced under its structural adjustment program have created an open and liberalized economy -- characterized by a liberalized foreign exchange system, a market-determined and highly competitive exchange rate, low tariff barriers, competitive factor prices, and no restrictions on imports and exports -- which provide a highly supportive environment which is naturally conducive to export growth. As a result, non-traditional exports -- principally wood and agricultural products -- have increased sevenfold between 1987 and 1993, when they totalled US$65 million.

Under the Investment Codes in Uganda and Zambia, incentives have been made available to both foreign and local investors, new firms or expansions of existing ones, and both export or import-substitution operations. In Uganda, an investment license automatically provides import duty and sales tax exemptions on imported capital goods as well. Once a firm receives a certificate of incentives, it is also entitled to exemptions from corporate taxes, withholding taxes, and taxes on dividends for 3 to 6 years. depending on the amount and location of the investment. Repatriation of profits and dividends is allowed so long as there is no local debt (this constraint is expected to be removed in the near future).

Since 1991, over 500 applications have been approved, which -- if fully implemented -- would represent over US$1 billion in investment; these totals include both export- and domestic market-oriented investment. A survey in June 1993 found that 65 percent of the approved projects have been implemented, US$150 million in fixed assets has already been invested, and 3,700 jobs have been created. The Uganda Investment Authority receives approximately 35 applications per month requesting incentives.

In Zambia, the Investment Act allows for duty exemption on capital goods, as well as dividend tax and employment tax exemptions for a period of seven years. A weakness of the program is that exporters can remit only 75 percent of after-tax profits. The Act was further

6 As such, it has many of the same elements as the neutral investment regime as discussed in Annex D. A truly neutral investment regime, however, would not offer incentives for any productive activities, but would treat them all equally. Nonetheless, within Sub-Saharan Africa, the investment codes of Ghana, Uganda, and Zambia represent a close approach to establishing a neutral investment environment.

weakened in 1993 when the three-year tax holiday and import duty exemptions were removed, and a minimum initial investment requirement of US$200,000 was introduced. This was disturbing to many observers in Zambia who noted that in the previous year more than 300 applications were approved, representing US$360 million in investment. These projects were primarily by South African investors in agricultural and tourism projects.

Export Retention Schemes

Owing to the difficulties in accessing hard currency in many African nations, a number of countries now offer foreign exchange retention schemes to exporters. Nearly all EPZ programs for example, offer this benefit. Zimbabwe offers an Export Retention Scheme (ERS) where exporters receive 50 percent of their export proceeds to cover their export requirements (with the exception of a negative list of prohibited goods). ERS entitlements can be freely traded among exporters and domestic producers and these entitlements are currently selling at a 20 percent premium. As such, Zimbabwean exporters are often more profitable on their currency transactions than on their sale of manufactured exports. An export retention scheme equivalent to 50 percent of export proceeds is also available in Kenya. Exporters in Zambia, Uganda, and Ghana are eligible for 100 percent export retention.

Investment and Export Financing

Long-Term Finance

Long-term finance is generally not available in the region. In Uganda for example, it is usually not possible to obtain commercial loans with terms beyond 180 days. Similarly, high rates of inflation in Zambia in recent years have meant a complete absence of long-term credit.

One exception to this regional pattern is found in Mauritius, where export firms for many years received finance at concessional rates established by the Bank of Mauritius. This system has recently been liberalized and commercial banks are now free to determine their own interest rate structure. In practice, however, the government and Central Bank have asked commercial banks to continue charging lower interest rates to EPZ firms and banks have abided by this request. Over time, however, it is expected that EPZ firms will have to compete with other sectors for finance on an equal footing. It should be noted that the GOM no longer guarantees loans to exporters because it had to assume the debts of too many failures under this mechanism.

In South Africa, enterprises exporting 60 percent of their output can receive preferential financing at nine percent (60 percent of the base rate) from the Industrial Development Corporation. Less preferential terms are available to firms exporting less than 60 percent but more than 30 percent. In addition, new foreign investors utilize the financial rand which effectively gives them a premium of 20 to 30 percent over the commercial rand.

The Zimbabwe Development Bank (ZDB) typically lends for projects of 5 to 8 years. The ZDB focuses on newer projects -- either import- or export-oriented -- unable to obtain commercial bank financing. The bulk of lending has been to firms in the manufacturing, textiles, horticulture, packaging, or food processing sectors. A venture capital fund has also been established with participation by the Reserve Bank, the International Finance Corporation (IFC), the Commonwealth Development Corporation (CDC), and nine commercial and merchant banks.

Export Finance

With the exception of Mauritius, South Africa, and Zimbabwe, no country in Sub-Saharan Africa offers an adequate export financing system for non-traditional exporters, and only South Africa and Zimbabwe are members of the Berne Union, the international association of credit and insurance providers. A pre-shipment credit guarantee program is operated by the Development Bank of Mauritius and is generally considered to work satisfactorily. A post-shipment credit guarantee program gives advances to exporters by banks through purchase negotiation, discount of export bills, or advances against such bills. Export credit insurance is provided by the Development Bank of Mauritius and the maximum coverage of losses is 90 percent, depending on the nature of the risks involved. Mauritius also allows for a 200 percent deduction from chargeable income on export insurance premiums.

Until recently, the export finance program in Mauritius was fairly rudimentary in nature and the government's export guarantee program worked so imperfectly that banks still required substantial amounts of collateral. Nonetheless, the inadequacy of the program did not seriously constrain exports, principally because many Mauritian exporting firms are foreign-owned and were able to obtain export financing from banks in their home country or in their final export market.

In Zimbabwe, trade finance is available through merchant banks, which provide funding through the acceptance of bills of exchange and processing letters of credit. The Zimbabwe Credit and Insurance Company (ZCIC), in which private shareholders hold a majority share, provides comprehensive export insurance against both political and commercial risk. The ZCIC has also established a program which insures banks against the failure of repayment when lending to new entrepreneurs beginning export operations. Finally, exporters may utilize a Reserve Bank of Zimbabwe facility providing favorable foreign exchange cover premiums, for periods of up to eight years, for protection on long-term overseas loan or equipment purchases.

Export finance is relatively well developed in South Africa and credit insurance is available for post-shipment finance from the Credit Guarantee Corporation. This is a private corporation owned by major financial institutions, which offers both domestic and international credit guarantee programs. Export credit insurance is available for commercial and political risk; the political risk component is reinsured with the RSA under a special arrangement. The Credit Guarantee Corporation reports that approximately 20 percent of eligible exports are covered by its insurance program.

Other Tax and Cost Incentives

Specialized Tax Deductions

There are a number of specialized tax deductions offered in the region. An obvious but essential point is that companies must be strongly profitable before these deductions become attractive. In Namibia, companies may write off the cost of production machinery and equipment over a three-year period. This policy has encouraged capital-intensive industries, and consequently, many Namibian manufacturers boast modern equipment. Similarly, Mauritius allows firms an initial one-year 50 percent depreciation allowance on machinery and equipment, and a 30 percent initial allowance for industrial buildings. This is followed by a straightline depreciation rate of 10 to 20 percent for machinery and equipment, depending on the item, and a 5 percent rate for industrial buildings.

Loss carry-forward provisions are included in Kenya's EPZ program. EPZ firms benefit from a ten-year corporate tax holiday, but are allowed to carry forward any losses incurred during this holiday into subsequent years, when they are subject to a flat tax rate of 25 percent; the corporate tax rate for non-exporting companies is 35 percent.[7] Obviously, a tax holiday is less attractive without a loss carry-forward provision as most firms do not make profits for at least the first two years, thereby diminishing the value of the holiday.

In order to encourage the use of labor, labor credits are available in Namibia, where deductions equivalent to 125 percent may be taken by all firms (not just exporting ones) on all non-supervisory wages. In most countries, firms can deduct 100 percent of their labor costs like any other expense; Namibia's policy amounts to a subsidization of employment costs by allowing firms to deduct an additional 25 percent. This policy was established in April 1993 and it is too early to assess its impact, but this type of deduction is not widely used elsewhere.

[7] Kenya's lower tax rate for exporters is a violation of GATT. GATT treatment of a variety of export incentives is discussed in detail in Chapter 3.

Subsidization of Export Marketing Expenses

In a number of countries, firms are allowed to deduct, often at subsidized rates, all export marketing expenses. Mauritius, for example, introduced in 1992 a 200 percent deduction from chargeable income for certain export promotion expenses such as participation in trade shows, overseas advertising, and preparation of tenders for the export of goods. Similarly, under South Africa's Export Marketing Assistance scheme, exporters are reimbursed in cash for 50 percent of the costs, up to a certain maximum amount, incurred in the development of new markets, including travel for market research, trade missions, buying missions, and participation in trade fairs. South Africa also gave exporters a tax-deductible marketing allowance. Typically, up to 75 percent of an exporter's expenditures in developing new markets could be deducted; if the marketing resulted in an increase of 10 percent or more in the firm's exports within a specified period, the full amount of the expenditure could be deducted.[8]

It is not clear whether the use of double deductions and other forms of subsidization of export marketing costs are in violation of GATT, as is discussed in greater detail in Chapter 3. In France, a public sector program called COFACE offers insurance to small- and medium-sized firms entering new export markets. For an annual premium, the program pays participants 65 percent of the difference between the company's real overhead costs incurred in market development; the insured company also reimburses COFACE in proportion to its increased export turnover resulting from the marketing efforts. Such a program, which is run on a commercial basis, is not a violation of GATT.

In general, the subsidization of export marketing expenses is an allowance that firms appreciate,[9] but given its recent implementation in Mauritius, it has obviously not been critical to that country's success. These programs have merit as an export promotion mechanism (although they are also subject to some abuse to subsidize personal travel), but they are typically a secondary consideration -- like export finance -- in the success of any export regime. As the Mauritian example demonstrates, it is more important by far to first establish a sound policy enabling environment in which the constraints to investment and export activities have been eliminated; once the appropriate economic, regulatory, and institutional changes have been made, policies such as assisting exporters with their market development expenses become relevant considerations.

8 This allowance did not apply to marketing expenditures in the BLNS countries.

9 In most countries, these expenses are typically deductible for all companies -- whether exporters or not -- as business development expenses, although double deduction is not commonly allowed.

Preferential Charges

Mauritius offers a preferential electricity rate to EPZ firms which is approximately 10 percent below that offered to other industrial users. Air freight rebates of 25 to 50 percent are also offered on selected products such as vegetables and orchids. Similarly, the South African Homelands have offered 40 percent subsidies on the cost of transport, as well as subsidized rental and financing rates. Despite these examples, however, preferential costs -- with the exception of subsidized rental rates -- are not commonly offered as export incentives.

Export Compensation Schemes

Export compensation schemes are offered in South Africa, Zimbabwe, and Kenya. These schemes are intended to compensate exporting firms for the high cost of imported inputs, due to high import tariffs, and costly local inputs, resulting from the protection of domestic industries. While popular with exporters, these programs are countervailable under GATT and have come under strong criticism from GATT, the World Bank, and IMF officials; Kenya was recently forced to withdraw its program in face of this criticism. From a policy perspective, these schemes are "sloppy" as compensation commonly bears no relationship between the payments received and the higher costs actually experienced by exporting firms.

South Africa's General Export Incentive Scheme (GEIS) is an export subsidy determined by a formula based upon local content, the overvaluation of the Rand, and local resource utilization (beneficiation). In practice, the subsidy varies from 3 to 27 percent while the typical GEIS level for most manufactured goods is 18 to 19 percent. For large claimants, the GEIS is paid using promissory notes good for a 6 to 18 month period. These payments are not subject to tax. From the exporter's perspective, the program is complex, forcing many firms to use consultants or accountants to prepare the claim forms. The regime's overall attractiveness, however, is evidenced by the fact that its annual cost to the RSA is R2 billion (US$597 million). The program has also been highly successful in stimulating exports. According to a World Bank study, it is doubtful that South Africa could sustain its current level of manufactured exports without the GEIS.[10] The GEIS has come under sharp criticism from the GATT, however, and is reportedly scheduled to be phased out over the next 3 to 4 years as part of a series of trade reforms agreed to with GATT as part of the Uruguay Round.[11]

Under Kenya's recently phased out program, exporters received 18 percent of the FOB value of selected exported products. As such, it

[10] World Bank, "South Africa: Review of Trade Policies," August 1993, p. 28.

[11] There are conflicting reports as to when this program is due to be phased out; the projected time period ranges from 3 to 4 years to 12 years.

was a much easier program to administer than is the GEIS, but payments under the program bore even less relationship to the higher cost differentials it was meant to address than does South Africa's GEIS. Approximately 300 firms and 1,333 products were registered as eligible. Both Tanzania and Rwanda imposed countervailing tariffs on some products receiving export compensation in Kenya. The program was abolished in 1993 and replaced by the DVR program described above.

Zimbabwe's Export Incentive Scheme is also a form of export subsidy. This program has been an extremely important benefit to Zimbabwean manufacturers. Exporters receive a 9 percent tax-free cash payment based upon the FOB value of all exports which meet a minimum 25 percent local content requirement. The nine percent margin has allowed many manufacturers to export to markets where they would otherwise not be competitive, and it is not uncommon for firms to export at a loss, knowing that their losses will be offset by the subsidy payment. The GOZ is planning, however, to phase out this scheme in the near term. It is not known how the GOZ will replace the program; an EPZ program has been discussed for years, but its fate is uncertain.

Exchange Rate Policy

A realistic exchange rate has been a strong contributor to investment and export flows within the region. The Mauritian EPZ program produced only limited results after its establishment in the 1970s until the rupee was devaluated by 50 percent between 1979-81 and maintained at realistic levels thereafter. In Zambia and Uganda, recent devaluations under their structural adjustment programs, in combination with other reforms, have contributed sharply to the recent inflows of investment.

Investment Facilitation

Many countries have claimed to have established one-stop shops for investment approval, although few have worked in reality owing to the reluctance of government agencies to transfer their authority over licensing and other approvals. Even in Mauritius, firms are subject to an extremely long and difficult business establishment process which involves up to 16 separate steps. Despite the far-reaching reforms introduced in Ghana, failure to expedite the investment approval process has sharply limited investment inflows to far below anticipated levels.

Nonetheless, progress has been made in a number of countries which have realized that the difficulties in establishing an enterprise sends a strongly negative signal to investors regarding a country's receptivity to new investment. Zambia's Investment Centre, for example, has reduced the delays facing new investors and investments are generally approved within the 30-day time period stipulated by law. Investors still encounter delays, however, when working with other agencies responsible for allocating land and work permits.

Investment facilitation is also the primary focus of the Uganda Investment Authority. While the UIA is supposed to act as a one-stop shop it does not have the power to unilaterally make all necessary decisions. The UIA does try, however, to facilitate the acquisition of all secondary approvals and licenses, as well as to assist investors in accessing land, clearing imported goods, and connecting necessary utilities. Investment applications are not screened for economic viability and are typically approved within two weeks. The UIA has tried to co-opt potential bureaucratic obstacles by placing key private and public sector officials on its Board of Directors. This strategy has worked to a large degree, and as a result the UIA enjoys support and access to the highest levels of the Ugandan government. Moreover, it was recently announced by the Minister of Finance that remaining legal obstacles preventing the UIA from becoming a true one-stop shop would be removed.

Summary

A variety of export incentive schemes are used in the region, with varying degrees of effectiveness. While duty drawback or exemption programs have been operation in most countries for many years, they have not been highly successful and a number of countries have recently established export processing zone programs as a way to stimulate exports. By contrast, the use of preferential tariff or rental rates, or labor credits, as export incentives is not widely adopted.

In most cases, export incentives have been introduced in the region to offset existing disincentives to export production; a key example is the use of foreign exchange retention schemes for exporters in countries characterized by hard currency shortages. In addition, a number of export incentives in use clearly violate GATT principles; the most egregious of these include the export compensation schemes in South Africa, Kenya, and Zimbabwe. Under pressure from international organizations, Kenya's program has been ended, and those of South Africa and Zimbabwe are due to be phased out. Excluding these export compensation schemes, Mauritius is the only country which has introduced an incentive aimed at partial exporters.

Recent economic reforms in Uganda, Zambia, and Ghana have made significant contributions to overall investment levels, particularly in the agricultural and horticultural sectors. The investment regimes in these countries make no distinction between investment in domestic- or export-oriented investment, and thus come the closest to creating a neutral environment for exporters. The transparency and automaticity with which incentives and permits are issued has been sharply improved over previous investment policies. Restrictions on the repatriation of profits, dividends, and other payments have been completely eliminated in Ghana and are due to be completely eliminated in Uganda.

Improved investment facilitation has been a key focus of investment-related reforms in Zambia and Uganda, and significant reductions have been made in the time needed for investment approval and business establishment. Investment facilitation is a key component of the EPZ programs introduced throughout the continent, although it has worked with varying degrees of success.

Finally, access to financing is not typically used as an export incentive. Long-term finance is generally unavailable within the region, although preferential financing has been made available to exporters in South Africa and Mauritius. Access to export finance is also generally limited, with the exception of Mauritius, South Africa, and Zimbabwe. In Mauritius, export insurance and credit guarantee programs are provided by the Development Bank of Mauritius, while in South Africa and Zimbabwe such services are provided by the private sector.

Factors Influencing the Design of an Export Incentives Program

Current Constraints/ Opportunities Affecting Non-Traditional Export Development in Botswana

Botswana's comparative advantages and disadvantages are well-known and have been extensively documented in a number of recent studies, most particularly in a comprehensive industrial review by the World Bank.[1] As a result, the study team was asked to focus on policy formulation, rather than undertaking an extensive inventory of the Botswana business environment. Nonetheless, a brief analytical review of the enabling environment from the perspective of export policy design is necessary in order to formulate appropriate policy recommendations.

Major Policy Issues

There are a number of policy issues which affect the design of a non-traditional export development program in Botswana. One of the country's most important advantages is the availability of foreign exchange and the freedom to repatriate capital, dividends, and profits. Moreover, businesses face no difficulty in accessing foreign currency for imported materials. The attractiveness of the foreign exchange regime differentiates Botswana from many of its competitors within the region.

That being said, some foreign exchange controls do remain. Botswana's longstanding reputation as having the most liberal foreign exchange policies in the region has been eroded substantially by recent developments in Uganda and Zambia.[2] A recent study on the issue concluded that while the existing controls have little impact on manufacturing activities, they do pose an important constraint on the country's ability to attract multinational firms interested in using Botswana as a regional headquarters.[3] In this sense, the existing

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1 Opportunities for Industrial Development in Botswana: An Economy in Transition, World Bank, Report No. 11267-BT, April 1993.

2 Owing to these liberalizations, the foreign exchange regimes in these countries may be more liberal than Botswana's for some types of transactions. For example, a number of countries in the region allow the use of foreign currency denominated accounts; in Botswana, companies must convert their foreign exchange earnings into pula and back again into foreign exchange, thereby encountering high transaction costs.

3 Phaleng Consultancies, in Association with Crown Agents, "Cost Benefit Study of Liberalizing Foreign Exchange Control Regulations," a report prepared for the Botswana Confederation of Commerce, Industry and Manpower and the Botswana Development Corporation, January 31, 1994.

controls limit Botswana's ability to become an international services center.

The most important incentive program in Botswana is the Financial Assistance Policy (FAP) which provides grants and subsidies to both new and expanding businesses, whether locally or foreign-owned, or engaged in exporting or import substitution activities. An extensive review of FAP is currently underway.

The only export policy program currently offered in Botswana is based in the copper-nickel mining community of Selebi-Phikwe. Under the Selebi-Phikwe Regional Development Project (SPRDP), a Special Incentive Package was established to supplement FAP by providing a company tax rate of 15 percent for a firm's first 20 years of operation, as well as providing a ten-year tax exemption from the withholding tax on dividends paid to non-residents. Firms qualifying for the Special Incentive Package originally had to employ 400 citizens and export 100 percent of their production outside the South African Customs Union (SACU) and Southern Africa Development Community (SADC) region. This has recently been changed to allow firms to sell within the region (with proportional reductions in benefits), and the minimum number of employees has been reduced to 200. While it is understandable that the program was designed with the intent of attracting large firms which are more likely to be reputable and less "foot-loose," experience in Mauritius demonstrates that many of the large-scale exporting operations began on a very modest scale. In the Caribbean Basin, the majority of EPZ firms employ less than 200 workers.

To date, the SPRDP has created approximately 2,000 jobs at six firms. While this is within range of revised targets, these jobs have been created at high cost. Managers of the program note that the program is economically justified at a cost of US$4,000 per job. A 1992 review of the program estimated that each job was created, however, at a cost of US$6,400 (based on the FAP subsidies disbursed and the administrative and salary costs of the SPRDP project unit). The cost of creating each job over a five-year period actually exceeded the average wages received by workers in the program in that same period. Similar programs in the Caribbean and Central America typically create jobs at a cost of approximately US$2,000 each. While the SPRDP does seem to be attracting somewhat higher levels of interest than might be expected in the absence of such a program, investor site visits have averaged approximately only one per month, despite strong efforts by the project team. It needs to be noted that the decision to offer special incentives in Selebi-Phikwe was due to uncertainty about the future viability of the mining operations located there. As such, the program was based on political rather than commercial factors. The establishment of regional export development programs on the basis of political reasons has rarely succeeded anywhere in the world, despite the fact that highly attractive incentives packages have usually been offered.

As with all countries in SACU, exporters in Botswana can make use of a duty drawback program. The rules of the program are cumbersome, however, and the program is not currently used by any firms in Botswana. There is also a duty exemption scheme which allows firms with bonded facilities to import materials duty-free. This program is widely used by apparel firms and works efficiently. Nonetheless, certain items are not eligible for duty surcharge or excise exemptions. Manufacturers who export more than 15 percent of their production have noted that the exemption on the surcharge imposed on capital goods imported from outside SACU works well.

Owing to Botswana's strong economic performance since independence, there has been no need to focus on the development of export policy. The government has never developed a long-term export strategy, and no export incentives are offered on a country-wide basis. In addition, there is no single agency responsible for the establishment or coordination of export policy. While the government has periodically discussed the need for an export policy framework, there have been few concrete actions taken to ameliorate constraints other than through the FAP. As a result, many business persons view the government's commitment to developing non-traditional exports with skepticism.

Institutional and Administrative Factors

Apart from obtaining land and utility connections, business establishment procedures are fairly simple and straightforward. Manufacturing licenses are required but are now issued virtually automatically. Procedures to obtain work and residency permits still elicit complaints, however, although most firms report that some improvement has occurred in this process in recent years.

The private sector is satisfied with import and export procedures. Botswana Customs operates on an audit basis, and as such, physical controls over merchandise are not necessary and spot checks are used only infrequently. Interviews with manufacturers indicate that corruption in the Customs Department is not a problem -- particularly relative to a number of other countries on the continent -- although they report that the incidence of corruption has worsened somewhat in recent years.[4]

Investment promotion is the responsibility of the Trade and Investment Promotion Agency (TIPA), a department within the Ministry of Commerce and Industry. As part of the Ministry, TIPA has no board of directors and no formal private sector input. Consequently, TIPA's

[4] This point was also made at the Francistown Private Sector Conference in 1991.

effectiveness has been limited by its lack of autonomy and strategic direction. TIPA works with six overseas representatives that are attached to embassies. Combining the functions of diplomacy with investment promotion has rarely been successful for any country due to the widely differing priorities and training that these tasks require, as well as to an absence of incentives to perform successfully. The weakness of Botswana's attractiveness as an investment site for non-mineral related investors[5] and/or current investment promotion efforts is evidenced by the fact that TIPA commonly receives only two to three serious inquiries per month; in fact, many potential investors never even meet with TIPA officials.

Unlike most promotional institutions, TIPA does not focus on investment facilitation to ease bureaucratic hurdles faced by investors both before and after start-up. This contrasts with the Selebi-Phikwe project which coordinates site visits, secures land or factory shells, and helps guide investors through the GOB bureaucracy. It is interesting to note that Elegant Crown -- a U.S./Hong Kong apparel venture -- has continued to seek SPRDP's facilitation assistance despite electing to locate in Gaborone.

TIPA is also involved in export promotion. TIPA assists companies in trade show participation; some of the firms interviewed found this assistance helpful as it led directly to sales abroad. The agency also provides assistance to individual firms but the potential value of this assistance has not been maximized due to donor restrictions which limit participation to citizen-owned firms.

Infrastructure Factors

Infrastructure, services, and labor costs are critical components in the competitiveness of any investment site. As shown in Table 3-1 below, Botswana has a competitive cost disadvantage in several areas relative to a number of countries in the southern and eastern Africa region. Each of these infrastructure and other factors -- land, construction, electricity, water, telecommunications, transport, and wages -- are discussed in detail below.

Land

One of the major constraints to industrial development in Botswana is the shortage of serviced industrial plots. With 70 percent of all land tribally controlled and 25 percent owned by the GOB, only five percent of all land in Botswana is privately owned. Despite the Accelerated Land Servicing Program established in 1987, shortages of reasonably priced serviced land continue, although the situation has improved. According to the World Bank, "current indications of demand and

[5] Although Botswana attracts 52 percent of the SADC countries incoming foreign direct investment, the country's large mineral development projects have accounted for the "major share" of this private total foreign investment, according to the World Bank. Notwithstanding this inflow of mineral-related investment, Botswana has not proven to be an attractive investment site for to investors in non-traditional sectors.

supply suggest that this [program] will not be sufficient to address the existing demands for industrial land." The land issue is a sensitive one, but the artificial scarcity and subsequent high prices cannot be ignored as the difficulty in accessing land poses a substantial impediment to investment. Land policy also affects the availability of finance as land is typically used as a common form of collateral in most countries.

The procedures for obtaining land are often long and difficult, particularly for smaller, local investors. Investments have been lost owing to excessive delays, and waits of several years are not unknown.

Construction costs are very high in Botswana -- which is partly due to "overspeccing" by the Botswana Development Corporation (BDC); that is, constructing buildings which are of higher quality than is required for light manufacturing use. The BDC -- which is responsible for the construction of much of the country's industrial space -- estimates that construction costs range from P700-1,000/sq.m. (US$280-400/sq.m.). By contrast, less extravagant factory shells that are built privately are typically completed for P300-400/sq.m. (US$120-160/sq.m.). Comparable rates for Mauritius are US$185/sq.m.; US$160/sq.m. in Zimbabwe; US$230/sq.m. in South Africa; and in Kenya the cost is approximately US$115/sq.m.

Owing to the high land and construction costs, industrial space is relatively expensive in Botswana. Factory shells rent for P8-10/sq.m./month (US$3.20-4.00/sq.m./month) around Gaborone. This compares to rates of US$1.60/sq.m./month in Kenya; US$2.50 in Mauritius; US$1.61 in Zimbabwe; and US$1.64 in South Africa.

Table 3-1
Comparative Infrastructure, Utility, and Labor Costs
(US$)

	Botswana	Mauritius	Zimbabwe	Kenya	South Africa
SFB Construction ($/sq.m.)	**280-400**	185	160	115	230
Factory Shell Rental Rates ($/sq.m./month)	**3.20-4.00**	2.50	2.13	1.61	1.64
Electricity ($/kwh)	**.0758-.1348**	0.076	0.048	0.022	0.064
Water ($/m3)	**1.280**	0.520	0.246	0.350	0.298
Telephone (per minute to Europe)	**2.80**	1.65	2.58	4.00	1.50
Transport (20-ft. container to Europe)	**2,500-3,500**	1,800	2,200	1,400	1,000
Airfreight ($/kg to Europe)	**1.86**	2.57 but rebates of 25-50% are available	2.00	1.70	1.70
Wages (burdened rate/month)	**100**	181	81	77	384

Utilities and Transport

Utility services are of a high quality with few reliability problems. Utility prices are high, however, owing to the large distances covered, low density use, and GOB policy requiring that prices for these services be based upon full capital cost recovery.

- **Electricity**: Loans from the World Bank for electricity development specify minimum rates of return that must be achieved, thereby helping to keep rates high. In a sense, urban industrial and residential consumers are paying a higher cost for electricity due to the cross-subsidization of rural users.

  Electricity rates are high in Botswana and are based upon a firm's consumption and capacity availability. A medium-sized apparel operation that operates a single shift five days a week would typically pay P0.3371/kwh or US$0.1348/kwh. The rate drops by almost one half for firms running three shifts, 30 days a month. For these consumers, a rate of P0.1896/kwh (US$0.0758/kwh) would be charged. Corresponding rates for medium industrial consumers in regional competitor countries include: Mauritius -- US$0.076/kwh; South Africa -- US$0.064/kwh; Uganda -- US$0.06/kwh; and US$0.048/kwh in Zimbabwe. Electricity rates in Kenya are only US$0.022/kwh. Nonetheless, most light manufacturing industries are not electricity-intensive operations, and total electricity costs generally account for only one to three percent of total production costs.

In the last year the Botswana Power Corporation instituted a policy of limiting electricity tariff increases to no more than five percent per annum. This rate of increase is considerably below the inflation rate experienced in recent years, and if this policy is continued it should eventually lead to positive adjustments vis-a-vis neighboring countries. Despite this policy, Botswana will offer the highest cost electricity in the region for the foreseeable future.

- **Water**: Despite a general scarcity of water, Botswana's supply of water has been regular, even in times of drought, which differentiates Botswana from some of its neighbors. Water rates are very expensive relative to the region. A medium to heavy user in Gaborone pays P3.20/m3 (US$1.28/m3). Water in Zimbabwe costs US$0.246/m3, versus $0.298/m3 in South Africa; US$0.12/m3 in Tanzania; US$0.35/m3 in Kenya; and US$0.52/m3 in Mauritius. Moreover, costs in Botswana are expected to rise by 70 percent when the new supply line from the north is completed and these costs must be recovered.

- **Telecommunications**: The telecommunications system is one of the most sophisticated in Africa; direct dialling is available to 80 countries and all main public exchanges are digital. Installation delays are common, however, and typically 6 to 8 weeks is required if a line in the area is available. According to the Commercial Director of the Botswana Telecommunications Corporation, new phone lines will not be available in some urbanized areas until 1996-97. Even in Gaborone West -- one of the country's most important industrial areas -- a shortage of lines will exist until mid-1994.

  While the quality of the telecommunications system is high, so is the cost of these services. As with electricity services, urban industrial and residential consumers are cross-subsidizing the provision of telecommunications services to rural areas. Phone calls to the United States are P8.40/minute (US$3.36) while phoning Europe is slightly less expensive at P7/minute (US$2.80). Corresponding figures for phone calls to Europe are US$1.50 for South Africa, US$1.65 for Mauritius, and

US$2.58 for Zimbabwe. Rates for Kenya, Uganda and Tanzania, however, are even higher than those charged in Botswana: calls cost US$4.70 in Uganda and Tanzania, and US$4.00 in Kenya.

- **Private Provision of Utility Services**: An effective mechanism used in other countries to reduce high rental and utility costs has been to allow the private provision of services to exporting firms. Due to the high cost and erratic supply of electricity service in the Dominican Republic, for example, the government has allowed competition in the provision of electric power. Subsequently, four or more private electricity producers have established operations to serve the export and tourism sectors.[6] Similarly, in an effort to encourage the offshore informatics industry (data processing, voice line services, computer-aided design, etc.), the Jamaican government has allowed a multinational consortium to provide high quality, low cost international telecommunications service. Response to the policy shift has been strong and more than 5,000 informatics employees serving overseas markets are now working in Jamaica. Private provision of utility services has also been permitted for export industries in Uruguay, Togo, and Cameroon.

  With the exception of transport, services are provided by government parastatals. There is some ambiguity over the possibility of allowing the private provision of utility services. The Botswana Power Corporation enabling legislation states that it is "responsible for the generation, transmission, supply, and distribution of electricity in areas approved by the Minister of Mineral Resources and Water Affairs." A precedent has been set for the private provision of electricity services by the soda ash plant which produces its own power. The question is less ambiguous on the issue of water as the Department of Water Affairs allows the drilling of 150 new boreholes yearly. A telecommunications firm recently established operations in Botswana which provided access to low cost international calls, but withdrew after encountering strong resistance from the Botswana Telecommunications Corporation.

- **Transport**: Owing to Botswana's landlocked position, road and sea transport costs are high. The cost of transporting a 20-foot container to Europe ranges from US$2,500-3,500. Nearly half of the cost consists of road transport to Durban, plus service, handling, documentation, and wharfage charges.

6 Although these firms provide electricity only to specific sectors, this does not violate GATT because these services are provided at commercial rates.

Comparable costs for Mauritius are US$1,800; US$1,400 in Kenya; US$2,200 in Zimbabwe; and US$1,000 in South Africa. Air freight is slightly more expensive in Botswana at US$1.86/kg while the cheapest rate in the region is found in Uganda with US$1.35/kg. Air freight costs in Kenya and South Africa are US$1.70/kg., while the cost in Zimbabwe is US$2.00. Air freight rates in Mauritius are nominally expensive at US$2.57/kg, but rebates of 25 to 50 percent are available to exporters from the government.

Labor Productivity and Wage Rates

There is a shortage of Batswana in many skill areas. As a result, expatriates play a prominent role in the private sector and it is common for even supervisory positions to be filled by foreigners. Non-citizens comprise 2.7 percent of all non-public sector employment, thereby increasing overhead costs compared to other countries where companies can rely to a greater extent on the use of on local employees. In contrast, unskilled labor is abundant and many firms report a steady stream of job applicants.

Productivity rates, while still low, are improving, and a few firms stated that 10 to 15 percent of their workers achieve internationally competitive standards. According to one report, productivity levels actually declined in the 1980s for textiles and leather products, two industries which Botswana has actively pursued.[7] This low productivity is due in part to the fact that FAP encourages the hiring of excessive numbers of workers.

Low productivity standards are also probably related to the fact that current workers are Botswana's first industrial generation, in contrast to many countries in the region with longer exposure to factory work; in addition, poor management also appears to be a factor in some cases. Piece-rate work is beginning to be utilized and has had some success in some firms in increasing productivity ratios; in other cases, however, its use has had to be suspended owing to complaints from less productive workers who disliked the payment of wage bonuses in proportion to the amount of work completed.

At present, permission must first be received from the Labor Department in order to implement a piece-rate system. Firms complain that minimum wages must still be guaranteed when such a system is used, but this is a common practice globally. High turnover and absenteeism rates are also a problem for many firms. In contrast to

7 Between 1980-90, productivity in the textile/apparel sector registered an average annual rate of growth of minus 13 percent. United Nations Industrial Development Organization, "Economic Diversification and Export Promotion in Botswana: Implications for Integrated Human Resources Development Planning," Report PPD.248 (SPEC.), 15 July 1993.

many countries in the region, firms reported that firing workers was not a problem as long as the prescribed procedures regarding the issuance of warnings, etc. were followed.

Despite increasing output levels, productivity is low by both international and regional standards. A number of firms reported productivity standards equivalent to one-half of those in South Africa and one-third of those in Asia. One manager stated that his productivity standards are one-tenth those found in Pakistan, and if the wage difference was taken into account, productivity in Botswana was equivalent to only one-twentieth of Pakistani standards. At these productivity levels, Botswana cannot be competitive in labor-intensive industries under current conditions without large subsidies.

One of the most disturbing aspects of Botswana's business environment is the long learning curve for unskilled workers. It is worth noting that the FAP was designed to train workers over a period of five years. In the Caribbean and Central America, apparel workers are generally expected to become "profit-makers" for the firm after 2 to 4 months on the job. Moreover, apparel managers can typically tell within a period of 2 to 3 weeks whether a new employee is going to become a successful and productive worker.

The current minimum wage for manufacturing is P1.25/hour (US$0.50/hour) and this is a typical starting wage for unskilled labor in Botswana. Although the relatively high wage rates are compensated for to some extent by the low statutory fringe benefits which average approximately 20 percent of salary,[8] current government policy regarding the payment of severance benefits -- which can be collected by an employee automatically after a fixed period, whether or not the employee is terminated or leaves his job -- add to labor costs.[9] Including statutory benefits, monthly salary for a new, unskilled worker is estimated to be approximately US$100 while corresponding figures are US$35 in Uganda; US$22 in Tanzania; US$65 in Kenya and Zimbabwe; and US$40 in Zambia. These differences do not take into consideration Botswana's lower productivity. The cost of labor is critical, as it has been the driving factor worldwide in the movement of manufacturing operations to developing country locations.

The World Bank has called for the end of the minimum wage in Botswana, a policy which is in effect in Zimbabwe and Uganda. According to manufacturers in Gaborone, workers waiting for employment outside of factory gates state that they are willing to work for P0.70/hour -- a substantial decrease from current standards and

8 Fringe benefit rates in other countries range between 30 to 35 percent.

9 In other countries, severance benefits are typically only collected when an employee leaves his job.

evidence that the minimum wage is unrealistically high and is serving as a disincentive to firms to increase employment opportunities.

Availability of Finance

Currently, commercial banks offer finance for up to five years, and in extraordinary cases will give loans of up to seven years in length. In addition, the BDC offers loans for up to 10 years and reportedly has a relatively low rejection rate. The BDC also acts as a venture capital company and takes equity in some projects. The poor availability of long-term finance in the region is evidenced by the fact that Botswana is above average by regional standards. Moreover, the differential between the rate of inflation and the prime rate is smaller in Botswana than in many other countries. In Uganda, for example, the inflation rate is 7 percent while the prime rate is 25 percent.

The current availability of export finance is unclear, and even the Bank of Botswana is uncertain as to whether or not it is adequately available.[10] Many manufacturers claim that pre- or post-shipment finance based on letters of credit is not obtainable, and imports of inputs and export shipments must be financed using general overdraft facilities.[11] By contrast, other firms report that they routinely use such mechanisms. Foreign exchange cover, to be used against the risks posed by adverse movements in exchange rates, is available, although it is apparently not often utilized by exporters.

Essentially, there is no organized or formal system to provide trade finance for pre-shipment or post-shipment needs. Well-established firms with good credit ratings and regular export markets are apparently able to obtain export finance. At least one firm has access to finance based on the use of back-to-back letters of credit. Smaller firms, firms with only occasional export orders, or firms with weak financial conditions seem to have no access to such mechanisms, which is typical for the region. Banks typically provide credit based on the overall financial needs of a company and the collateral it can provide; no distinction is made between the credit needed for overall operations and the specialized or unforeseen credit needed for export operations. Due to the lack of an export guarantee system, collateral requirements are high because banks have no other way to secure their loans.

10 The Bank of Botswana is currently conducting an inquiry into the availability of commercial bank export finance facilities.

11 Pre-shipment finance refers to the capital required to finance the purchase of inputs and production costs necessary to fill an export order. Post-shipment finance is used to provide capital during the period between the order's shipment and the time payment is received; it is particularly helpful in enabling exporters to extend credit to buyers. Export guarantees protect banks against non-payment by borrowers, while export insurance protects firms from non-payment due to political or commercial factors.

Export credit insurance against commercial risk is reportedly available from the Botswana General Insurance Company for exports to South Africa. Insurance is issued by the South African Export Credit Guarantee and Insurance Corporation, while payment is made in pula to the local insurance company. Owing to the availability of this insurance, exporters have been able to get their export bills discounted by a local factoring organization. Use of the facility reportedly has been limited, and its availability has been poorly advertised.

The lack of any formal system of export finance may reflect in part the fact that current non-traditional export levels are so low that the commercial banks are unaccustomed to lending for export, or may be unwilling to enter this market given the availability of more profitable lending opportunities elsewhere in the economy. This factor may change if export levels grow significantly or more competition enters the banking sector.

Other Factors

In addition to the factors mentioned above, Botswana's high quality of life needs to be cited. Overall political and economic stability, a low crime rate, high quality medical facilities, and an English speaking population are significant advantages in attracting investment. Botswana housing is more expensive than in many places, although the housing shortage which caused high rents has now been alleviated to some extent. Educational facilities for international students are expensive, however, and admission is sometimes subject to waiting lists.

A common complaint among exporters who rely on South African raw materials is that they are more expensive than those available outside SACU. There are also differences in quality. One apparel manufacturer stated that the regional fabric supply is not internationally competitive in terms of quality. In addition, in contrast to South Africa or Zimbabwe, all zippers, thread, and other inputs into apparel manufacturing must be imported.

Comparative Assessment of Botswana's Export Competitiveness

Although it is impossible to rank the importance of the various factors behind successful export development, a number of generalizations can be made, on both a macro and micro level. On a national level, the cost of labor remains a critical factor for many highly price-sensitive light industrial sectors such as apparel and footwear manufacturing. This is because labor costs can sometimes comprise as much as 60 percent of total operating costs. Conversely, water and electricity comprise only a small percentage of total operating costs and, as such, the reliability of supply is more important than cost.

For more capital-intensive activities, the relative importance of the various factors of production differs dramatically. For these sectors, the educational level of the labor force, the cost of transportation, availability of local raw materials, and the cost of available infrastructure are more important considerations.

Botswana clearly has a competitive advantage in terms of political and economic stability, foreign exchange access, and the quality of infrastructure. Unlike most countries embarking on export promotion policies, Botswana's constraints are more related to costs than to policy (although it must be noted that high costs are sometimes a reflection of policy, e.g. minimum wage levels). As noted in Chapter 2, export policies are more commonly instituted in relatively closed economies with heavy policy distortions. While Botswana clearly suffers from some distortions, it is a relatively open economy.

As seen in Table 3-1, Botswana has a comparative disadvantage on labor, utility, and transport costs. The country also lags far behind its regional competitors in the area of productivity, despite the high levels of GOB spending on education and the relatively literate labor force. Owing to these factors, the study team believes that Botswana's comparative advantage lies in capital-intensive -- rather than labor-intensive -- activities. The GOB's focus on expanding employment opportunities is commendable. Nonetheless, the current incentive structure encourages firms in Botswana to maximize use of its greatest weakness -- a relatively high cost and unproductive labor force.

Market Access and Preferential Trade Accords

International market access is indispensable to a country such as Botswana, where the domestic market is restricted by the limited purchasing power of a small-sized population, and where the personal income of the majority of consumers is low. Trade accords, therefore, have a consequential impact on both input and output markets.

The skewed nature of Botswana's national trade patterns provide another reason why the country's multilateral and bilateral trade agreements are critical. Botswana has become an important customer for the producers and commercial sector of South Africa and, to a much lesser degree, other member countries of the South African Customs Union (SACU). Botswana's SACU partners do not offer comparable markets for Botswana's producers, however, who primarily find buyers for their products in Europe, or to a lesser extent, elsewhere in Africa.

Botswana's most important trading partners are countries within the common customs area of SACU, Botswana's major import source, and in Europe, Botswana's major export destination. The heavy trade deficit that Botswana runs within SACU is more than offset by the large surplus on its trade account with Europe. Only one tenth of the country's foreign transactions, usually in a deficit balance, occur outside these two regions. Therefore, the SACU Accord (SACUA) is a key determinant of Botswana's trade and development, as are the terms and conditions undertaken by Botswana in contracting to the General Agreement on Tariffs and Trade (GATT).

The multilateral trade negotiations of the Uruguay Round were completed only last December, approximately the same time as Botswana confirmed its 1987 accession to GATT. As details of the concluded agreements of the Uruguay Round become known, notable modifications in GATT's policies regarding the use of export incentives have become apparent.[12] Significantly, under the revised framework, the lessons and established precedence from past experiences of developing countries regarding export incentives are now less valid, or possibly no longer provide adequate grounds for similar treatment.

Trade agreements serve key functions in export trade development, although they are obviously not the only instruments for that purpose. The articles of such accords establish conditions or terms which can shape the design of an export incentives program. The discussion below addresses the impact of these trade agreements on the design of an export incentives scheme in Botswana. Since SACUA and GATT are Botswana's most important trade treaties, they are discussed in more detail, but Botswana's other trade arrangements area also briefly reviewed to determine their impact, if any, on the design of an export incentives program.

South African Customs Union Agreement (SACUA)

Under the terms of SACUA, the scope for implementing export incentives is limited. Even within the union area, trade in South African goods is favored over the production of the BLNS countries[13] due to the built-in protective nature of the tariff schedule, which is determined by South Africa for the whole Customs Union. Raw material inputs for use in production are subject to rates of duties which are designed to favor South African industry, and which may incidentally help, or even harm, BLNS industry.

The comprehensive structure of rules and administration of SACUA is dominated by the decision-making power of the South Africa Board of Trade and Industry (BTI). The BTI protects and supports the interest

[12] Important trade liberalizing issues are still in the process of being completed, including the submission of final tariff schedules with all concessions, in addition to negotiations on the government procurement code; provisions on trade in steel, aircraft, and shipbuilding; and formulation of the organizational and work plans for the World Trade Organization (the new trade institution which is to be established) and emerging trade and environmental issues. The formal conclusion of the Uruguay Round of multilateral trade negotiations will take place on April 15, 1994 at a meeting of trade ministers in Marrakesh, Morocco. Afterwards, the participating countries must obtain domestic approval of the accord by July 1, 1995, which is the starting date for the phase-in of the various new provisions of the agreement.

[13] The BLNS countries are: Botswana, Lesotho, Namibia, and Swaziland, all of which join South Africa in membership in SACU.

of South African business through its responsibility for the formulation of tariff rates, and as a result, dampens potential exportation in general.

The bias of BTI is evidenced by the procedures granting duty drawbacks and exemptions, which are administered more to protect local industry than to encourage exports. To qualify for a duty exemption or drawback on raw material imports, an exporter must justify the need to use imported materials rather than local products; prove that local producers cannot supply needed materials; show that the imported material was used only in producing export goods; and finally, submit an accounting of quantity and FOB value of the imported material used in the export product, and the amount of customs duty paid.

One result of these rigorous rules is a bias towards high-cost import substitution and the production of non-tradable goods. Another result is a higher general price level which in turn raises the costs of all economic activities -- for the production of goods and services alike -- within the whole SACU area. The World Bank estimates that the effective rate of protection for manufacturing is 30 percent, and that as a result, manufacturing costs are 15 percent higher in South Africa than in the OECD countries.

Although the SACU Accord prohibits the use of export incentives for goods sold within the Customs Area, a number of other areas which are relevant to the design of an export incentives scheme in Botswana are not mentioned in SACUA. For example, only merchandise trade is covered in the present SACU agreement; while services of all types are not mentioned. Consequently, exporters of services may receive specialized tax incentives. In addition, SACU provisions would allow for export incentives such as lower industrial utility costs, investment facilitation, export finance, export promotion, and training. Finally, SACUA does not prohibit the use of export incentives on goods destined for countries outside the Customs Union area.

For a number of reasons, the importance and relative advantages and disadvantages derived from Botswana's SACU membership is currently subject to evaluation. Botswana and the other small partners in the Customs Union often complain about the one-sided nature of this trade arrangement. Consequently, they are examining the benefits of membership in the Customs Union, as well as weighing the potential merits of various possible modifications to the accord. At the same time, they are considering practical alternatives to SACU membership.

A large part of the problem is due to the total decision-making power held by South Africa in the determination of tariff rates. With regard to goods imported from outside SACU and goods produced in the common customs area for use in any industry, the treaty states that

> Any rebates, refunds, or drawbacks of customs duty [or "excise duty", as the case may be] or sales duty ... granted by the Government of Botswana, Lesotho or Swaziland ... shall be identical to any such rebates, refunds or drawbacks in force in South Africa in respect of such goods for use in or used in a corresponding industry in South Africa.[14]

As a result, the BLNS countries are constrained in their ability to allow their manufacturers to import inputs at world market prices -- and thus to make exporters competitive with other producers on the world market. In earlier years of SACUA, this restriction was less important, but in an increasingly open global economy it seriously restricts the competitiveness of producers and potential exporters. Moreover, the fluidity of the tariff rate structure and its complexity, which is subject to frequent changes in tariff rates and coverage in response to the protectionist demands of the South African business community, creates an uncertain environment for producers in Botswana.

Since 1910, when SACU was first formed and Botswana was a small economy, the governing authorities have been sheltered by the agreement from much of the work and responsibility involved in the Accord's administration; for example, the formulation of a customs schedule, as well as the work of collecting most of the customs duty. As a result, the GOB is partly relieved of revenue collection. On the other hand, it is claimed that transfers are two years in arrears, and under current arrangements Botswana does not accrue any interest..[15] Even within the 1969 revision of the agreement, Botswana relinquishes effective power of decision-making and policy execution in this area of economic management.

Producers in Botswana, nevertheless, potentially derive a significant market advantage from SACU membership. By giving its members duty-free access to countries within the common Customs Area, SACUA enables the small BLNS countries to overcome the limitation on economic growth posed by a small domestic market..

Botswana is an important market for South Africa and other SACU countries. Botswana buys 80 percent of its imports from its union

[14] Articles 4 and 6 of SACUA.

[15] It is also pointed out, however, that no calculation has been made of the exact amount of transfers in arrears, taking into account the transfer made in advance when the arrangement was started. Therefore, the period of the arrears may be significantly shorter than two years.

partners, but sells only about 5 percent of its exports within the union. As a result, Botswana is a major source of hard currency for the area, and should be able to negotiate from a position of substantial strength on the future structure and design of SACUA.

In order to create a trade environment that is conducive to exporters, the GOB should, in future discussions on the accord, focus on disincentives to trade and investment. The major disincentives currently faced by Botswana are "price raising effects", "industrial polarization effects," and "loss of fiscal discretion", arising from stipulations contained in Article 4 of SACUA[16]:

> ... the customs tariff and duties and the sales duties as in force in South Africa from time to time shall be applied to goods imported into the common customs area from outside....

A customs duty schedule and sales tax regime designed particularly for South Africa is likely to have a negative impact on the competitiveness of Botswana's production and on the complementarity of industrial activity in the economy, consequently leading to missing opportunities for external economies among enterprises. Any future negotiations on the accord should address these disincentives to more efficient economic activity.

General Agreement on Tariffs and Trade

A close examination of the GATT Agreement is warranted for two reasons. One, Botswana is considering introducing an export incentives program at a time when the recently completed Uruguay Round of trade negotiations is creating a new world order for trade. Two, Botswana has recently joined the GATT, and under the terms of reference for this study, it was requested that any proposed export incentives program be in compliance with GATT rules and requirements.

GATT is founded on two major principles: one, imports from any origin, and exports for any destination, will be given the same tariff preference as those given by any country to its most favored nation (MFN) trading partners; and two, free trade should be fostered through the elimination of non-tariff barriers (NTB) and the reduction of tariffs. The possible exceptions to MFN are free trade areas and customs unions, particularly those, such as SACU, that have been in effect before the formulation of GATT.

[16] The specific effects of SACUA are named in the World Bank report on Botswana, Opportunities for Industrial Development in Botswana: An Economy in Transition, page 31. Although the source of the "industrial polarization effect" is not traced by the World Bank to the present procedure for setting the rates of customs tariff and excise tax, the rates have such effect because they are set in favor of South Africa's industrial development aims.

The contracting parties to GATT agree to liberalize international trade by reducing or eliminating regulations and, wherever possible, other restraints on trade The objective is pursued by a number of GATT agreements or codes of trade procedures that are supplementary or corollary to the two major principles. The GATT Council is the institutional body responsible for appeal and adjudication against the improper use of trade or tax measures by a country's trading partners.

One of GATT's major codes deals with subsidies to exporters or monetary payments of any kind based on exports or export performance. Such payments are viewed as serious infractions of the terms of the GATT accord, which is strongly enforced by the contracting parties. Efforts to gain a market advantage or dominant position by pricing exports lower than the same items for domestic sale (i.e., "dumping"), especially with financial help from a government, are also highly objectionable. Likewise, any official bias against imports is unacceptable.

Under the provisions of GATT, particularly since the addition of Part IV on "trade and development" in 1965, special and differential treatment of the developing countries has been a salient principle. Articles XXXVI and XXXVII present the objective of economic diversification and the program of non-reciprocal preferences given by developed countries in the generalized system of preferences (GSP). These articles recognize that the progressive economic development of all contracting parties is an important objective, and that the attainment of this objectives "is particularly urgent for the less-developed" members.[17] As a result, certain departures taken by developing countries to foster their economic development, particularly to correct severe balance of payment problems, are tolerated, or allowed to pass unnoticed. In general, only the leading industrialized countries are kept under rigorous surveillance against objectionable breaches.

Given its joint mandate to design a comprehensive export incentives scheme which is also compatible with GATT, the study team interviewed a wide number of entrepreneurs and government officials in order to explore all possible areas for the possible application of export incentives. There is a wide diversity of views on the extent to which Botswana should comply with all the conditions set forth in the GATT Agreement. Considering its recent accession to GATT, some of those interviewed believe that any export incentive that might be a transgression of GATT principles should be avoided. Others, drawing upon the example of South Korea and Mauritius, believe that Botswana should go ahead and grant incentives to exporters even if they are technical violations of GATT (e.g., preferential tax rates for exporters), based on the observation that in the past GATT has condoned such

[17] Article XXXVI, 1.(a) of the General Agreement on Tariffs and Trade.

incentives when provided by small developing countries with low export levels.

Although GATT prohibits a large number of commonly used export incentives, some export mechanisms do not violate GATT principles. Incentives which involve subsidies are nearly certain to be the target of an objection and perhaps a retaliatory action. As discussed in Chapter 2, major objections have risen recently over export sales subsidies paid to Zimbabwean and Kenyan exporters. As a result, the Kenyan program was recently phased out, and the Zimbabwean program is due to be ended. Dumping is equally disreputable. Anti-dumping actions are mentioned as early as Article II in the agreement; and three articles -- Articles, VI, XVI, and XXIII -- are dedicated to the problems of subsidies and dumping and remedies against such actions.

Although not an export incentive, restraints on competition in the granting of government contracts for procurement is also a contravention of GATT; Botswana's Local Preference Scheme (LPS) is an example of such a restraint on competition. The degree of trade distortion or injury caused by the LPS, however, is unlikely to be great enough to cause objection, and typically such actions are challenged only when potential sellers are denied access to economically important markets; for example, the United States has recently challenged government procurement procedures in Japan, and has forced changes in the process to make it more open to foreign bidders.

Some types of export incentives -- such as assistance for productivity development, export marketing assistance, and certain subsidies and forms of tax relief -- have been officially provided by developing economies to exporting firms without challenge from other GATT contracting parties. Nevertheless, export incentives of this nature are usually in conflict with the tenets of GATT, and have been the subject of appeal and adjudication among the industrialized countries. Past consideration or regard may not be necessarily continued, as will be discussed in further detail below.

The recent completion of the Uruguay Round of negotiations does not appear to substantially change the types of export incentives which may be employed in Botswana. Beginning with the Tokyo Round of negotiations in 1973-79, GATT negotiators began to focus on the issue of protectionism, particularly in the form of non-tariff barriers, rather than simply focusing on tariff reductions, which had been the subject of previous rounds of negotiations. In the Uruguay Round, negotiations set out to rectify the faults that have become particularly contentious among the contracting parties since the Tokyo Round, as well as to take GATT in new directions. The principal objectives of these discussions were to enhance the status of GATT; to improve the operation of agreements under GATT and extend the coverage to products, sectors, and conditions that have been inadequately covered; to broaden country participation in the agreements; and to put additional commodities on the schedules of eliminated or reduced tariffs.

The Uruguay Round of multilateral trade negotiations culminated in a number of comprehensive agreements, commonly called codes or provisions and arrangements. They comprise agreements on market access (reduction and/or elimination of tariffs and non-tariff measures); services (including provision for continued negotiations on telecommunications services and financial services); agricultural commodities; trade-related investment measures (TRIMs); trade-related aspects of intellectual property rights (TRIPs); textiles and clothing (eventual successor to the MFA); subsidies and countervailing measures; anti-dumping measures; and government procurement, among others.

The negotiators in the Uruguay Round reached agreements in several areas that are of particular significance for this study. These are the areas of country participation in particular agreements or arrangements; subsidies for exporters; specification and treatment of developing countries; and the agreement on textiles and clothing.

Country participation will be integrated with the creation of a new institution, the World Trade Organization (WTO), which will incorporate GATT and the agreements of the Uruguay Round. This new institution will be a permanent forum for international trade, as the framers of the Bretton Woods Agreement, which founded the IMF and the World Bank, had intended.[18] Decision-making by consensus will be the rule and general practice of procedure in the WTO.

The new Uruguay code on subsidies and countervailing measures is more comprehensive than the existing GATT and Tokyo Round codes on the subject.[19] Any export incentive that fits the definition of a subsidy or dumping action is subject to strict restraining or countervailing measures. The new subsidy code will apply to all

[18] This institution, which is not yet created, is mentioned as the Multilateral Trade Organization (MTO) in certain official documents of the Uruguay Round. It is expected to be similar to GATT in its main aspects and organized on the same structure without expansion or increased costs.

[19] The subject is comprehensively treated in the 50-page Agreement on Subsidies and Countervailing Measures. Besides defining subsidies and counteractions, the Agreement provides for a Committee and other subsidiary bodies for enforcement in Part VI, Article 24 and elsewhere; a code for the "Special and Differential Treatment for Developing Country Members" in Part VIII, Article 27; and the specific identification of the countries qualifying for special and differential treatment in Annex VII with reference to Article 27. Note that subsidies concerning agriculture are covered separately in the Agreement on Agriculture.

members, including developing countries. As explained below, the practice of giving special and differential treatment to developing countries is now more distinctly drawn and narrower.

The new code is also more explicit. The term "subsidy" is precisely defined for the first time. The code also states what conditions must exist for a subsidy to be actionable, and sets forth three classes of treatment. In essence a subsidy is defined to be a financial contribution, which is provided by a government directly or indirectly through an agent, and which confers a benefit. For a subsidy to be actionable, it must be specific to an enterprise or industry, or group of enterprises or industries.[20] The three classes of subsidies are: (1) prohibited subsidies, (2) actionable subsidies, and (3) non-actionable subsidies.

The first group, prohibited subsidies, are subsidies that are contingent upon export performance or upon the use of domestic over imported goods. These include twelve types cited in the "illustrative list of export subsidies" from the Tokyo Round and adopted in the Uruguay Round. Among them, for example, are financial payments to exporters to offset their costs; payment of a bonus based on export earnings; mandated reductions in transportation rates or other charges on domestic services to exporters; exemption, remission, or deferral of direct taxes or social welfare charges; allowance of special deductions on the direct tax base; and exemption, remission, or deferral of indirect taxes; provision of export credit guarantees or insurance at premium rates below the economical operating costs for such programs; and export credit granted on favorable terms below the rate that would be available on the world capital market.

Specific subsidies are actionable multilaterally and countervailable unilaterally if they cause adverse trade effects. Such effects are listed as: injury to the domestic industry of another member, nullification or impairment of benefits accruing to other members, or serious prejudice to the interests of another member. Otherwise, specific subsidies are presumed to be permissible.

The third group, the non-actionable subsidies, are provided according to criteria intended to limit their potential for external trade distortion. Therefore, they are permissible and non-countervailable. This "green light" category encompasses non-specific subsidies, as well as specific subsidies of the following kinds: (1) certain government assistance for research activities; (2) certain government assistance for regional development; and (3) certain government assistance to adapt existing

[20] A subsidy may be specific if access to the benefit is limited or available only to a particular type or group of enterprise either by explicit legislation, discretion, or protected market conditions.

plant and equipment to meet new environmental standards. In order to be acceptable, these specific subsidies must satisfy certain criteria.[21]

Effective from mid-1995, the new codes will apply to all members, including developing countries. The practice of giving special and differential treatment to developing countries is now more distinctly drawn and narrower. As for subsidies, which are commonly used as export incentives, the special treatment of developing countries is defined and the qualifying countries are now specified.[22] The agreement on subsidies states an overall principle: "Members recognize that subsidies may play an important rôle in economic development programs of developing country Members."[23] The specified developing countries are (a) the least-developed countries designated by the United Nations, and (b) another twenty listed countries with GNP per capita below US$1000.

The prohibition on subsidies contingent upon export performance does not apply to the least-developed countries and the twenty low-income countries until their per capita GNP reaches US$1000. All other developing country members will be required to eliminate such export subsidies within eight years from the date of the establishment of the WTO.

A developing country cannot increase the level of its exports subsidies, and must remove them within a period of less than eight years when the use of such export subsidies is inconsistent with its development needs. If the country does not grant export subsidies as of the day of establishment of the WTO, the level of export subsidies granted in 1986 is the reference level.[24]

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21 These criteria are: **Assistance for research activities**: Research may be conducted by firms or establishments of higher education or research. The maximum assistance that may be provided is limited to 75 percent of industrial research, up to a first prototype or pilot project; and up to 50 percent of the next stage, called pre-competitive research, in which the results of industrial research are translated into a plan, blueprint of a product, process, or service, or a prototype or pilot project of non-commercial use. **Assistance for regional development**: Regional development subsidy programs must be for regions that are disadvantaged as determined by specific criteria of low income or high unemployment. **Assistance for adaption to environment standards:** Explicit criteria must be satisfied. including the requirements that it be a one-time occurrence, limited to 20 percent of the cost, and available to all firms.

22 In Part VIII and Annex VII of the Agreement on Subsidies and Countervailing Measures.

23 Article 27.1 of the Agreement on Subsidies and Countervailing Measures.

24 Presumably "beating the deadline" by setting up a program of export subsidies between this moment and prior to the establishment of the WTO is not permissible under the "standstill" rule that was made at the start of the Uruguay Round of multilateral trade negotiations.

The prohibition on subsidies contingent on the use of domestic over imported goods does not apply for eight years in the case of the least-developed countries and for five years in the case of developing countries.

The Uruguay Round also set forth a schedule for the gradual phase-out of quotas established under the Multi-fibre Arrangement (MFA).[25] Global textile and clothing trade will be integrated into GATT over a ten-year transition period -- twice the normal five-year period used for other phase-outs -- on a basis of strengthened rules and disciplines for expanded trade, improved market access, and improved safeguard mechanisms.

This development may have a consequential impact on Botswana efforts to encourage the development of a textile and garment industry. The program will be affected by the response of investors, especially from the Asian quota-filled countries which currently seek low-cost locations without quotas as investment sites. Although a new plant for the production of textile garments for export to the United States is scheduled to being operation in the next several months, Botswana will probably find it increasingly difficult to attract textile and apparel companies to set up factories to produce for the North American and European markets in the upcoming years.

In particular, the key GATT provisions which will affect the design of an export incentives program in Botswana include the following:

- **Direct export sales subsidies**: Such a policy is actionable multilaterally, and countervailable unilaterally, when countries (other than the least developed countries) provide such assistance only to exporters. Under the new agreement, a sales augmentation program, if condoned for any period, could be provided for a maximum of eight years, and possibly for only a shorter period. However, the study team is skeptical that a subsidy of this type would be allowed under the new international trade system. Since the Tokyo Round, there has been an increasing level of disapproval aimed at those countries, even developing countries, that did not sign the Subsidies Code. This disapproval culminated in the Uruguay Round decision to eliminate the "free-rider" option and to require full country participation in all GATT agreements and codes .

- **Private provision of utilities solely to exporters.** The private sector provision of utilities, such as

[25] GATT, Agreement on Textiles and Clothing, from the Uruguay Round.

telecommunications, electric power, or water, only to exporters would probably not be a violation of GATT if such provision occurs in competition with the economy-wide distribution of such utilities by state monopolies, and if private utility services are provided at market prices. By definition, a private firm would be providing such services at commercial rates. It is difficult to see how such a policy would violate GATT's technical definition of a subsidy, and the GATT Council would be unlikely to look seriously into the matter unless another member of GATT could show injury.

- **Favorable corporate tax rate for exporters.** Clearly, this policy is actionable under the terms of the new agreement, which removes the free-rider option.

- **Tax relief.** As with a differential tax rate for exporters, tax relief in any form which applies only to exporters would be a violation of the new GATT Agreement.

- **Subsidized export market promotion**. This subject does not appear to be addressed in GATT, although U.S. trade law does not permit it and countervailing actions could be initiated, as reportedly experienced by South Africa. The European countries have not, and in the future would not be likely to oppose such measures if used to further the economic development of a non-industrial, developing country. In addition to the provision of broad support for market development, assistance for industrial research for product and process development is permissible under GATT.

- **Incentives for export service industries**. Before the Uruguay Round, a number of service industries were not addressed by the GATT accord. This omission has now been corrected, and a General Agreement on Trade and Services (GATS) is due to be effective in 1995. This new agreement addresses services, including information services, and as a result, incentives which are permissible for services are the same as those which are permissible for manufactured goods, as outlined in the above discussion of export sales subsidies, private utility provision, corporate tax rates, tax relief, and subsidized export market promotion.

In conclusion, the study team believes that Botswana should design an export incentives program that is in compliance with GATT provisions. While the contracting parties and GATT Council are not likely to embark immediately upon a totally changed treatment of developing country members, a trend towards the non-differentiated treatment of developing countries has been initiated. Thus, while in the short-term the use of such of non-compliant export incentives might not be challenged, it is highly conceivable that by the time such a program is designed and implemented, it would be subject to close scrutiny and challenge.

In particular, there is an increasing intolerance of the use of subsidies. In designing an export incentives program, therefore, the GOB would be advised to avoid the use of export subsidies in the form of direct payments or bonuses; below-cost charges, interest rates, or insurance premiums; or other payments based on export performance or which are only given to export industries. Incentives such as these will probably attract increasing attention and retaliatory actions may be introduced. Preferable export incentives would include the following: lower industrial utility costs; investment facilitation; research and development assistance; expeditious export finance and guarantees of low (but commercial level) interests rates; or general programs of export market development, product promotion, and leadership and management advisory services.

Other Trade Arrangements

Lomé Convention

The Lomé Convention provides duty-free access to the European market for most goods produced in the developing countries of Africa, the Caribbean, and Pacific regions. Its most important impact to date on Botswana has been the liberal quota access and high price given to Botswana's beef exports. The agreement places no restrictions on the creation of an export incentives regime, although products must meet minimum local content rules to qualify for preferential access to the European Community.

General System of Preferences (GSP)

The GSP is an arrangement for the non-reciprocal reduction or elimination of customs duties payable in a number of industrialized countries on a range of imports from developing countries. Botswana has GSP arrangements with the United States and Japan. To date, the impact of the GSP on export markets for Botswana has been low.

Duty-free treatment on more than 4,000 products is available under the U.S. program. Certain product groups are legally excluded, including textiles and apparel, some footwear, and leather goods, among others. The conditions for duty-free treatment are: (1) the imported value cannot exceed 50 percent of the total value of United States imports of the product or a value determined by the level of the GNP of the United States; and (2) the product must contain at least 35 percent Botswana value-added, comprising direct materials and direct labor, only.

Preferential Trade Agreement (PTA)

Botswana is not a member of the PTA, which is comprised of eastern and southern African nations, but is an observer at PTA meetings and maintains an option to join. Botswana cannot join unconditionally, however, because the country's obligations under the present SACU accord would conflict with PTA conditions.

Some businessmen in Botswana have reported that it is difficult to export to PTA countries with hard currency shortages. Opportunities would be expected to be greater if Botswana joined the PTA, regardless of the hard currency reserves of the importing members, because of the PTA monetary clearing facility. The facility works but trade imbalances within PTA are sources of fundamental trading difficulties. The preferential gains for Botswana would be limited by the relatively high local content requirements; in addition, as one of the more relatively prosperous countries in the region, PTA membership would entail a transfer of revenue from Botswana to support PTA activities, while the lost advantages of being in SACU would not likely be offset by advantages of trading within PTA.

The Southern African Development Community (SADC)

SADC (which was formerly SADCC), or the Southern African Development Co-ordination Conference) is mainly an organization for the development of mutually needed infrastructure. Botswana is a member and the seat of the administrative secretariat of SADC. Botswana gains no particular trade advantages from this relationship, nor disadvantages.

SADC does not impose any restrictions on adopting export incentives, and the organization does not have an international trade objective in its founding charter. Nevertheless, the organization has recently taken an interest in strengthening and expanding trade relations among its members. All SADC member countries are signatories of the Abuja Treaty, which has the objective of intensifying economic integration and establishing an African Economic Community. This objective has been given increased significance with the decision of the heads of state of the PTA to bring SADC and the PTA together in a common market for eastern and southern Africa to be called COMESA.

Botswana-Zimbabwe Trade Agreement

In 1988, Botswana and Zimbabwe amended an outdated, pre-independence trade agreement. The implicit purpose of the amended treaty is to promote trade in products made from local materials between the two countries. Export incentives are not addressed in the accord and therefore are not prohibited.

The amended agreement seems to retain many sections from the original accord that are no longer important and the treaty is not working well. Problems are currently arising in interpretation of its condition and in its application, particularly with regard to the 25 percent local content requirement exclusive of cumulative investment.. Zimbabwe is said to have sometimes imposed special taxes; Botswana initially imposed no quota on imports from Zimbabwe but now imposes the same quota that Zimbabwe has always applied (duty-free treatment on listed goods up to a maximum value of P7.2 million); the Reserve Bank of Zimbabwe introduced an import deposit requirement on Zimbabwe importers; and recently a road tax on mileage from port of entry to premises in Zimbabwe has been introduced. Trade was initially in Botswana's favor until Zimbabwe introduced protective measures.

Botswana-Malawi Trade Agreement

Trade between Botswana and Malawi is subject to the same outdated agreement that was amended for trade between Botswana and Zimbabwe. It does not constrain Botswana's options in formulating an export incentive program.

Implications for the Design of an Export Incentives Program

SACUA and GATT are the most important accords with respect to Botswana's options in the formulation of an export incentive program. Both accords impose significant limitations on the design of an export incentives program.

The main difficulty in designing an export incentives program without violating SACUA is lack of control over domestic prices for imported material inputs used primarily by exporters. The rates of customs duties, sales and excise taxes, and the ability to receive rebates or exemptions on these tariffs is determined by South Africa. Since South Africa is the natural market for Botswana industries, this is a serious constraint on an export incentives program aimed at expanding sales in that market. However, incentives of this nature appear not to be disallowed on production for markets outside SACU.

The greatest scope for an export incentives program that complies with both GATT and SACU is in the areas of activities that are not mentioned in either agreement. These types of incentives include investment facilitation, export promotion, and training. Nonetheless, until the unstable price distortions caused by the current procedure of setting custom duties and related fiscal charges is removed, and liberal measures are in place concerning trade both within and outside SACU, the impact of export incentives for manufactured goods will likely be seriously attenuated.

A larger market, the development of non-traditional economic activities in Botswana, a more collaborative arrangement for setting advantageous, and stable schedules of custom duties and other taxes on trade are crucially important for Botswana's success in export promotion.

On a final note, the GOB and businessmen in Botswana should maintain a perspective in which SACU is viewed as an expanded local market, not necessarily a more accessible foreign market. Such a changed view of the market environment would be a determining factor in production efficiency. The scale of production of goods and services could be more economical in a wider "local" market, and producers would have more opportunity to work out management problems and to improve processes, products, and marketing strategy. Producers of goods and providers of services would learn from experiences and be better prepared for addressing and successfully adjusting to the challenges of export markets.

Constraints Affecting Export Incentives Program Design

Applicability of Standard Export Incentives to Botswana

As discussed earlier in this report, export incentive policies are most effective when implemented in economies that are severely distorted. While there is certainly room for improvement in Botswana's investment climate, the country's economy is clearly not subject to the massive economic, fiscal, and administrative distortions found in most countries embarking on the design of an export policy framework. Moreover, as discussed in the previous chapter, the design of export incentives is constrained to a large extent by Botswana's membership in SACU and GATT.

In order to determine what types of export incentive policies are applicable, it is useful to examine the relevance of the most commonly used export policies in terms of Botswana's current obligations and situation. These include:

- tariff relief;
- tax relief;
- export sales subsidies;
- foreign exchange retention;
- simplified regulatory procedures;
- preferential utility rates;
- export promotion activities;
- export finance; and,
- training assistance.

Each of these will be discussed in turn.

- **Tariff Relief**. As a recent World Bank report on South African industry noted, the most important policy which could be enacted by the RSA would be to give exporters access to inputs at international prices. The SACU tariff system is -- as stated by the World Bank -- "overly complex," and "extraordinarily variable," and is characterized by a strong anti-export bias.[1] At present, however, the GOB has little say in the determination of tariff policies which are established in South Africa by the Board of Trade (which is reportedly heavily

[1] World Bank, "South Africa: A Review of Trade Policies," Discussion Paper 4, August 1993.

influenced by South African manufacturers). As a result, Botswana cannot establish a less complex tariff schedule, an important and commonly used export incentive which is allowed by GATT.

It should be noted that exporters can receive surcharge and duty exemptions on selected raw materials and capital goods and that the scheme does work fairly efficiently. (A duty drawback program does exist but is not extensively used and is not considered effective.) The GOB has no flexibility in granting exemptions, however, unless they have been provided for in the tariff code. Moreover, there have been several cases where SACU officials made unilateral and abrupt decisions terminating surcharge exemption privileges on selected inputs. This lack of stability places a large constraint on both domestic and foreign investors in Botswana because they cannot be assured of a relatively constant tariff regime.

- **Tax Relief**. Tax relief is an important element in many export programs. These incentives can include outright tax holidays, low flat taxes, or special deductions for export marketing, accelerated capital depreciation, and training or labor deductions. While these benefits have clearly played an important role in attracting investors in some countries, tax relief for exporters is considered countervailable under GATT, although to date, GATT has never fought the establishment of such policies. Sales to South Africa, however, would not be eligible for this incentive under the terms of the SACU agreement.

As with tariff relief, a tax relief program is already in place in Botswana. Under the FAP, industries in Botswana are eligible for a step-down tax holiday (100 percent for the first two years and eventually decreasing to 25 percent by year five). For exporting companies, this tax holiday is not as generous as export incentives offered elsewhere in the region -- EPZ firms in Kenya, for example, receive a ten-year tax holiday followed by a 25 percent flat tax rate -- but it is very attractive for companies oriented to the local market, particularly in light of the fact that domestic-oriented companies -- unlike exporters -- can sell in a market that is characterized by high levels of protection offered under SACU.

The use of tax relief as an incentive to firms in Botswana is not universally appealing, as firms must be profitable before tax relief becomes applicable. While the Ministry of Finance was unable to provide information on the percentage of corporations which pay taxes, many of the firms interviewed are not profitable. Further indication of this pattern is demonstrated by companies with which the BDC has involvement -- only half of which are considered profitable, despite the fact that only a handful reportedly do not receive either FAP, Local Preference Scheme, or operate under an exclusive license or behind high import tariff barriers.

- **Export Sales Subsidies**. As described in Chapter 2, one of the most popular export incentives for manufacturers is an export sales subsidy. In Zimbabwe for example, exporters receive a payment from the government equivalent to 9 percent of FOB value. Manufacturers like this program because it is simple and straightforward, and managers interviewed in Botswana frequently referred to the need for such a program. Export sales subsidies are countervailable under GATT, however, and World Bank and IMF officials have made strong efforts to eliminate the use of this type of export policy. Since this incentive is a direct subsidy, these officials view it as much less justifiable than tax relief for exporters. It is also viewed as a highly inexact policy because the value of its payments typically bears no direct relation to the higher rates for which exporters are supposedly being compensated. Under pressure from these organizations, Kenya recently terminated its program and the Zimbabwean equivalent is expected to be phased out over the next few years; South Africa's program is also due to be phased out, although there are conflicting reports as to when this is likely to be completed.

  The sales augmentation grant under FAP is similar in practice to the export sales subsidies, but is differentiated by the fact that it is applied to both local and export sales. As long as such a grant is applied equally to both local and export sales, it appears not to be a violation of GATT rules.

- **Foreign Exchange Retention**. Exporters in most developing countries experience difficulties in accessing foreign exchange to import needed raw materials and equipment. As a result, foreign exchange retention policies are an extremely popular incentive in countries characterized by hard currency shortages. This incentive has had tremendous impact in a number of African countries and is not countervailable under GATT. Although a few remaining foreign exchange controls remain in Botswana, foreign exchange is clearly not a problem and this policy is not an appropriate or necessary incentive.

- **Simplified Regulatory Policies**. Easing regulatory constraints and accelerating bureaucratic processes are key elements in many export programs. Such measures are also legal under both GATT and SACU. This goal can be reached through modifications in policies and procedures (such as Botswana's recent simplification of policies to obtain manufacturing licenses) or by institutional changes (such as creating an organization responsible for investment facilitation). This incentive is generally more important to new foreign investors than to existing firms which usually know how to solve these problems owing to their better contacts and understanding of existing procedures.

While Botswana clearly has a need to improve regulatory policies and procedures with regard to the allocation of land access and work permits, the study team heard far fewer complaints about the regulatory environment than is common in most developing countries. Typical problem areas -- such as Customs and capital fund repatriation -- were not evidenced. As such, work in this area is likely to be needed, but is relatively less important than in countries such as Ghana, Kenya, or Uganda.

- **Preferential Rates**. A few export programs offer preferential or subsidized rates on items such as transport, electricity, factory rentals, and finance. These are countervailable under GATT, but no examples of their being contested could be found. If preferential treatment is made to all industries, rather than just to exporters, this policy would not violate GATT provisions.

  Many exporters in Botswana favored this type of incentive. Subsidizing high rates is generally not recommended, however, since it is both distortionary and politically difficult to end once the subsidies have begun. Nonetheless, economists generally prefer a focused subsidy which is directly linked to the rates actually incurred by the exporter (e.g., tax credits to offset transport rates), to a broad one such as an export sales subsidy in which payments often bear little relationship to the costs actually experienced by the firm. A more ideal approach, however, would be to address the problem directly through mechanisms such as allowing for the private provision of utility services.

  Most companies reported that utility rates account for only 2 to 4 percent of their total costs, and a number of firms interviewed by the study team did not cite utility rates as a serious constraint on their operations. For these firms, utility rates are a minor factor relative to the financial impact of high labor rates and low productivity. Nonetheless, high utility rates do pose a significant constraint on some sectors. Data derived from license renewal applications show that for approximately 10 percent of firms, combined water and electricity rates account for 5 to 20 percent of total sales; furthermore, if telecommunications costs were included, this proportion would be higher.

Clearly, high utility rates are a considerable constraint for some existing industries, and probably impose a deterrent to certain types of new investment which may be characterized by moderately heavy utility usage. For most firms, they add one more element to an already high cost operating environment. In terms of the overall magnitude of problems facing most manufacturers, however, the establishment of preferential or subsidized rates is unlikely to have a large impact. Moreover, since such a policy would have to be aimed at all industries in order not to be countervailable under GATT, preferential utility rates would be a particularly costly way to address a problem which is a substantial constraint on only a small percentage of manufacturers. As noted above, the most effective way to eliminate this burden is to address the roots of the problem directly -- through the private provision of utility services, adoption of measures to reduce the BPC's internal operating costs, changes in the tariff structure or policy of cross-subsidization of consumers, or other measures -- rather than to try to offset the impact of high utility rates on business.

- **Export Promotion Activities.** Export promotion activities include a variety of actions ranging from individual firm assistance to trade show participation, and the use of such activities is becoming increasingly widespread in Africa. Although export promotion programs have generally lacked the proper focus to be effective, some successes have been recorded. This activity is allowable under both GATT and SACU. Export promotion activities are generally oriented to existing rather than new investors as it is seen as a way to re-orient companies to external markets. It must be mentioned that export promotion programs are of secondary importance generally; a firm must first produce competitive products in order for an export promotion program to be successful. Nonetheless, a commercially operated program such as COFACE could be a useful mechanism to spur exports at a relatively low cost.

  Export promotion activities are not well developed in Botswana. Under BPED, BOCCIM can provide assistance to firms but this assistance is fairly general rather than the highly specialized assistance provided under the more successful export promotion programs. The ITC has reportedly had success with its export promotion activities, but the program has been limited to citizen-owned enterprises. Manufacturers in Botswana were not averse to this form of incentive but it clearly is less attractive to them than an export sales or cost subsidy.

- **Export Finance**. Export finance programs have been important in a number of countries, particularly when the exporters were local and lacked international experience, although typically they are not critical in the first stages of export development. This element is allowable under both GATT and SACU, but like export promotion activities, should be considered a secondary factor to policy, rates, productivity, political stability, and infrastructure in encouraging export-oriented investment. As will be discussed in further detail below, it is not clear that there is a need for an export finance program in Botswana at this time.

- **Training**. Training activities for export-oriented firms are allowed under GATT and SACU. Unfortunately, the performance of training activities in stimulating non-traditional exports globally has been disappointing. Most firms prefer to train their own employees on the company's machinery to prevent the "bad habits" that can occur from poor training. In Costa Rica for example, apparel manufacturers found that INA (the national training institute) utilized outdated machinery and fostered techniques that were less than optimal. As a result, many companies found it easier to hire and train their own employees rather than use trained recruits. In Jamaica's HEART training program, students employed by firms were found to have poor work attitudes due to unrealistic expectations concerning their starting positions and payscales. As a result, many Jamaican manufacturers avoid HEART graduates.

  Mauritius has found that training programs are difficult to design and can lead to waste and economic inefficiency. Due to Mauritian concerns that an increase in skills is necessary if the country is to move to the next stage of economic development, the GOM has begun to offer a number of training programs. A one percent levy on payroll is assessed and most training programs are reimbursed by the GOM. Because 200 percent corporate income tax rebates are offered for training, many firms send their workers to be trained regardless of the effectiveness of the program, and the government absorbs this cost. Many ineffective training schools have been established as a result to enable firms to benefit from the training rebates.

Botswana already offers an attractive training incentive under the FAP which has not been extensively utilized because on-site training is not allowed, and the use of a similar incentive for exporters is likely to be even less successful. In addition to the problems outlined above, export firms generally prefer to train on-site using their own production methods, but it is very difficult to monitor training grants to prevent abuse under those conditions.

Economic Models for Botswana

In addition to the constraints outlined above which affect the design of export incentives scheme, few countries dominated by a strong mineral or commodity export have been able to develop non-traditional export programs. Economists call this syndrome the "Dutch Disease," which refers to the negative impact that large natural gas exports had on Holland's economy in the 1970s and 1980s. The Dutch Disease occurs as the currency becomes stronger as a result of high trade surpluses. This "overvaluation" of the currency raises the prices of exporters' goods and services, thereby making them less competitive than they would otherwise be on international markets.

The impact of the Dutch Disease is apparent when examining countries that have developed successful non-traditional export programs. Taiwan, Hong Kong, South Korea, Singapore, Thailand, the Dominican Republic, and Mauritius are all relatively poor in terms of mineral resources. Labor in these countries was inexpensive, and was made more so by government policies which purposefully kept their currencies either realistically priced or undervalued in respect to their export markets.

In contrast, major oil producers in the Middle East, West Africa, and Latin America have generally been unsuccessful in establishing sustainable non-traditional exports. Dubai has attracted hundreds of companies to its US$1 billion port and free zone, but the great majority of firms are involved in transshipment activities. There are a few garment producers using imported labor to avoid quotas in European markets, but this does not comprise a substantial part of Dubai's economic activity. There are also a few energy-intensive industries such as aluminum, but these are owned by the sheik and benefit from the availability of extremely low cost energy. Saudi Arabia has been moderately successful in generating some manufactured exports, but these have been heavily subsidized and are unlikely to be sustainable without continued subsidies. Mexico and Indonesia both have strong oil exports and expanding non-traditional exports, but oil plays a less important role in these economies than do diamonds in Botswana.

In many ways, Botswana's economy more closely resembles the relatively well-off countries of the Caribbean Basin than it does other

African nations. Botswana has a number of similarities with countries such as Barbados, Bahamas, and nations in the Eastern Caribbean which are characterized by:

- long-standing democracies characterized by political stability;
- economic well-being compared to most of the region;
- sound infrastructure;
- well-educated workforces, relative to the region;
- small domestic markets that are dominated by a geographic neighbor;
- access to developed markets under preferential trade agreements;
- high utility and labor rates compared to neighboring countries;
- good foreign exchange accessibility; and,
- sound legal systems and generally competent and non-corrupt bureaucracies.

Given these strong advantages, it might be expected that these countries could successfully develop manufactured exports. All of these countries have implemented export promotion policies, but the results have been disappointing. The Eastern Caribbean has attracted only a few firms and those that have located there have had a high failure rate due to uncompetitive labor rates and productivity levels. The Bahamas' export program has also attracted only a few manufacturing firms, and the country has had more success in luring transshipment companies. Of these nations -- Barbados, Bahamas, and the Eastern Caribbean countries -- the country which has had the greatest success in generating manufactured exports has been Barbados. In the 1970s and 1980s Barbados was host to a number of large electronics and apparel manufacturers. Nearly all of these companies have since shifted their operations, however, to lower cost locations such as the Dominican Republic and Jamaica.

All three of these countries have now determined that their comparative advantage lies not in labor-intensive manufacturing but in service industries. Consequently, the three are focusing on offshore informatics, offshore financial services, and tourism.

Botswana's Competitive Position

As pointed out in the previous chapter, Botswana suffers from a number of inherent internal constraints which are difficult to address in the design of an export incentive framework. High labor, utility, and transport costs and low productivity will make it extremely difficult for Botswana to significantly reduce its unemployment rate. In fact, given Botswana's foreign exchange surplus and the outdated plant and equipment found in competitor countries in the region, it could be argued that Botswana's comparative advantage lies with more capital-intensive industries.

The great majority of firms interviewed by the consultants are operating under one or more incentive schemes such as FAP or the Local Preference Scheme. In addition, many firms are protected from international competition by SACU's high import tariffs. While it is true that local firms receive little protection from the strong competition presented by RSA manufacturers selling in the Botswana market, the high rate of tariff protection given to South African firms has made them relatively inefficient by world standards; as a result, the fact that many Botswana firms have difficulty competing with RSA firms indicates their relative uncompetitiveness.

There is significant body of evidence to support this conclusion:

- productivity actually declined in the apparel/textiles and leather industries in the 1980s -- two sectors which are widely considered "the future" of export manufacturing in the country;
- Botswana captured little of the disinvestment which occurred in South Africa despite its proximity, stability, and liberal foreign exchange regulations;
- local manufacturing investment in Botswana is small and the level of local investment is often an important symbol to foreign investors; and,
- firms are having severe difficulties competing with South African imports which makes it extremely unlikely that they will be able to compete in more competitive developed country markets.

Consequently, it is unlikely that Botswana will be able to compete successfully in attracting highly labor-intensive industries such as t-shirt and uniform assembly. Attracting these firms will be complicated by the fact that Asian investors are typically more focused on finding the lowest cost locations with quota access. While Botswana can offer quota access, it cannot provide a low-cost operating environment.

Despite Botswana's high cost structure, a number of persons interviewed by the study team appear to believe that apparel production is a potential growth sector for Botswana. This view appears to be based largely upon the fact that Botswana has been successful to date in attracting some apparel manufacturing firms. The study team believes that optimism about this sector's future growth is misplaced, however, and this growth has been an anomaly for the following reasons.

- Botswana attracted a number of Zimbabwean apparel firms in the 1980s which began operations for export to Zimbabwe. These firms began operations in response to a number of factors, including the attractiveness of Botswana's exchange regime vis-a-vis that of Zimbabwe, the overvaluation of the

Zimbabwe dollar, and the continued access to supplies of subsidized Zimbabwean cotton. Their operations proved unsustainable, however, once Zimbabwe's structural adjustment reforms began. As the supply of subsidized cotton was ended and the Zimbabwe dollar was devalued, exports to Zimbabwe from Botswana became uncompetitive and these firms ceased operations.

- Botswana's strong exchange rate and production factor costs sharply argue against the country's apparel production potential. The international apparel industry is among the most cost-competitive sectors in the world. As a result, it is extremely sensitive to exchange rate values; sharp drops and increases in annual export volumes over time in countries such as the Dominican Republic and Mauritius can be directly linked to the overvaluation and devaluation of the national currency. The pula's value will continue to remain strong as a result of the high level of diamond exports, thereby substantially limiting Botswana's competitiveness.

While it is theoretically possible to compensate for higher production costs by manufacturing high-end garments, Botswana does not possess a sufficiently qualified and productive labor force to produce these more sophisticated items. In contrast to the assembly of simple t-shirts and uniforms, countries typically undergo a learning curve of many years before the workforce has the skills to produce for this sector. Moreover, production for these markets is extremely fashion- and time-sensitive and air freight is usually used to move these items to market; current air connections to Europe do not have either the sufficient frequency or capacity to serve this market.

Finally, the future growth of this sector is limited owing to changes being implemented in international markets. Under the Multi-fibre Arrangement (MFA), quotas were imposed against successful exporters of apparel in East Asia. These firms have roamed the world in search of production sites with quota-free access to developed country markets. Under the recently signed Uruguay Round of the GATT negotiations, however, the MFA is being phased out and replaced with tariffs over the next 10 to 12 years. While the search for quota-free access will continue to fuel investment in this sector in the near- to medium-term, this fundamental structural change in the international market will eliminate Botswana's current edge -- quota-free access to Europe and the United States -- in attracting apparel investment.

As a result, Botswana is unlikely to find an economic panacea in apparel or any other single export manufacturing sector. This is borne out by the experience of other countries. Those with higher wage rates generally have more diverse production sectors. Low-cost centers such as Guatemala, Bangladesh, and El Salvador have been dominated by apparel; higher cost centers -- such as Costa Rica -- have attracted a more diverse mixture of firms including apparel, electronics, and pharmaceuticals. To the degree that Botswana is successful in encouraging exports, it is likely to be in small niche industries. This is already evidenced by the fact that some large apparel and textile firms are suffering, but smaller niche specialty exporters are doing well.

In addition, Botswana is more likely to find success in service-oriented sectors such as offshore informatics, regional corporate headquarters, and perhaps offshore financial services. These sectors are more compatible with Botswana's higher cost structure; current pattern of education; strong exchange rate; and a liberal exchange control system. Furthermore, Botswana's comparative assets -- political stability, a high quality of life for expatriates, and high quality and reliable infrastructure -- have greater importance to investors in these sectors than they do in lower-end industries such as apparel manufacture where labor rates are of paramount importance.

The potential and characteristics of niche industries, as well as offshore informatics and offshore financial services, are examined in turn below.

Niche Industries

Among the various determinants of market demand, product <u>price</u> is the main basis for competition among many manufacturers, who aim for a large market share, and produce in large volume. In contrast, small volume producers find or make a *niche* in a market -- and compete on a basis other than price, usually a certain product quality or uniqueness. Their products are distinctive in material, character, or design, or provided with a novel service. Their customers may prefer uncommon rather than mass produced products. Consequently, price is not the primary factor in the sale of these products.

A niche industry in Botswana may succeed despite the high cost of labor, transportation, and utilities, if local resources or products are characterized by a special quality for which the buyer will consider no substitute. There may be limitations due to a lack of industrial linkages, certain high-technology services, or infrastructure. The non-traditional product of a niche industry in Botswana is likely to be based on the abilities of a creative, innovative entrepreneur. It could also be based on an imported material input and the firm's unmatched ability to meet and maintain strict standard and quality controls.

At a pre-investment stage, niche products and markets are difficult to identify. Much depends on unknown, undiscovered potential market factors and the entrepreneur's ability to find or to create a market. To best encourage the risk-taking needed to develop such products, policy makers can only provide incentives that are flexible and adaptable, and ensure a sound enabling environment. The incentives might include facilitated access to venture capital funds provided by the government, specialized training assistance, overseas publicity and export promotional projects, or a special commission of governmental experts charged with responsibility for expeditious resolution of problems that confront entrepreneurs in niche industries.[2]

There are several promising types of niche products which are currently being explored by several institutions and entrepreneurs in Botswana and, in some cases, by international buyers or investors. Some of the more promising niche operations that should be encouraged are discussed below; however, since this is a study on export incentives rather than an industrial survey or analysis, they are only briefly mentioned.[3]

- **Game Ranching**: Game ranching and ostrich farming for the production of meat, hides, skins, and other products such as horn, bone, feathers and egg shells is an area of some potential; ostrich farming in particular has been quite successful in Namibia. Springbok and wildebeest meat has been exported by one farmer in Botswana. Arguments and evidence for developing productive activities in raising wildlife for commercial exploitation are presented in a study on game ranching in Botswana by the Department of Wildlife and National Parks.

- **Horticultural Products**: The potential for horticultural products is obviously limited by the availability of arable land and water. Nonetheless, one enterprise which has already done considerable original development in horticulture which suggests that various gardening activities are sustainable.[4] Export industries could possibly be developed from these

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2 The executive structures of these incentives could be created and operated within existing institutions, such as the recently established Botswana National Productivity Center or the Institute for Development Management and the Botswana Technology Center.

3 Further discussion of Botswana's industrial potential and analysis can be found in Botswana: Industry Location Study; Phase 1: Target Industry Selection by Simon Winter, Gaborone, Botswana, 1993. Winter reviews Botswana's resources and capacities that determine the economy's comparative advantage, and provides a brief analysis of the prospects for development of about twenty-five industrial branches. The World Bank's report, Opportunities for Industrial Development in Botswana, (Chapter 7) briefly covers similar ground in a section on the development of downstream industries. Finally a comparable range of potential industries and products is mentioned in a study by the United Nations Industrial Development Organization, Economic Diversification and Export Promotion in Botswana, Vienna, UNIDO, 1993.

4 Sanitas Nurseries & Garden Center, Gaborone (Dr G I Nilsson, Managing Director).

innovations. The BDC is currently supporting greenhouse cultivation of tomatoes and cucumbers, near the Gaborone dam, for local sales and export. Raw silk production, on which cloth and clothing could be based, is also thought to have potential.

In addition, indigenous horticultural products, called *veld* products, are frequently mentioned as being potential exports. Various development efforts apparently reveal a strong potential in commercial production for export of indigenous, or veld, fruits and nuts or medicinal plants and essential oils.[5] These may include dried or pickled fruits and preserves, such as a prickly pear fruit or the morula or morotse melon, or mirama beans and desert truffles. The grapple plant or devil's claw is used in making a medicine, which is currently bought by a German firm and marketed in Namibia, and which has attracted South Korean interest for marketing in the United States. The cochineal insect, which feeds on a cactus plant and is the source of a red dye, provides another possibility.

- **Eco-tourism**: As part of a program for the development of wildlife and unique resources, small-scale, up-market tourism -- referred to as "eco-tourism" -- would appear to be an ideal niche industry. The GOB has introduced several initiatives in this area and has recently implemented a new tourism policy to this end.

- **Leather and leather products**: Leather and leather products would appear to be a perfect industry for Botswana, but tanning processes are environmentally unfriendly because water is critically scarce. Botswana has a game skin tannery, but cattle hides are exported in wet-blue condition. Perhaps tanned leather could be imported, possibly as an arrangement with the export deals in hides. Linkage with the game skin tannery may be possible for an industry in leather and skin bags and travel goods. Asian producers are the competitive challenge; a high proportion of American name-brand luggage is made in China.

  Besides hides, another by-product of the cattle and meat industry is tallow. This could provide the industrial basis for manufacturing soap, candles, or glycerine.

5 Recognized work is being done by Veld Products Research (Rural Development Consultants, Frank Taylor, Director), Gaborone; and Thuasano Lefatsheng, an NGO for agricultural research and rural development, Gaborone. In addition, evaluation projects have been established by the Botswana Natural Resources Management project, with the support of USAID, in markets for grapple plant, cochineal, and traditional veld products.

- **Clay and ceramic products**: Clay and ceramic products, such as architectural tiles or perhaps sanitary ware, may be developed based upon existing industry. Glass production may have some potential because of its requirement for soda ash, which is already mined and exported.

- **Furniture and wood products**: Hardwood in the Chobe Forest Reserves could be the source of supply for a small industry in cabinetmaking and fine furniture. The resource is unlikely, however, to support mass production activity.

Finally, several government officials and businessmen interviewed by the study team believe that Botswana is geographically well located to serve as a transshipment point for traffic between Walvis Bay and points on the north-south corridor from Durban to the Copperbelt in Zambia. While major transshipment points are usually seaports, on major ocean shipping lanes -- for example, Singapore; Kingston, Jamaica; Miami, Florida in the United States; and Rotterdam, in the Netherlands -- inland transshipment centers have developed in cities such as Indianapolis and Denver in the United States. Moreover, Botswana's political stability could be an influential factor contributing to the creation of SACU regional distribution center, especially for items with high sales taxes in South Africa.

Offshore Informatics

One industry which appears to have potential is offshore information processing, also known as offshore informatics. Offshore informatics includes a wide variety of activities but can generally be defined as labor-intensive services produced for export markets. The offshore informatics industry has grown substantially in the past few years and appears to be following the movement of "production sharing" assembly and manufacturing investment overseas. The advent of low-cost computers and more affordable telecommunications has created the development of offshore information industries. Many of the services provided by these firms are labor-intensive, and firms based in industrialized countries are increasingly looking for offshore processing facilities as a way to reduce costs. Common activities include the processing of insurance claims, coupons, and warranties; responses to direct mail solicitations; and inventory management systems which all rely heavily on keyboarding operations.

Currently, the major export-oriented information industry in developing countries is data entry operations. Approximately 20 years ago, large multinational corporations began shipping source documents by air freight to developing countries for labor-intensive keyboarding operations. An estimated 37,000 offshore data entry operators are currently employed in this manner, including 9,000 in Mexico, 8,000 in the Caribbean, and 20,000 in Asia. Operations include data base formation, inputting of text/numeric documents, and indexing of files.

A key emerging sector is image processing which is heavily dependent on low-cost telecommunications. This process utilizes high-speed scanning operations to bypass the need to physically send documents offshore. Estimated by Forbes magazine to be a US$35 billion market by the end of the 1990s, image processing is being given top priority by companies such as Kodak, IBM, Wang, and 3M. Increasingly, insurance and financial companies are viewing the use of image processing as integral to timely and cost-effective claims processing operations. Other growth areas which are moving offshore include voice center operations, electronic publishing, research/technical writing, computer-aided design, translation services, and software development.

In late 1988, a joint venture teleport (with majority ownership by Cable & Wireless and AT&T, and a minority holding by the government of Jamaica) was established in Montego Bay, Jamaica. Telecommunications costs are as low as US$0.24/minute for voice service operations to the United States. Approximately 1,900 data entry workers are employed in office facilities near the teleport, while another 2,300 are located elsewhere in the country. Other teleports in the Caribbean Basin can be found in the Dominican Republic, Grenada, St. Lucia, Mexico, and Costa Rica.

Information processing exports are also emerging in Africa. Mauritius employs approximately 200 typesetters and data entry operators for the French publishing industry. Significant growth of the sector has been stymied to date by a lack of competitive telecommunications rates; however, a forthcoming informatics park is expected to address this problem through the completion of a teleport-like bypass facility. In Zimbabwe, more than 100 jobs have been created in the keyboarding of municipal records for the United Kingdom. An inability to offer favorable telecommunications rates, however, has resulted in the loss of fast-turnaround image processing business to Jamaica and Asia.

Informatics industries appear to be compatible with Botswana's comparative advantages for the following reasons:

- The industry requires a literate labor force offering at least a two-to-one cost advantage relative to developed country standards. As such, informatics is sensitive to labor rates, but labor cost is not as critical a factor as it is for industries such as apparel and footwear.
- Botswana's English-language speaking population is also an advantage.
- Similarly, because it is less cost sensitive, Botswana's strong exchange rate poses less of a competitive constraint to

informatics activities than it does to apparel or footwear activities.

- Botswana's landlocked nature -- and thus the constraint posed by high transport costs -- is irrelevant since information is carried by telecommunications links and air freight.
- Since Botswana shares a similar time zone with Europe, this gives Botswana an advantage over Asian and Caribbean locations when marketing in Europe, which is likely to be Botswana's chief export market for such services.
- Finally, as a service industry, the offshore informatics industry is exempt from GATT and SACU regulations.

Obstacles to the development of this sector are relatively easy to identify and address. The necessary conditions for the establishment of this sector include: a low tax environment; appropriately configured office space; strong intellectual property rights; and private, low-cost, high quality telecommunications services. While the last factor may be difficult to achieve for political reasons, the provision of competing telecommunications services is technically easy and is relatively inexpensive. It is one of the most important actions the GOB could take to differentiate itself as an investment site within the region and to allow the country to become a player in the offshore informatics sector. Moreover, the loss of revenue to the Botswana Telecommunications Corporation would be minimal, as this industry would represent new and incremental investment, rather than a diversion of existing users.

One possible constraint on this sector that needs to be further explored, however, is the potential impact of SACU's tariff code. It is unclear whether computers, software, and other items necessary for the industry could be imported duty-free under SACU, despite the fact that they are the equivalent of production equipment for an export industry. Finally, it should also be noted that while there is good potential for the development of an offshore informatics industry in Botswana, this potential does not apply equally to all informatics-related activities. Although Botswana's educational standards are better than some countries in the region, and are probably sufficient for offshore data entry operations, they would probably be inadequate for offshore computer programming which requires a comparatively higher level of education.

Offshore Financial Services

The offshore financial services industry includes offshore banking, corporate registry, maritime registry, and captive insurance. Although these sectors are often accused of serving those involved in illegitimate activities such as drug smuggling and arms sales, the bulk of the activities undertaken in so-called tax havens are legitimate. Moreover, the programs can be designed to reduce fraudulent or undesirable elements to a significant degree. Each of the four types of offshore financial services is discussed below.

- **Captive Insurance**: Of the four sectors, captive insurance has the least near-term potential for Botswana. The movement of insurance companies offshore has occurred in response to lower taxes and regulations found in offshore domiciles. Captive insurance companies have primarily established operations in older, well-established tax havens such as Bermuda and Barbados. More recently established tax havens, such as the British Virgin Islands and the Turks & Caicos, view the development of the insurance sector as a second or third phase of growth in the development of their offshore financial services programs.

- **Maritime Registry**: Maritime registries have developed in order to enable shipping companies to enjoy lower taxes and licensing fees, lower cost employees, and less stringent regulatory procedures. Among African countries, maritime registry has proven to be highly successful for Liberia. Liberia's program is over 40 years old and has commonly provided 10 to 15 percent of government revenue. Although the sector has become increasingly competitive, a number of countries -- such as Belize and St. Vincent -- have recently launched maritime registries with great success. Contrary to what might be expected, Botswana's landlocked nature is not necessarily a constraint. Ship inspections are undertaken in major ports, and ships typically never visit the country of registration. The quick growth of Luxembourg's program demonstrates that a country's land-locked nature is not an issue.

- **Corporate Registry**: Corporate registries are utilized by individuals and corporations to protect assets, reduce tax liability, and ensure high secrecy standards. Of the four offshore financial sub-sectors, corporate registries are the most likely to achieve rapid growth in Botswana because this sub-sector has the lowest service requirements for investors. Within the first five years of the British Virgin Islands' program, over 22,000 companies were registered, and this program now accounts for 40 percent of all government revenue. The Turks & Caicos registered 2,500 firms in its first three years of operation, yielding US$700,000 in annual revenue.

- **Offshore Banking**: There have basically been two strategies adopted in the design of offshore banking programs. The first is to adopt a laissez-faire approach and to grant licenses liberally. This approach can produce quick results as there is always room in the international marketplace for the registration of questionable or illegitimate bank activity. Some countries which have adopted this approach -- such as the Cayman Islands -- have later evolved to the point where authorities can be more selective in granting offshore banking licenses. Such an evolution is not always easy, however, and some countries -- such as Montserrat -- have later faced embarrassing disclosures of illegal activity.

A second approach, followed by Barbados, Gibraltar, Cyprus, and Mauritius, is to grant licenses only to prestigious international banks after a lengthy vetting process. This approach naturally leads to much slower results in the short-term and much higher administrative expenses for the government. Such a strategy is more likely to eliminate illegal activities, however, and is well-suited to countries with double taxation treaties.

Successful offshore financial service centers typically have a number of similar attributes; most of these are shared by Botswana. The primary ingredients for success in this sector include:

- political and economic stability;
- similar time zone with developed country markets;
- geographic proximity to wealthy investors;
- legal system based on British common law;
- English language capability;
- high quality of life for expatriates;
- excellent and reasonably priced international telecommunications service;
- liberal immigration policies for expatriate workers;
- a freely exchanged currency;
- low tax rates; and,
- strong secrecy provisions.

As with informatics industries, the strong value of the pula is a factor of little significance for offshore financial services. Similarly, this sector is less sensitive to high utility rates than are many manufacturing activities. Particularly in the short-term, however, the jobs created by offshore financial services industries are primarily limited to expatriates,[6] and even in the long-term, such programs produce

[6] Currently, the level of education in Botswana is probably insufficient to support offshore financial services, although as discussed above, it is adequate for some forms of offshore informatics activities. Since most employees working in the offshore financial services sector are initially expatriates, however, this level of education does not pose a constraint. Typically, the first phase employment benefits for an offshore financial services program are more likely to be in sectors such as construction or the hotel industry, where educational levels would not pose a constraint; moreover, given the government's emphasis on education and computer training, it is likely that there will be a sufficient supply of Batswana to fill expatriate positions over time.

relatively few jobs. After more than 20 years of operation, only 3,000 Bahamians work in its offshore financial services sector. Nonetheless, offshore financial services have had a highly positive effect on small economies such as the Cayman Islands and Bermuda. In addition, these industries typically have a beneficial impact on tourism levels and indirect employment in sectors such as construction, hotels, and the service sector. As a result, these two islands have virtually eliminated unemployment on the basis of tourism and financial service activity.

Summary

As discussed above, Botswana has a number of similarities in common -- in terms of population size, cost structure, relatively well educated workforce, and political stability, among other factors -- with some of the economically better-off countries in the Caribbean where service industries have been successfully established. The experience -- and failure -- of these nations in trying to foster export-oriented manufacturing is illustrative. Similarly, their success in developing offshore service industries is equally instructive. Botswana appears to possess the necessary ingredients for similar success, and given the country's comparative disadvantage in labor-intensive manufacturing, the potential for this form of service industry development should be actively explored.

The likely pattern of Botswana's economic diversification and export development, however, is not likely to be dominated by any one form of investment owing to the country's small market size and other constraints. It is probable that Botswana's non-traditional economic growth will necessarily be fuelled by small levels of investment in a variety of small or niche areas. In addition, a country such as Botswana -- with political and economic stability, access to foreign exchange, and a pleasant living environment -- will always be able to attract a few "cowboy" investors. These are investors who give a disproportionately low emphasis on finding the least cost environment because they like a particular country and have a niche product which is less susceptible to predatory low pricing. It is extremely difficult to target this sort of investment, however, which complicates the design of any sort of export incentives program.

There is also a growing realization that the regional market -- particularly the RSA -- is Botswana's natural market (an important exception is likely to be offshore informatics services, where the main market is likely to be Europe). Apparel/textile firms originally planning to sell to Europe are increasingly turning their orientation from developed countries to South Africa as they discover that developed country markets are more difficult to penetrate than is the South African market. As one manufacturer pointed out, the regional market will accept lower quality goods at higher prices than are acceptable in industrialized countries. This market provides a natural stepping stone for local firms to enter the export market. It also provides an important potential source of investment and joint venture partners which could play a significant role in providing local firms with the capital, marketing skills, and other factors that currently limit their capability to export.

Section 5

Proposed Design of a Comprehensive Export Promotion Program

Recommended Strategy to Promote Investment and Exports

As discussed in the previous chapter, Botswana faces a number of significant impediments to attracting investment, particularly export-oriented investment. The country does have a number of advantages which are highly attractive to investors, including a stable and democratic political climate, relatively free foreign exchange system, preferential access to regional and overseas markets, and geographical proximity to South Africa's large domestic market.

Nonetheless, the constraints identified in the previous chapters of this report are significant and are highly difficult to address through the implementation of export incentives. In fact, Botswana's situation is more difficult than many African countries where significant reforms remain to be introduced; in these countries, the use of export incentives is often appropriate in order to offset deterrents to investment and export until significant liberalization takes place. In contrast, the GOB has already introduced a wide number of important liberalizations. In addition, the country's uncompetitiveness in cost- and labor-intensive activities eliminate the source of growth that has typically fuelled export expansion in other developing countries.

As a result, Botswana is faced with a difficult situation. Since no single incentive or reform is likely to attract significant investment or exports, it will be necessary to implement a comprehensive package of measures in order to maximize the attractiveness of the investment and business operating environment to the broadest possible range of firms and industries. Given the country's competitive disadvantages, no single industry sector, no single source of investment, and to a lesser extent, no single market is going to provide the basis for export-oriented growth. As noted above, Botswana has enough advantages to attract some firms in a variety of areas, many of which will be niche areas exploited by innovative or entrepreneurial companies. As a result, it is not a realistic option to tailor the investment climate to certain types of firms or industries. Instead, it is only through the creation of a thoroughly liberalized, market-oriented economy that Botswana can maximize the country's attractiveness to the broadest range of firms.

The measures proposed below aim to create that pro-business environment. Their primary focus is on the elimination of policy and administrative constraints which currently act as disincentives to both foreign investment and export activities. The proposed actions are both conservative and cost-effective; they are in compliance with Botswana's treaty obligations under GATT and SACUA; and they expressly avoid any type of subsidy to export activities.[1] The specific purpose of these measures is to create, using highly pragmatic policy and administrative changes, an economic environment that is free of distortions and subsidies, supportive of investment and export activities, and administratively simple to implement and monitor.

The proposed recommendations are divided into two categories: core recommendations and supplemental ones. The core recommendations represent the minimum measures that should be introduced to maximize Botswana's competitive advantage and overcome the limitations identified above. Without these measures, Botswana's competitiveness as an investment site -- particularly vis-a-vis South Africa and Zimbabwe -- will be limited, given the strengths and attractions of these two neighboring economies.

The supplementary recommendations represent additional actions which are important to strengthening Botswana's competitive position and to ensuring that the environment for export and investment is as supportive as possible. These measures are secondary only in the sense that they will be ineffective in improving Botswana's competitiveness in the absence of the core recommendations. It does not mean, however, that these measures are unimportant.

Core Recommendations

Implementation of the following measures is recommended to maximize Botswana's comparative advantage and improve the country's relative competitiveness as an investment site. These measures are:

- abolish the current system of exchange controls;
- examine the potential for the establishment of offshore informatics services;
- examine the potential for the establishment of offshore financial services;
- allow for the private provision of international telecommunications service;
- address the constraint imposed by high wage levels;
- further reduce the non-mineral corporate income tax rate as permitted by budget constraints;
- make TIPA into an autonomous agency which focuses on investment facilitation;

[1] Aside from the economic and efficiency reasons for avoiding subsidies, it should be noted that the danger of retaliation under GATT is higher for countries which extend compensatory fiscal and tax incentives to firms operating under the protection of high import tariffs, as is currently the case in the Customs Union.

- establish an export marketing support program; and
- guarantee expedited access to expatriate visas.

Each of these recommendations is discussed in detail below.

- **Abolish the current system of exchange controls.** The current exchange control system in Botswana has been extensively analyzed and will not be reviewed here.[2] Nonetheless, it must be reiterated that although Botswana's foreign exchange control system is still the most liberal in the region, its relative competitiveness has declined in recent years owing to recent liberalizations introduced in a number of neighboring countries. While Botswana's system operates fairly and quickly in most cases, difficulties remain in the payment of some types of services and when engaging in certain types of capital account transactions.

  As noted in the exchange control report, the current system has probably not deterred investment by manufacturing firms, but has posed a substantial constraint on the establishment of service-related investment. Botswana's competitive edge does not lie, however, in the manufacturing sector. In order to attract the services industries which are more compatible with Botswana's relative strengths, the abolition of exchange controls is necessary. Elimination of exchange controls in itself may be sufficient to attract regionally based service industries such as engineering or architecture; in the case of offshore financial services, such liberalization is one of the several necessary conditions for success.

  While several countries have made selected liberalizations of their exchange control regimes, none offer the same prospect of continuity and financial stability as does Botswana. Moreover, few countries have the financial reserves which would enable them to successfully abolish such controls. While this change will make macroeconomic management more difficult, Botswana's comparative disadvantages and resultant need to encourage every form of investment suggests that exchange control liberalization is a necessary and unavoidable step in the transition towards a more diversified economy.

  Although the decision to abolish exchange controls must necessarily be made on economic and industrial policy

2 See Phaleng Consultancies, in association with Crown Agents, "Cost Benefit Study of Liberalizing Foreign Exchange Control Regulations," prepared for the Botswana Confederation of Commerce, Industry and Manpower and the Botswana Development Corporation, January 31, 1994.

grounds, it is important to note that such a change could be an important promotional tool. Investors, particularly U.S. investors, frequently have a negative perception of Africa as an investment site, and assume that political instability, foreign exchange and capital restrictions, corruption, and government interference in business activities are pervasive across the continent. Botswana, owing to its small size and lack of historical ties with the United States, is particularly unknown to many investors. The abolition of exchange controls would concretely demonstrate that Botswana has a sophisticated business environment that is not only unlike that found in the most of the continent, but is comparable to leading investment sites outside of Africa.

- **Examine the potential for the establishment of offshore informatics services.** As discussed in the previous chapter, Botswana possesses many of the characteristics needed to attract offshore informatics industries. This potential should be explored further to determine what regulatory changes will be necessary to encourage this sector's growth; it is probably not necessary, however, to introduce any new legislation if the current recommendations are implemented. Botswana is currently not a signatory to either the Berne or Paris Conventions governing intellectual property rights; accession to these agreements will probably be necessary to encourage the establishment of industries such as computer-aided design and software programming. In addition to these measures, implementation of the recommendations regarding facilitated access to expatriate work and residency permits (see below) and the elimination of foreign exchange controls (discussed above), will be necessary conditions for the establishment of this industry.

- **Examine the potential for the establishment of offshore financial services.** As with the informatics sector, Botswana possesses many of the attributes needed to attract offshore financial service industries. Further study is needed, however, to determine which specific sub-sectors (e.g., offshore banking, corporate registry) within this industry sector have the greatest potential for successful establishment. In contrast to what is required for the establishment of an informatics industry, it will be necessary to introduce competitive legislation and regulations, and to establish an institutional body to oversee the regime.

  Although the typical job impact of offshore financial services is limited, there may be important ancillary benefits. Both informatics and offshore financial service activities are prestigious forms of investment that are typically found in more sophisticated economies. As such, the establishment of even a very small number of firms, in conjunction with Botswana's proximity to the South African market, may produce a positive promotional tool in establishing Botswana's image as the appropriate location for corporate headquarters seeking to serve the region. In addition, offshore financial services typically have a positive impact on the tourism and construction sectors. While the direct financial and employment impact of such industries may be limited, the potential indirect benefits of this type of investment are not insignificant.

- **Allow for the private provision of international telecommunications service**. In order for Botswana to be competitive in export services such as the informatics industry, a substantial cost reduction in international telecommunications rates is necessary. To date, the Botswana Telecommunications Corporation has not established lower tariffs for high volume companies or sectors. As a result, current tariff rates are set at levels which are too high to attract companies in this emerging sector.

  Unlike most other labor-intensive industries, it appears likely that Botswana could be competitive in this sector if a few policy changes are introduced. Allowing competition in the telecommunications sector is technically easy and it is relatively inexpensive. It is one of the most important and simplest actions the GOB could take to differentiate itself within the region and to enable the country to take part in the offshore informatics sector. The loss of revenue to the Botswana Telecommunications Corporation would be minimal, as the growth of this industry would represent new and incremental investment, rather than a diversion of existing users. If necessary, private telecommunications service could be confined to a specific area. (This approach was found acceptable to the telecommunications monopoly in Jamaica, although it has reduced the growth of the sector outside the office park designated to receive the service.) An official at the Botswana Telecommunications Corporation noted that they are open to suggestions in this area, given the importance of foreign investors to future economic growth and diversification, and the importance of low cost telecommunications to the offshore informatics sector.

- **Address the constraint imposed by high wage levels:** The relatively high cost of wages and low productivity levels have been widely identified by a number of studies as a constraint on manufacturing. Interviews conducted for this report indicate that although productivity is rising, overall levels remain low even by regional standards. This combination of high wages and low productivity sharply undermines Botswana's competitiveness.

The fact that labor is overpriced is indicated by that fact that workers seeking jobs outside of factory gates in Gaborone will work for significantly less than the minimum wage. In successful exporting countries such as Singapore and Hong Kong, the wages of unskilled and semi-skilled labor were market-determined and were close to shadow wages. By contrast, one study has estimated that Botswana's shadow wage rate is 50 percent of the minimum wage, indicating the difficulties that the country faces in using labor-intensive industries as a stepping stone to export success.

In order to reduce this constraint, the GOB must pursue policies to adjust wages to more realistic levels which are competitive with other countries in the region.[3] The World Bank has suggested several options to achieve this goal, including eliminating the minimum wage entirely; collapsing the current wage structure to a single minimum rate; exempting certain categories of workers, such as manufacturing workers, from the minimum wage; and allowing the real value of minimum wages to be eroded by inflation. The GOB could also reduce the rate at which public sector salaries are increased, since these increases often exceed the rate of inflation and put pressure on private sector companies to raise wages commensurately. While some of these measures are preferable over others, any of them are acceptable as long as some reduction in real wages is achieved until significant increases in productivity occur. Although some observers have argued that the current minimum wage is inadequate to support a family of four, it should be noted that minimum wages -- in both developed and developing countries -- are not intended to support entire families. Thus, this issue does not argue against lowering minimum wage levels.

In order to help firms to further increase productivity, the GOB should also give wider sanction to the use of piece work. Piece work, usually paid in addition to a base wage, has been very successful in encouraging productivity increases in a number of developing countries. A number of companies in Botswana, with permission of the labor authorities, have introduced such incentive programs to encourage

[3] In Uganda, there is no minimum wage; similarly, Zimbabwe does not have a minimum wage but establishes wage levels by collective bargaining.

improvements in productivity. At the moment, however, firms must get specific permission to utilize these incentive schemes. The GOB should change this requirement so that all companies are free to implement piece work programs without receiving prior approval from the appropriate labor authorities.

In addition, the government has a role to play with regard to educating Batswana that wage increases should be linked to productivity. As discussed in Chapter 3, a number of companies have achieved some success in the use of piece work to raise output. In other firms, however, this practice has failed because less productive workers failed to accept that an individual's wages should be linked to the amount of work completed. Public statements by government, preferably coupled with policies to eliminate or reduce statutory wage rates, can be influential in contributing to the success of these productivity-enhancing measures.

Finally, the benefits resulting from the introduction of a more flexible wage system can be both economic and political. Current low levels of productivity have led to the use of compensatory policies such as the FAP. In countries worldwide, the use of such policies creates political constituencies seeking to prevent the elimination of such subsidies. By contrast, realistic wage rates, in combination with greater skills training, not only raise the overall competitiveness of the labor force, but also reduce the pressure on government for subsidy payments to offset high labor costs.

- **Further reduce the non-mineral corporate income tax rate as permitted by budget constraints.** The current tax rate in Botswana is 35 percent which is within the normal range for African nations. This rate is not competitive compared to the export incentives offered by other countries, however, and does nothing to compensate for Botswana's overall higher costs. While the study team seriously weighed the use of various types of tax incentives for exports, it was finally decided that a lower flat tax was the optimal solution, given the characteristics and limitations imposed by Botswana's external trade agreements and the difficulties that the GOB has experienced in monitoring its other incentive programs.

  One of the key reasons underlying the recommendation for a lower corporate tax is Botswana's proximity to South Africa and its membership in SACU. Based on conversations with private and public sector representatives, it seems clear that Botswana's natural export market is South Africa. Under

SACU, however, a specialized income tax regime for exports within the region is not permissible. This restriction automatically precludes, therefore, the use of partial or total tax holidays for exporters. Similarly, SACU membership also pre-empts the possibility that Botswana might implement an improved and expanded duty and surcharge exemption scheme.

In addition to these key factors, there are a number of other strong arguments for a lower tax rate with minimal exemptions, special credits, and superdeductions. The positive implications of this measure would include:

- A low flat tax would instantly differentiate Botswana from its neighbors and would be an attractive promotional device.
- A simple and transparent flat tax would be easy to implement and would simplify the task of monitoring for the GOB.
- A low income tax is neutral and thus gives no extraordinary incentives to any one sector. As such, Botswana can more easily maximize its natural advantages and avoid the pitfalls of trying to pick winners.
- A flat tax benefits both new and existing investors, domestic and foreign ones, and is fair in its eligibility requirements (i.e., it applies to everyone).
- Botswana's recent membership in GATT makes export sales subsidies, preferential utility rates, and a special tax regime for exporters countervailable.
- Direct subsidies to exporters on transport, utility costs, and financing are inadvisable due to their distortionary affects, frequent lack of time limits, and failure to address the true causes of these constraints.
- Finally, Botswana's future economic growth is likely to be based on niche products and services that will be difficult to target. Consequently, a broad-based low income tax will be best suited to encourage these risk-taking enterprises as opportunities emerge.

This recommendation is superior to the current use of Development Approval Orders (DAO) from the Ministry of Finance. The DAO process is highly discretionary and uncertain, owing to the requirement that Parliament ratify each Order. In addition, the Ministry of Finance can exempt on a case-by-case basis certain kinds of income from the withholding tax on dividends. Again, this is discretionary and non-transparent and could provide an environment that is conducive to corruption. Rent-seeking investors typically prefer this type of process, while legitimate companies have a strong preference for a process which is automatic, clearly defined, and transparent.

Finally, the experience of successful developing country exporters suggests that this approach is more likely to be successful than is a package of specialized incentives or a strategy of "picking winners." A recent pathbreaking report by the World Bank on the high-performing Asian economies -- Japan, Hong Kong, Korea, Singapore, Taiwan, Indonesia, Malaysia, and Thailand -- extensively reviewed the historical experience and key policies characterizing their success. In its analysis of the effectiveness of tax incentives for investment, the Bank concluded that while incentives are probably necessary to attract investment to an economy with high corporate taxes, the Hong Kong alternative -- few incentives and a low, universal corporate tax -- would appear to be a simpler and more dependable way to achieve the same results.[4]

Similarly, while some of the East Asian countries provide prominent examples of the gains that can be realized by successfully picking winners, these nations have also erred in their selections, thereby demonstrating that such a strategy is more difficult than it appears, even in countries as sophisticated as Japan.[5] Based on an analysis of three types of policy interventions used in East Asia -- the promotion of specific industries and sub-sectors, directed credit, and an export-push strategy -- the World Bank concludes that "the promotion of specific industries generally did not work and therefore holds little promise for other developing countries." Given the uncertainty of success and the high cost attached to such a strategy, the adoption of a low flat tax in Botswana is the single best and most equitable measure to promote and reward the risk-taking critical to investment and economic growth.

The impact of this policy on government revenues should be relatively minor. According to MFDP figures, non-mineral income tax revenue, including personal income tax revenue,

4 World Bank, The East Asian Miracle: Economic Growth and Public Policy, 1993, p. 231.

5 The best known example of a country's failure to pick a winner is the case of Honda Motor Company in Japan, which was denied assistance by the Ministry of Trade and Industry because the company was deemed as unlikely to succeed. Similarly, as discussed in Chapter 2, Mauritius has attempted without success to target a number of export sectors -- including export services, jewelry, and optical goods -- as future growth areas.

comprise only ten percent of total revenue in 1991/92 -- the most recent data year. If the various subsidies under the current FAP were reduced or eliminated, the overall impact of this change would be even further minimized. It should be strongly emphasized, however, that this recommendation is not based on the fact that the GOB can afford it. This recommendation is justified even if the GOB would face budgetary difficulties as a result of this policy's implementation.

Moreover, it should not be assumed that a decrease in corporate tax rates would necessarily entail a loss in overall revenue. Experience in Chile, Mexico, Colombia, Pakistan, India, and Indonesia demonstrates that government revenues can actually increase when lower and fairer tax systems are instituted. This occurs because lower taxes typically stimulate economic activity and reduce the incentive for tax evasion.

It is difficult to establish a straightforward correlation between changes in corporate taxes per se and subsequent government revenue flows because governments have typically introduced such reductions in the context of wide-ranging fiscal reform, including reductions in personal and corporate taxes, and introductions of value-added taxes. Nonetheless, a World Bank study assessing the impact of tax rates on economic performance in 20 developing countries found that investment, productivity, and employment grew faster in countries with lower tax rates.[6] The study reported that "higher rates of economic growth allowed a substantial rise in real living standards in the low-tax countries ... At the same time, growth expanded the tax base and generated increased revenues."

In addition, the study found that "an <u>increase</u> of one percentage point in the tax/GDP ratio <u>decreases</u> the rate of economic growth by 0.36 percent." Moreover, gross domestic investment grew at a substantially higher pace in the low-tax countries -- at an average rate of 8.9 percent annually, compared with an annual decline of 0.8 percent in high-tax countries. Similarly, "an increase in the total tax ratio of 1 percentage point lowers the rate of growth of investment by 0.66 percentage points." Low-tax countries were also found to have "succeeded in expanding and diversifying their exports;" furthermore, non-agricultural employment and productivity increased more rapidly in low tax countries.

[6] Keith Marsden, <u>Links between Taxes and Economic Growth</u>, World Bank, 1983. Evidence cited from the report is from pages, 4, 8, 12, 19, and 20.

While an argument for outright tax holidays could be made (and has been proposed by BOCCIM), it is felt that this drastic reduction would be politically unacceptable. In addition, many European countries' double taxation agreements do not include "tax sparing" clauses, and France and the United Kingdom have forced some investors to pay taxes in Europe despite the fact that they were operating under tax holidays in developing countries.[7] This factor was partly responsible for the Mauritian government's decision to replace its tax holiday with a 15 percent flat rate of tax on exporters. In order for foreign-owned firms to fully benefit from this low tax rate, the government of Mauritius has signed double taxation agreements with the United Kingdom, France, Germany, India, and Italy.

Similarly, if Botswana decides to proceed with the low flat tax recommendation, the GOB should expand its current double taxation treaties beyond the two currently in force (South Africa and the United Kingdom).

- **Make TIPA into an autonomous agency**: This point has been made many times before and does not need to be belabored. Successful investment and export promotion is not possible as long as TIPA remains underfinanced and part of the Ministry of Commerce. TIPA should be an autonomous government agency, with an independent board of directors comprised of both public and private sector representatives.[8] Ideally, private sector representatives should hold a majority on the board, and should be elected by the private sector. The impact of private sector representation on investment promotion efforts in other countries has been substantial. The public sector investment promotion agency in Costa Rica, for example, was highly ineffective in promoting investment or export-oriented growth. In the early 1980s, the establishment of CINDE, an entirely private investment promotion agency

7 Some developing countries have been able to negotiate "tax sparing" clauses in double taxation treaties which allow a company whose home tax jurisdiction is the developed country to credit against its home country liability the taxes that would ordinarily have been paid in the developing country, but which were not paid due to a tax incentive granted to attract investment. Most countries are not willing, however, to agree to tax sparing clauses.

8 Despite being funded by the government, it is possible for such an agency to remain autonomous if a truly independent board of directors is established by law which has full responsibility to determine and set policy direction (within its legislative mandate), make hiring decisions, etc.

financed by USAID, had a tremendous impact on the economy and on exports in particular.[9]

The agency's chief focus should be investment facilitation. At a minimum, TIPA must actively assist investors with all stages of the investment approval and business establishment process; the activities of the promotional unit at Selebi-Phikwe provide an excellent example of how this should be done. Preferably, TIPA should be made into a true one-stop shop with the delegated power to issue all needed permits. Finally, following the successful example of countries such as Singapore, Malaysia, Costa Rica, and the Dominican Republic, TIPA should also be staffed with personnel with private sector backgrounds -- preferably in service industries such as banking and insurance -- who possess the marketing and facilitating skills needed to attract and serve investors, rather than civil servants.

There are a number of strong arguments in favor of making TIPA an autonomous private/public sector agency. Extensive research and empirical evidence shows that the creation of a mixed board of directors is the best institutional structure for creating a highly effective investment promotion agency with the skills to and flexibility to implement effective marketing programs.[10] Private sector representatives are skilled at identifying issues which need to be addressed by the agency and the government, particularly with regard to investment procedures or investment facilitation services, while public sector representatives can help to ensure that these actions are properly implemented. In addition, mixed government agencies -- because they do have some ties with government -- can often be very effective in assisting investors with the acquisition of needed permits and licenses. As an agency operating outside of the government and the civil service system, however, such quasi-government promotion agencies are better able to recruit and retain a higher quality, more business-oriented staff. Finally, a strong private sector presence also serves as a useful promotional tool to foreign

9 Similarly, the establishment of the mixed private/public sector Investment Promotion Council (IPC) in the Dominican Republic in the early 1980s gave a substantial impetus to investment and economic growth. Prior to the IPC's establishment, only 20,000 jobs had been created in the export sector; this grew to 140,000 jobs by the early 1990s, in large part due to the IPC's highly successful investment promotion efforts.

10 Based on a study of investment promotion agencies and programs in ten countries and a survey of twenty-eight companies involved in foreign direct investment. Louis T. Wells and Alvin G. Wint, "Marketing a Country: Promotion as a Tool for Attracting Foreign Investment," (Foreign Investment Advisory Service, World Bank, 1990).

investors that the government is seriously committed to private sector growth and investment.

True one-stop shops with the power to issue all necessary approvals and permits have been established in Singapore and Ireland. Most countries which claim to have established such one-stop agencies have done so in name only, and have failed for political or bureaucratic reasons to delegate the necessary power to their investment approval agencies.[11] Nonetheless, even these agencies can be highly effective if they can work successfully to assist investors in the acquisition of all necessary permits and approvals from the key agencies; if they fail to fulfill this facilitation function, however, they simply add one more layer of bureaucracy with which investors must deal.[12]

Ultimately, the most important factor in ensuring an effective investment approval process is the extent of government will and commitment at the highest levels to ensuring that the process is quick and transparent. A wide range of institutional approaches has been successfully used worldwide, but the key factor in all of these institutional arrangements has been adequate government support. If this support is lacking or half-hearted, and if the process is delegated to lower-level bureaucrats, the investment approval process is likely to remain an impediment to investors.

The experience of other countries worldwide demonstrates clearly that the creation of an effective investment promotion and facilitation institution is critical to export success. Given the constraints faced by Botswana, it is even more imperative that TIPA be a strong and independent agency.

- **Establish an export marketing support program:** Given the limited policy options available to Botswana for the development of non-traditional exports, it is recommended that an export marketing support program be established along

[11] As seen by the example of Singapore and Ireland, it is possible to establish a one-stop shop under a British-style parliamentary system. In such cases, the power to issue permits and approvals is simply delegated to the designated authority. In countries worldwide, the key barrier to the establishment of a one-stop shop is not the type of legal system in place but the lack of political will to actually implement the necessary changes to make such a body effective.

[12] In order to ensure that investment approvals are dealt with expeditiously in such a system, some countries (e.g., Cameroon and Togo) have introduced automatic default approval mechanisms whereby all investment applications are automatically approved if the investment agency fails to issue an approval within a pre-defined period of time (e.g., 30 days). While such mechanisms appear to be an effective way to expedite investment approvals, their record in practice is a mixed one.

similar guidelines as the French COFACE program. These programs have often demonstrated an ability to encourage existing small- and medium-scale enterprises to develop export markets.

This approach offers a number of advantages. First, given the fact that Botswana's economic policy environment is relatively sound, it is appropriate to focus on and establish an export marketing mechanism. Second, an export marketing support scheme is likely to be a relatively low-cost program. Third, an export marketing program designed along the lines of COFACE, and operated on a commercial basis, would not be in violation of GATT. Fourth, a COFACE-type program -- unlike export marketing subsidies in Mauritius -- relies on reimbursement of a portion of actual expenses rather than super deductions from tax liabilities; this is important, because most manufacturing firms in Botswana do not pay corporate income tax, because they are not profitable, and would therefore not benefit from an additional tax deduction. Fifth, funds channeled through this kind of export marketing program -- in contrast to export promotion organizations -- give support directly to the firm, rather than to an institution where much of the money is often utilized in paying for the institution's overhead.

- **Guarantee expedited access to expatriate visas**: A number of companies interviewed by the study team report that the expatriate visa process has improved. Nonetheless, others have stated that it remains a problem; one South African manager reported that he has worked for the past four years using a series of temporary visas.

  While foreign investors generally prefer to bring in expatriates for key managerial and technical positions, there is a strong financial motive for firms to limit as much as possible the use of expatriate employees in order to reduce overhead costs. In Botswana, however, owing to the shortage of technically skilled workers, firms are forced to rely to a greater degree on the use of expatriate labor than they would be in a country such as South Africa, where a large supply of skilled technical and managerial labor is available. Given that the limited availability of skilled labor in Botswana already places the country at a disadvantage vis-a-vis the RSA or Zimbabwe in attracting investment, continued restrictions or delays in the issuance of expatriate visas will further reduce Botswana's competitiveness as an investment site.

As a result, investors should be given facilitated access to expatriate work visas. Foreign firms routinely expect a more or less automatic system of working visas. Countries such as Tunisia automatically grant a number of work permits without requiring special application; Ghana is also currently introducing a similar automatic system. Both Togo's and Cameroon's export programs allow 20 percent of all staff to be granted automatic expatriate work permits. Botswana should adopt some form of expedited issuance, either through the use of a "positive list" of automatically approved expatriate skill categories as suggested by the World Bank, or through a significantly expedited issuance process.

The GOB is rightfully concerned that Batswana, rather than expatriates, be hired for skilled positions. As noted above, foreign firms have a strong economic preference for hiring locally skilled staff whenever possible, and as firms become established in their operations and their training of local staff advances, and as the general supply of skilled Batswana grows, companies will increasingly prefer to reduce their expatriate staffs. In the interim, however, Botswana will be at a competitive disadvantage in attracting investment unless the government adopts a pragmatic policy of accepting the entry of expatriate skilled personnel.

Supplemental Recommendations

In addition to the core recommendations listed above, the following supplementary measures should be introduced:

- allow the private sector to compete with the BDC in industrial estate development;
- consider rural utility provision to be a development expense;
- obtain hands-on technical assistance to help selected firms to enter export markets;
- examine the need for additional export finance facilities;
- create a government and private sector export advocacy committee; and,
- focus greater efforts on resolving unfair regional trade policies.

Each of these recommendations is discussed in detail below.

- **Allow the private sector to compete with the BDC in industrial estate development**. For a number of reasons, private industrial estates are often effective mechanisms for attracting foreign export-oriented investment. First, an industrial estate can be an attractive promotional tool. Many foreign-owned firms prefer to locate in the controlled environment offered by an industrial estate, and to be located near other companies. Moreover, once several firms have established in an industrial estate, it demonstrates concretely and in concentrated form that foreign firms are able to operate within ~~the host~~ country. This too is a useful promotional tool as foreign investors prefer to meet existing firms when considering an investment site.

Two, private estates typically conduct the types of investment facilitation which has been largely unknown in Botswana (with the exception of that conducted at Selebi-Phikwe). Estate managers often assist investors with problems such as obtaining work permits, finding housing, or assisting with Customs delays.

Third, the attractiveness of private estates is enhanced by the fact that many provide services and facilities that could not be accessed elsewhere. In contrast to publicly owned and operated estates, private developers have risked their own capital and thus have a greater incentive to provide a quick, high quality response to tenant needs. Private estates often provide buildings and grounds maintenance services, including refuse collection, lighting, and landscaping; emergency services such as fire protection, medical and security services; and shared facilities such as banking facilities, job banks, cafeterias, and day-care centers. In the Caribbean, companies are willing to pay substantially higher rental rates to locate in a privately owned estate than in a publicly owned one, thus demonstrating the greater attractiveness of private industrial estates.

The creation of a private industrial estate open to both export and non-export firms is suitable for Botswana for a number of reasons:

- it remains difficult to find serviced industrial plots in Botswana's urban areas;
- private estate management would be able to provide lower cost factory space than is currently available due to the BDC's practice of "overspeccing;"
- companies would have the option to rent or purchase their factory buildings;
- companies would have the option to design and construct space more suitable for their specific requirements;
- utility hook-ups are generally accelerated in industrial estates which can help to avoid the excessive delays that currently delay the establishment of some businesses;
- a private developer would be more likely to actively work to compensate for Botswana's relatively weak investment promotion and facilitation efforts;

- since Customs in Botswana relies on audit rather than physical controls, an industrial estate can enlarge its clientele (and therefore its commercial viability) by serving both exporting and non-exporting firms; and.
- a private industrial estate/office park could provide a teleport for high quality, low cost international telecommunications.

If privately developed, an industrial estate would not be a high cost item to the GOB. Typically in these cases, the host government provides only for infrastructure up to the gate. The cost of land and building construction would be assumed by the developer.

Finally, it should be noted that the introduction of competition into the provision of industrial estate facilities is the most efficient means of reducing the current constraint imposed on manufacturers resulting from inadequate and expensive supplies of industrial land. A commonly used alternative approach to this problem has been to subsidize industrial estate rental rates. While often viewed as an important necessary investment incentive, this approach has usually been found to be short-sighted. Rent subsidies eventually prove harmful because they deprive the property management company of the funds needed to maintain buildings and infrastructure. The resultant decline in the physical state of the industrial estate has typically posed a substantial deterrent to investors. In addition, charging market rental rates does not necessarily deter investors, as noted above. In the Caribbean and Central America for example, many firms willingly locate in privately owned industrial estates despite rental rates US$2-4/sq.m./month higher than those offered by subsidized, government-owned industrial estates.

- **Consider rural utility provision to be a development expense.** Past and on-going GOB efforts to provide utility services throughout the country are commendable. Even more impressive is the fact that the GOB has undertaken the extension of utility services to remote areas without imposing heavy losses on the utility companies. Nonetheless, the costs of this policy to make utility services available to all Batswana have been passed on to urban and industrial users who can justifiably claim that they have cross-subsidized these rural development efforts.

  In many countries, rural electrification or telecommunications development is considered a national development expense. As such, urban and industrial users are not saddled with higher rates to compensate for increasing capital costs. By contrast, the effective cross-subsidization of rural consumers by urban and industrial users places additional costs on firms which are already operating at a cost disadvantage owing to high transport costs and low productivity levels.

- **Obtain hands-on technical assistance to help selected firms to enter export markets.** According to extensive World Bank analyses, there have been few successful export promotion institutions in developing countries, particularly those outside of East Asia. Notable success has occurred, however, in well-targeted efforts for selected firms chosen to be demonstration projects. USAID experience in Latin America and the Caribbean has shown that the provision of enterprise-level technical assistance and brokerage services to a limited number of producers is the most cost-effective form of trade and investment project in a constrained environment.[13]

  One advantage of this approach is that it is policy neutral; that is, it has been found to be effective even in countries which have been reluctant to enact significant changes in the policy environment for exporters. It assumes that there are major constraints placed on local producers and investors that can only be overcome by highly targeted technical assistance in production and marketing. Assistance is directed at firms which have a number of the ingredients necessary for success, but which require further expertise in technical aspects such as production methods, quality control, pricing strategy, inventory control, or market brokerage assistance. The assistance should be hands-on and firm-specific, rather than provided in the form of general marketing and feasibility studies.

  In Kenya and Uganda, hands-on intensive assistance is being given to high potential non-traditional agricultural exporters. While the project in Kenya is too new to evaluate, the Ugandan project has had a clear impact on vanilla and floriculture exports. TIPA is currently providing assistance to individual firms, but the potential impact of this program has not been maximized owing to donor-imposed restrictions which limit participation to citizen-owned firms. An additional program should be started to help locally based firms -- whether citizen-based or not -- to obtain assistance in the areas of quality control, market identification, packaging, and other areas as needed.

  Extensive on-going assistance should be aimed at a few firms -- such as five per year. The process for selecting firms for assistance should be based upon two criteria. One, how much

[13] "Promoting Trade and Investment in Constrained Environments: AID's Experience in Latin America and the Caribbean," Louis Berger International, November 1989.

assistance would be required to enable the firm to export successfully (the less the better). Two, whether the firm is willing to share any portion of the technical assistance costs. The latter is crucial as it demonstrates the firm's commitment to the program and will encourage the firm to take the assistance more seriously. As the object of the program would be to increase jobs and exports, assistance should be eligible to any firm currently established in Botswana (firms that are not yet in existence should be excluded as they offer no track record by which to measure accurately their potential).

- **Examine the need for additional export finance facilities.** It is not clear that export finance is currently posing a significant constraint on the export sector and that this is a problem that immediately needs to be addressed. Automatic access to trade finance is important to export development, but it is not a precondition of export growth. It would be premature for the government to address the export finance situation -- assuming there is a problem -- until and unless the core policy and administrative changes outlined above are introduced. These changes are necessary to create the enabling environment necessary for export development; without this environment, the availability of export finance is an ancillary consideration.

  Export finance and export credit guarantee and insurance schemes have played an important role in the growth of manufactured exports from a number of developing countries. Nonetheless, these schemes, particularly credit and guarantee programs, have typically not been present or necessary in the initial years of export growth. Mauritius, South Korea, and Malaysia are among the countries that did not implement export finance programs until many years after their export programs were initiated. The lack of such programs did not constrain export growth because export expansion stems almost uniformly from foreign firms in the early years of export development, and foreign companies are able to obtain finance from banks in their home country or final export market.

  Significant export growth in Botswana in the near- and medium-term is likely to follow this same pattern, given domestic firms' inexperience, small size, and dependence on protection or government subsidies. In addition, since South Africa is likely to be a significant source of investment, these companies will have access to a functioning export finance and credit system as would local firms operating in joint ventures with South African companies.

Export finance systems do have an important role to play once export growth occurs in large and significant volumes, and such programs can be particularly important in assisting small, or new, domestic firms to enter export markets.[14] In the medium-term, the GOB should re-examine the availability and need for such facilities and the types of institutional and administrative changes that would be required to encourage commercial bank lending to these firms; typically, the establishment of any export financing program requires a number of years of institution-building efforts for both the central and commercial banks. Export credit guarantee schemes are typically unnecessary in the early stages of export development owing to the small volumes of exports likely to be generated. To the greatest extent possible, any export insurance or credit guarantee program should be designed on a "risk-sharing" rather than a risk guarantee basis, and should be predominantly operated by the private sector through commercial bank or commercial insurance facilities.

In addition, it should be noted that any export finance system should make financing available at market rates of interest. Although some countries have provided subsidized interest rates for exporters, empirical evidence from countries worldwide indicates that subsidizing interest rates for exporters is not a particularly effective form of export promotion. Moreover, subsidized interest rates are technically countervailable under GATT. The specific level of the interest rate on export finance loans is of secondary importance compared to the availability of, and access to, such export financing at market-based rates.

- **Create a government and private sector export advocacy committee**: As demonstrated in East Asia and the Caribbean, a strong political commitment to an export-oriented strategy is critical. Government -- in conjunction with the private sector -- must define its strategy, ensure that the relevant government agencies effectively implement its program, and must continually refine and modify its program in reaction to changing circumstances. In addition, a strong public-private sector partnership is essential. A strong working relationship between business and government in Hong Kong, Singapore, and Korea has enabled these governments to identify problems and opportunities and determine appropriate action. In Mauritius, the government has made a conscious effort to bring

[14] In particular, such schemes can be use to encourage indirect exporters; that is, firms that supply inputs to exporting firms, either in physical form or in the form of services such as packaging or shipping. These programs play an important role in extending the benefits of export growth to the entire economy.

the public sector, private companies, and labor together to discuss export strategy and design. Similarly, a public/private sector group created in the Dominican Republic was instrumental in identifying the legislative and procedural reforms needed to revitalize that country's export program.

At the Francistown Private Sector Conferences held in 1988 and 1991, a concerted call was made for the establishment of a Cabinet-level body through which the government and private sector could consult about key issues facing the economy. Although a public-private sector consultative group called NEMIC currently does exist, this group meets infrequently and does not appear to have significant influence over industrial policy decisions. The mere creation and existence of such a consultative body is not sufficient to ensure its success. The key factor underlying the success of the public/private groups successfully established in Mauritius, a number of East Asian countries, and the Dominican Republic is the government's political will to utilize such groups in the policy formation process, to build consensus, and to provide feedback on the implementation of policy.

Properly designed, a public-private sector consultative group could play an important role in the development of a viable export policy in Botswana. While the investment and business operating environment works smoothly relative to many African countries, such a forum is ideal for identifying those remaining procedural or bureaucratic impediments to business establishment or operation. In addition, such a public-private group provides an ideal forum for reviewing proposed legislative or administrative changes before they are implemented, thereby ensuring consensus and aiding effective implementation. In order for such a group to function effectively, however, the GOB must be committed to actively involving it in the policy formation process; otherwise, any new body will be as ineffective as NEMIC currently appears to be.

- **Focus greater efforts on resolving regional unfair trade policies**. The GOB plays a strong economic role in the regional economy and should exercise a stronger voice in representing the country's economic interests. The pattern of Botswana's exports -- primarily to Europe -- and its imports -- predominantly from the region -- means that Botswana is a major source of hard currency earnings for the Customs Union. Similarly within SADC, Botswana accounts for only 1.5 percent of the total population, but produces 9 percent of the region's combined GDP, and attracts 52 percent of incoming foreign direct investment.[15]

Despite Botswana's small size, it clearly is an influential economic player in the region, particularly within the Customs Union. The government should capitalize upon this influence. The government's recent action to defend its automotive assembly industry against discriminatory excise duties applied by the RSA under SACUA is a good example where the GOB has vigorously acted to represent the interests of its exporters and manufacturing sector. There are other sectors, however, where the government could act more assertively on regional trade issues. For example, South Africa's insistence that Botswana's exports meet South African Bureau of Standards (SABS) requirements is a common form of non-tariff barrier to exports that may warrant government attention. In addition, as a recent GATT signatory the GOB may want to consult closely with GATT trade experts to explore ways to use the trade agreement's mechanisms to ensure that South Africa's trade actions do not continue to violate GATT provisions at Botswana's expense.

Anticipated Programs Costs and Benefits

The terms of reference for this study specified that the costs and benefits of the report's recommendations be estimated. The study team has attempted to do this, but many of the recommendations cannot easily be translated into such quantitative terms. The analysis presented below is derivative, based on the experience of other countries; a true cost-benefit analysis using economic modelling far exceeded the scope of this study. Nonetheless, it is hoped that the following estimates are useful to the GOB in assessing the cost and impact of the report's recommendations. It should be noted that the estimates included below are not solely costs which will be borne by the GOB; the cost of some of the recommendations can be assumed by donors and the private sector.

Core Recommendations

- **Abolish the current system of exchange controls.** According to the recent draft report on foreign exchange controls, this change was estimated to cost P38 million per year in 1992 prices, based upon the amount of funds estimated to leave the country and the loss of tax revenue on these

[15] Although Botswana attracts 52 percent of the SADC countries incoming foreign direct investment, the country's large mineral development projects have accounted for the "major share" of this private total foreign investment, according to the World Bank. Notwithstanding this inflow of mineral-related investment, Botswana has not proven to be an attractive site for investors in non-traditional sectors. World Bank, Opportunities for Industrial Development in Botswana, p. 42.

funds.[16] This would be offset by lower interest rates on BoB certificates, on which the Bank of Botswana makes a loss. While there is some prospect that additional tax revenues would be gained from new flows of inward investment, it is difficult to estimate these incremental gains without making complex assumptions regarding applicable tax rates, types of investment, etc. Consequently, the authors of the foreign exchange controls report offered no estimate of the overall cost impact of this change.

The initial net employment impact was estimated to be small. Some civil service jobs would be lost in the short-term, but it was anticipated that this loss would be offset in part as personnel could be redeployed to collect the balance of payments statistics needed to monitor the system. In the medium- to long-term, any job loss would be offset by the potential job creation resulting from the establishment of informatics or offshore financial services firms, or from the establishment of multinational firms attracted to Botswana as a site for regional headquarters.

- **Examine the potential for the establishment of offshore financial services.** The GOB should undertake a study of Botswana's potential as an offshore financial center. A feasibility study by international experts could be expected to cost approximately US$100,000. If considered viable, the GOB would need to introduce regulatory and legal changes to permit the establishment of the industry. Drafting competitive laws and regulations by lawyers with relevant experience would be likely to cost an additional US$100,000. A regulatory and promotional unit to monitor the regime would need to be established within the BoB; with a long-term technical advisor and periodic specialized technical assistance, the cost of the program could be estimated at US$400,000 per year.

  Based on the experience of other countries that have established competitive programs, this sector can begin earning substantial returns after a few years. In the fifth year of the British Virgin Islands corporate registry program, offshore companies provided US$4.6 million in revenue while the cost of supervising the program was US$215,000. If Botswana can attract 500 firms at an annual license fee of US$500, annual revenue from this sector alone would be US$250,000. These assumptions are not unrealistic, given that the Turks & Caicos attracted 2,500 firms in the first three years of its program's operation while the British Virgin Islands attracted 22,000 firms

[16] A separate calculation from the same report estimated a revenue loss of P45 million in 1993 prices.

in the first six years following its program's establishment. Annual license fees in tax havens range from US$300 to several thousand dollars. As such, the regime could quickly pay for itself and serve as the initial building block for other offshore financial service sectors. As noted previously in this report, however, initial job creation would primarily be limited to expatriates and there would be little direct increase in Batswana employment -- particularly in the short-term.

- **Examine the potential for the establishment of an offshore informatics services sector.** As with the above recommendation, the GOB should undertake a study of the potential for developing an offshore informatics industry. A feasibility study by sector specialists could be expected to cost approximately US$100,000. If the study's conclusions are positive, the GOB would find it necessary to offer low cost telecommunications through the private sector provision of these services (see the recommendation below). The private sector provider could furnish the necessary technology (appropriate equipment is now reportedly as low as US$200,000) and office park facilities, although this could be a project in which the BDC or Botswana Technology Centre might wish to take an interest. The GOB might need to negotiate with INTELSAT on reduced international telecommunications rates; the GOB would also have to provide stronger intellectual property rights to provide adequate security for firms in this field. It is unknown how much these negotiations would cost the GOB.

  Establishment of this industry has a potentially substantial impact. Jamaica has attracted over 4,000 workers in this sector in the past seven years. Similarly within the last five years, Barbados has attracted 2,000 employees, and the Dominican Republic 1,000 employees. If Botswana was able to attract 1,000 employees in its first five years, the value of wages alone would be likely to represent over US$2 million annually.

- **Allow for the private provision of international telecommunications services.** This recommendation, if implemented, would impose a minimal cost on the GOB. In other countries that have enacted this policy, the private sector has typically provided the technology and capital investment costs. According to officials at the BTC, the shift in policy could be enacted by a ministerial decree, rather than Parliament, which would ease the difficulties of its enactment. In countries that have confined this service to offshore informatics and offshore financial services sectors, the local telecommunications companies have faced little change in their revenues and earnings as the new sectors represent incremental changes in usage, rather than a diversion of existing users into the new system. For the impact of this recommendation, see the discussion below on offshore informatics and financial services.

- **Address the constraint imposed by high wage levels**. The World Bank has offered a number of suggestions for dealing with this sensitive issue. The cost of imposing any of their recommendations would be minimal, and could be accomplished through a ministerial decree. That being said, the consultants realize that a policy shift on minimum wages would be likely to have a heavy political cost.

The impact of any change in minimum wage policy depends on the option chosen. Clearly, the elimination of the minimum wage would have a greater impact than the gradual erosion over time of the real cost of the minimum wage through annual increases that are set below inflation. While it is not possible to estimate the impact of a wage decrease -- since measuring such an impact is dependent on both the form of wage reduction adopted and the types of industry likely to locate in Botswana -- it can be noted that employment levels in other countries such as Mauritius, Mexico, the Dominican Republic, and Jamaica have increased sharply in non-traditional export industries following the implicit reduction in wage costs that is inherent in a devaluation of the national currency. In Mauritius, for example, the employment growth fell to zero percent in 1977 and averaged only seven percent per annum from 1978-80. Following a 50 percent devaluation between 1978-81, however, total employment surged by 47 percent in 1984, and grew at an annual average rate of 25 percent between 1984-88.

For many reasons, of course, the impact of a currency devaluation in Mauritius is not an accurate proxy for measuring the impact of a reduction in the minimum wage in Botswana. Exchange rate devaluations obviously not only reduce labor costs but also make exports cheaper, thereby increasing their markets and creating favorable conditions for new investment which in turn generates more employment; thus, it is not possible to determine to what extent a reduction in labor costs per se was responsible for the increase in employment. In addition, apparel industries in Mauritius are more sensitive to wage costs -- and therefore more likely to expand their production and workforces if wages fall -- than are potential informatics investors, for example, in Botswana. Nonetheless, the example is illustrative because even in industry sectors such as informatics, wages account for a significant proportion of total costs and any reductions in the overall wage bill can add significantly to the industry's viability and growth potential.

- **Further reduce the non-mineral corporate income tax rate as permitted by budget constraints.** Ministry of Finance data for 1991/1992 show non-mineral corporate tax revenues of P311 million out of a total revenue and grants figure of P3.8 billion -- representing approximately eight percent of government revenue.

  A reduction in the tax rate would likely have a short-term negative impact on GOB revenues but would have relatively little impact on total government revenue. In the medium-term, taxable income under a lower flat tax would likely increase, due to the increased economic activity typically generated by the reduction, as evidenced by the experience of other countries. While more costly in the short-term, the long-term impact of a neutral flat tax would be significantly more beneficial to the economy and would better allow Botswana to take advantage of its natural comparative advantages. In contrast to the FAP, a low flat tax is easy to monitor. It would also not require the establishment of a new oversight institution or department to monitor the program; a statement which could not be made about other export programs such as EPZs.

- **Make TIPA into an autonomous agency which focuses on investment facilitation.** Developing country investment promotion organizations have annual budgets ranging from US$500,00 to US$5 million. Given the needs in Botswana, a US$1 million budget would allow TIPA to carry out a limited amount of overseas promotion, but more importantly, would allow it to provide adequate investment facilitation services. In many countries, these costs are assumed by interested donor agencies. The net cost of this proposal would presumably be lower than US$1 million as the GOB is already financing TIPA.

  Institutions of this type commonly generate jobs at around US$2,000 apiece; Selebi-Phikwe officials estimate that jobs generated at a cost of US$4,000 are economically justifiable given Botswana's average wage rates, etc. Using this US$4,000 figure, the US$1 million expenditure would represent the creation of approximately 250 jobs.[17] Even with

17 The use of a figure of US$4,000 per job is also a reasonable estimate based on current FAP disbursements. In 1993, new FAP allocations were granted to 446 projects which will employ an estimated 5,355 workers and cost P60 million over the five-year period of disbursements. This effectively works out to be an approximate

Botswana's numerous constraints, this would appear to be an easily reachable figure.

- **Establish an export marketing support program:** Utilizing the COFACE specifications (premium amount of 3 percent, indemnity ratio of 65 percent, and a repayment rate of 5 percent) and a few other assumptions, it is possible to illustrate in broad terms the impact an export marketing program would have in Botswana. It is assumed that 10 firms would utilize the program and undertake marketing efforts costing US$50,000 each, and that average export sales would increase by approximately US$100,000 each starting in the second year. As such, the annual marketing expenses could be expected to be US$500,000 for 10 firms over a three year period, while exports would increase by US$1 million in year 2 and again in year 3.

  Firms would receive an indemnity of US$325,000, while the policy premiums would be US$15,000 annually, and repayments of US$50,000 in years 2 and 3. Overall, within the first three years of the program, the net cost to the GOB would be US$180,000, while exports would increase by US$2,000,000 over the same period. Assuming that these exports would not have occurred without the program, and that the net economic benefit is 10 percent of export value, the net economic benefit under these assumptions would be US$20,000 for the first ten firms over the first three years of the program's operation.

- **Guarantee expedited access to expatriate visas**. Easing access for obtaining expatriate work permits and visas would entail little cost to the GOB as it would likely be enacted through a ministerial decree or other administrative change. As with the minimum wage recommendation, this change could have a political cost, although less than that associated with a reduction in minimum wages.

  The impact would be to strengthen Botswana's investment environment and differentiate it from most of its neighboring countries which still are reluctant to accept foreign workers. The negative impact of failing to implement this recommendation is not quantifiable, but is likely to be significant given Botswana's comparative disadvantage in competing for investment with South Africa, where large

cost of US$4,500 per job. If the government is willing to pay this much to create jobs through FAP, expenditure of US$1 million on investment facilitation does not represent an excessive cost, particularly since much of it may be paid by donors.

numbers of skilled technical and managerial personnel are locally available. There are many precedents for easing work and residency permits for investors. Countries such as Mauritius, Canada, Australia, the United States, and Belize have benefitted substantially and directly from enacting this type of reform through the increased foreign investment inflows that have resulted.

Supplemental Recommendations

- **Encourage the private sector to compete with the BDC in industrial estate development.** One of the great advantages of private sector industrial estate development is that it dramatically reduces the cost of development to a government. In private sector industrial estate development, it is typical for the government to agree to pay for the installation of infrastructure to the so-called "gate" of the project. The cost of this would vary tremendously and would depend on the size of the estate, its location (and therefore distance from utility lines), target sectors (which would determine the needed utility capacities), cost structure of the local utility firms, etc. In addition, governments sometimes agree to provide the land. This could be done either on a long-term lease basis or the government could take equity in the zone based on the contribution of the land. It would be typical for the developer to assume costs for prefeasibility and feasibility studies. The cost of these studies would depend on the level of detail required, but a total figure of US$200,000-250,000 could be expected.

Industrial estate sizes can range in size from 10 to 500 hectares. Given Botswana's small size and limited manufacturing potential, it is estimated that a 25 hectare site would be more than adequate. An estate of this size, assuming 25 percent green space and 40 percent under-roof cover, would yield 75,000 square meters of under-roof factory space. The approximate cost of such an estate would range from US$15 to US$25 million depending on the quality of the buildings, cost of the land, level of landscaping and other ancillary services and facilities desired.

With 2,000 square meters per factory, this estate could host 35 to 40 firms, employing approximately 5,000 total workers per shift. Of course, it should be emphasized that the construction of the site alone is not sufficient to generate this level of employment. Investment promotion and facilitation from the developer and national investment agency would also be required.

- **Consider rural utility provision to be a development expense**. The cost of this recommendation is likely to be large and its calculation is beyond the scope of this study. Still, it ~~would be appropriate for~~ the GOB ~~to consider~~ this matter as the current policy of cross-subsidization unfairly punishes urban and industrial users.

- **Provide hands-on technical assistance to help selected firms to enter export markets**. Both USAID and the World Bank have provided this type of technical assistance in a number of countries, and could be approached by the GOB for similar assistance. The project would require the provision of assistance on an on-going basis by short-term consultants with industry-specific expertise. This project could be managed through a broad-based institution such as BOCCIM so that no new organization would have to be created. Owing to the relatively small number of firms that would be assisted, this would be a fairly low-cost program. If five firms per year were assisted at US$50,000 each, the program would have an annual cost of US$250,000.

  As mentioned above, this type of program has been very cost-effective. If it was assumed that each firm employed 75 workers at approximately 50 percent capacity, and the program allowed them to reach full capacity through exports, an additional US$2,000 in exports per worker could be expected (based on a calculation using the minimum industrial wage and assuming a 30 percent labor content). Under these assumptions, the program would increase exports by US$750,000 annually. Moreover, firms that receive assistance can became role models for other enterprises.[18]

- **Examine the Need for Additional Export Finance Facilities**. As noted in Chapter 3, the Bank of Botswana is currently assessing the availability of export finance facilities. While the availability of export finance may not be a constraint in the short-term, particularly on larger or foreign exporters, it could pose a constraint in the medium-term. Estimating the cost of establishing a formal export finance program is difficult because it depends on the nature of the program and the extent of government involvement. Previous studies and recommendations in this area have typically called for extensive government involvement, particularly in the form of

[18] World Bank research has shown that the success of individual domestic exporting firms can have an important catalytic effects in encouraging other local firms to enter export markets.

establishing an export credit guarantee and insurance program.[19]

In South Africa and Zimbabwe, however, existing export finance schemes have only minimal government involvement. Post-shipment finance in South Africa, for example, is available through a private corporation owned by the major financial institutions. Similarly in Zimbabwe, trade finance is available through merchant banks, and export insurance and export credit guarantees are available through a private insurance company in which the private sector has a majority share.

It appears feasible that the establishment of similar programs in Botswana could also predominantly rely on the private sector (either solely on financial and insurance companies operating in Botswana, or in conjunction with such firms in South Africa), perhaps with some government involvement from the Bank of Botswana or BDC. The advantage to relying on the private sector to provide such services lies not only in its greater efficiency, but in its potential to reduce the cost of such programs to government; the BoB has indicated a preference for a program that would be operated by the private sector on a commercial basis. In most countries, the most fundamental changes that are needed are institution-building in nature, both for the central bank and the commercial banks to acquaint them with the necessary processes, reporting requirements, practices, etc.; according to the BoB, this is also the primary change that would be required in Botswana.

Establishing an export finance program, therefore, would require only administrative changes rather than policy ones. Institution-building efforts would be required, but these can probably be acquired through technical assistance from agencies such as the IMF, the U.S. Export-Import Bank, or similar institutions in other countries. This cost, therefore, would probably be minimal. The total impact of such a program depends on the extent to which potential exporters are currently deterred by a lack of trade finance. In the short-term, these firms are probably more deterred by high costs, poor quality control, non-tariff barriers, or poor marketing or packaging than by finance considerations. Thus the impact in the near term may be small; should these other constraints be alleviated, however, the impact of a formal export finance system can be significant in the longer term in developing

[19] For example, H.P. Chowdhury, "Proposal for the Introduction of an Export Financing System," International Trade Centre, UNCTAD/GATT, 1993.

sustainable export growth from small- or medium-sized domestic firms.

- **Create a government and private sector export advocacy committee.** Creation of such an advocacy group would have a nominal cost and its impact would be intangible. It is clear from discussions with the private sector that the GOB does not always have a good understanding of the problems experienced by businesses in Botswana. This group would improve communications and coordination between the two groups, and aid the effectiveness and implementation of government policies.

- **Focus greater efforts on resolving unfair regional trade policies.** The cost of increasing present efforts in this area should not be substantial. A contact person within the Ministry of Commerce should be given the primary role in meeting with the private sector to identify those unfair trade policies which pose the greatest constraint on Botswana's exporters. In addition, the GOB may wish to bring in a trade lawyer with extensive negotiating experience on matters such as GATT to help the GOB determine the most effective strategy in addressing these issues. Given the fact that many business persons mentioned unfair trading practices from their South African and Zimbabwean counterparts, the effect of this recommendation could be significant, although it is not possible to quantify its impact.

  It has been proposed that Botswana establish its own bureau of standards to overcome the current barrier to exports to South Africa resulting from the requirement that certain exports comply with SABS standards. Given the current low levels of exports to South Africa, this would be a costly approach. A more effective response would be for BOCCIM or another agency to arrange for the periodic visit of SABS inspectors on a cost-sharing basis between the firms requiring certification, with a possible contribution by BOCCIM.

Conclusion

Those developing countries which have become successful exporters have adapted their policies and practices to successfully offset to the greatest extent possible those comparative disadvantages which cannot be easily changed or modified. While Botswana suffers from many comparative disadvantages which are difficult to overcome, the recommendations proposed here represent a comprehensive and pragmatic approach to offset these disadvantages to the greatest extent possible.

Many of the measures proposed are administrative in nature and are therefore relatively easy to implement from a policy perspective. Clearly, some of the proposed measures are less easily implemented from a political perspective, but the transition to a more diversified and industrialized economy is never easy for any country, and given the constraints outlined in this report, will certainly require a strong and consistent commitment from the GOB. While conditions and circumstances vary from country to country, experience has shown that few nations have become successful investment sites or exporters through the adoption of half-hearted or less than comprehensive investment and export promotion efforts. Given the close proximity of two highly attractive investment locations -- South Africa, and to a lesser extent Zimbabwe -- Botswana cannot afford either to delay the implementation of the recommendations proposed here, or to implement a program that is anything but comprehensive in nature.

Economic growth is not static, and it is not possible to predict with precision what types of industries are likely to invest under the recommended reforms contained in this study. While Botswana may have a greater comparative advantage in attracting more capital-intensive or service-related investment, this does not preclude the establishment of a variety of other types industries. Since future economic growth is difficult to target, however, a liberalized investment climate which is free of distortions and subsidies; which is supportive of investment and export activities; and which is administratively simple to implement and monitor, provides the best possible enabling environment for all types of economic activity. Most importantly it lays the basis on which to attract industry and investment which is viable without subsidy and which can provide the economic diversification that is essential for sustained economic growth and employment generation.

ANNEX A

ANNEX A

MEMBERS OF EXPORT INCENTIVES DESIGN STUDY REFERENCE GROUP

Ministry of Commerce and Industry

Mrs. T. Ndzinge
Mr. F. Chambers
Mr. J. Batson
Mr. R. Wolfe

Botswana Development Corporation

Mr. B.M. Disele
Mr. J. Eaton
Mr. B. Mmualefe

Botswana Private Enterprise Development Project

Ms. J. Booker

U.S. Agency for International Development

Mr. P. Barese

Botswana Confederation of Commerce, Industry, and Manpower

Mr. E. Dewah
Mrs. P. Ndai

Private Sector Representatives

Mr. D. Stefanovic, Leading Auto Engineering
Mr. Morala, Leading Auto Engineering
Mr. M. Abkenari, Solar Power
Mr. J. Mol, Botswana Cap and Helmet Manufacturers
Mr. J.A. Kroger, Botswana Cap and Helmet Manufacturers

ANNEX B

SUBCONTRACTOR SCOPE OF WORK

BACKGROUND:

Traditional exports in Botswana are diamonds, copper, nickel, and beef. Non-traditional exports (those that have been developed in the last ten years) include textiles, handicrafts, processed foods, and other miscellaneous items. The market for traditional exports has primarily been Europe. Non-traditional exports are primarily to countries in the Southern Africa region.

Botswana's mineral export revenues are likely to level off over the next few years, and the country will have to look to other sectors of the economy to sustain growth and increase opportunities for employment creation. As a consequence, Government policy now emphasizes the need for accelerated economic diversification through the promotion of new sources of growth in both production and exports.

The principal Government policy instruments for promotion of economic growth and diversification have included the following:

- The Financial Assistance Policy (FAP), a primarily manufacturing-oriented, cash assistance program that includes various combinations of grants for capital investment, reimbursement of labor expenses, sales augmentation, and training, as well as reimbursement of profits tax paid. The FAP program, established in 1982, is available for import-substitution products as well as export-oriented production.

- The Selibe-Phikwe Regional Development Project (SPRDP), focusing on an area within Botswana where the decline of copper and nickel mining has created a particularly acute need for new industry. This project features a special supplemental package of cash and tax incentives available in addition to the normal FAP grants. Participants must export their entire output outside of the Southern Africa region, and must also meet specific investment and employment requirements.

- Development Approval Orders, individually negotiated tax reduction agreements which can be granted to manufacturers in lieu of a FAP grant.

- Various incentive programs focusing on procurement by Government and parastatals, notably the Local Preference Program (LPS), which provides a price advantage to Botswana-registered companies in bidding for tenders from Government departments, local authorities, and state-owned enterprises.

At present, with the exception of the SPRDP, which is limited to one geographic area, no special package of export incentives exists that is available generally to exporters of non-traditional products. In contrast. Botswana's regional trade partners and competitors. notably South Africa. Zimbabwe and Zambia. offer generous export incentives to manufacturers.

As manufacturing employment in Botswana has stopped growing and. with the worldwide recession. has actually begun to decline over the last two years. the need for redesign of Government assistance programs has been recognized. The SPRDP has recently been evaluated. A study of industrial opportunities has also recently been conducted by a study team from The World Bank. with participation by Botswana government employees and advisors. The FAP program will undergo major review beginning February 1994. Incentive programs focusing on the domestic market are in various stages of review.

OBJECTIVE OF STUDY: To design an appropriate set of export incentives and to estimate their likely costs and economic benefits over the first five years of operation. The sponsors of the study intend for its results to be considered with the results of the other studies mentioned above in the general redesign of Government incentive programs that is expected to take place during the next year.

SCOPE OF WORK: The contractor will conduct the necessary reviews and analyses to answer the following questions:

1) What are the specific objectives of an export incentives package for Botswana? What industries should/could Botswana attract with a competitive export incentive program? Given the geographic. economic and human resource characteristics of Botswana. what incremental growth and diversification can realistically be expected from a properly designed and administered set of incentives. in the short term. medium term. and long term? What historical evidence (e.g. from other countries' experience) exists to support these expectations? What export incentives are in place in other countries in the Southern Africa region. and what success have they had?

2) Given Botswana's current multilateral and bilateral treaty obligations. what it the "opportunity frontier" for an export incentives package: i.e. what are the most aggressive incentives that could be applied without violating the terms of Botswana's current treaty obligations? To what extent would each of these incentives prejudice Botswana's prospective membership in GATT or run afoul of its participation in preferential trade programs for developing countries?

3) Taking into consideration the results of analyses #1 and #2 above. the industrial development goals of NDP VII. and the experience of Botswana's current incentive programs. what types of special incentives should be made available for export activity? What should the eligibility criteria be? What products should be included? How. and by whom. should the program be administered? Are there any disincentives to export development that can be removed cost effectively. and. if so. how should they be removed?

4) What industries can be expected to locate/grow in Botswana if the recommended program is put in place? How would the proposed incentives impact the anticipated return on investment for these industries? How much incremental (net) employment will be created in these industries on an annual basis for the next five years, and in the long term? What will the financial cost of each incentive be? (For the above projections, assume as a baseline that no other incentive programs will exist for exporters).

ANNEX C

ANNEX C

LIST OF INTERVIEWS

Government of Botswana

Ministry of Commerce and Industry

Mrs. Dorah T. Tibone
Director, Industrial Affairs

Mrs. Thabalogo Ndzinge
Head, Policy Unit

Mr. Fergus Chambers
Economic Consultant

Mr. Felix Mogatusi
Assistant Director of Trade

Miss Keletso Mokgatlhe

Mr. Richard Wolfe
Policy Analyst

Department of Trade and Investment Promotion (TIPA)
Ministry of Commerce and Industry

Mr. Dihelang Tsheko
Director

Mr. John R. Batson
Chief Technical Advisor
Export Market Development

Ministry of Finance and Development Planning

Mr. Freddie Modise
Secretary for Financial Affairs

Mr. T. Nyamadzabo
Chief Economist (Macro)

Mr. Modise D. Modise
Director of Macroeconomic Planning
Division of Economic Affairs

Mr. David Wall
Principal Statistician
Central Statistical Office

Bank of Botswana

Mr. J. Clark Leith
Director of Research

Department of Customs and Excise

Mr. D.M. Tatedi
Senior Customs and Excise Officer

Botswana Power Corporation

Mr. Saul Hlambelo
Commercial Engineer (Services)

Attorney General's Chambers

Mr. George O.L. Dyke
Principal Legal Draftsman

Botswana Telecommunications Corporation

Mrs. Mmasekgoa Masire-Mwamba
Group Manager Commercial

<u>Private Sector</u>

Mr. Spencer Watt-Pringle
General Manager
Sportsline

Mr. Ian Kenny
Financial Manager
Sportsline

Mr. Colin Willis
Executive Director
Marble Products

Mr. Morteza Abkenari
Managing Director
Solar Power

Mr. J. Stevanovic, Managing Director
Mr. Dusko Stevanovic, Director
Leading Auto Engineering

Mr. A.L. Jordan
General Manager
Lonrho Holdings Botswana

Mr. M. Shahid Ghafoor
Managing Director
Western Textiles

Mr. D. Khonat
Managing Director
Algo Group of Companies

Mr. Vajihuddin N. Saiyed
Managing Director
Pearl Creations

Mr. M.C. Tibone
Jenkins Botswana Ltd.

Mr. Patel
Rocket Fashions

Dr. Gus I. Nilsson
Managing Director
Sanitas Nurseries and Garden Centre

Mr. Gani Abdullah, Director
Mr. Fakir Abdullah, Director (Marketing)
Lobatse Toilet Paper Manufacturers

Mr. J.A. Kroger
Director
Botswana Cap and Helmet Manufacturers

Mr. Ian Gee, General Manager
Miss Thembela Mabutho, Sales & Marketing Manager
Manica (Botswana)

Mr. D.I. Mosienyane
Corporate Manager
Barclays Bank

Other Organizations

Botswana Development Corporation

Mr. Boikhutso M. Disele
Manager, Project Department

Mr. Charles L. St. Clair
Management Assistance Advisor
Industrial/Division

Mr. Marc Shiman
Operations Officer
Industrial Division

Mr. L. James Eaton
Special Projects Advisor

Botswana Confederation of Commerce, Industry & Manpower

Mr. Millard W. Arnold
Policy Advisor

Mr. Wayne Meyer
Business Management Advisor

Mrs. Pilane Siwawa-Ndai

Selebi-Phikwe Regional Development Project

Mr. Joe Beirne
Consultant

Dr. Sylvester Cahill
Industrial Project Consultant

University of Botswana

Dr. Keith Jefferis

Natural Resources Management Project

Mr. Richard Hartley
Resource Specialist

Mr. John Hardies
Deputy Chief of Party

U.S. Government

U.S. Agency for International Development

Mr. David H. Mandel
Assistant Director

Mr. Paul Barese
BPED Project Manager

Mr. Robert E. McColaugh
Agricultural Development Officer

Department of Commerce, International Trade Administration

Daniel E. Gardner
International Economist, GATT Affairs Division

Mark P. Lunn
Economist, Import Administration, Office of Policy

ANNEX D

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ANNEX D

REVIEW OF ALTERNATIVE EXPORT POLICY MECHANISMS

INTRODUCTION

A wide range of export policy mechanisms have been used worldwide to promote the growth of non-traditional exports. These range from fairly simple measures with perhaps a single objective -- for example, a duty drawback program which enables firms to import inputs at world market prices -- to large, more complex programs such as export processing zones, which create an entirely separate policy, administrative, and institutional regime. Some countries may employ more than one type of export policy mechanism in an effort to encourage exports from the largest variety of firms possible, including small and large firms, domestic and foreign ones, direct and indirect exporters, and partial and 100 percent exporters.

This annex will review the most common forms of export policy measures used to promote non-traditional exports. After describing the basic characteristics of each measure, the advantages and disadvantages of each will be addressed. In addition, specific countries in which these measures have been used will be identified.

It should be noted that this discussion focuses on the basic characteristics of each export mechanism. Both the precise design and implementation of these policies differs from country to country in accordance to each nation's institutional and administrative capabilities, export characteristics, extent of liberalization, and financial resources, among other factors. In addition, it should be noted that a number of countries use a variety of direct or indirect subsidies to encourage exports.[1] Such subsidies are directly countervailable under GATT, and in light of the terms of reference for this study, are accordingly not discussed here.

THE PURPOSE AND TYPES OF PREFERENTIAL EXPORT SCHEMES

Preferential export schemes are introduced in most developing countries to offset significant distortions or disincentives that deter export activities. Manufacturers operating in developing countries typically face a variety of constraints which impede their ability to compete in international markets. These include high duties on inputs, overvalued exchange rates, controlled access to foreign exchange, small market size, poor infrastructure quality, high rates of taxation, and structural rigidities in labor markets that raise the cost of labor.

The most effective way of dealing with these distortions is to eliminate them so that manufacturers can operate in a liberalized business environment. Ideally, manufacturers should operate in a trade regime which is essentially "neutral;" that is, all national trade and investment policies should offer equal incentives to the production of all tradeable goods. Such an outward-looking strategy does not

[1] For example, a number of countries in southern Africa currently employ such subsidies. See Chapter 2 for further discussion.

discriminate between production for the domestic market or exports, nor between the purchase of domestic goods or foreign goods.[2]

In many countries, however, such complete liberalization of macroeconomic and trade policies is not undertaken for political reasons. As a result, the "second-best" alternative is to introduce specific policies that offset the disincentives to export production. Since exporters compete in world markets, it is necessary to counter such impediments in order to place export manufacturers on an equal footing with their competitors operating in market-oriented economies with relatively free trade status. Achieving neutral status for exporters in developing countries is generally defined to require the introduction of policies which guarantee flexible and realistic exchange rates, free trade in inputs and outputs, competitive financial and money markets, competitive input markets, and non-discriminatory domestic tax rates.

High tariff walls, used to protect import substitution industries, increase the cost of imported inputs for exporters, thereby raising their production costs and lowering their competitiveness against foreign producers. Narrowly defined, the majority of export incentive mechanisms focus primarily on enabling exporters to obtain inputs at world market prices; that is, free of import duties. These mechanisms, which are discussed in detail below, include duty drawback/exemption programs, temporary admission programs, and bonded manufacturing programs.

Export schemes which only address the high cost of imported inputs, however, fail to correct the other impediments typically facing export manufacturers in developing economies. These problems -- such as inadequate access to foreign exchange or cumbersome regulatory requirements -- are not addressed by duty exemption regimes. In countries where governments are unwilling to undertake broad economic liberalization, export processing zone (EPZ) programs have been introduced as a way to address these other impediments. Finally, an increasing number of countries have used structural adjustment measures or other liberalization measures to systematically eliminate constraints to export manufacturing throughout the entire economy. Each of these measures will be discussed below.

DUTY DRAWBACK/EXEMPTION PROGRAMS

Duty drawback schemes provide for a refund of the duties and indirect taxes that have been paid on imported intermediate goods and raw material inputs used directly in export production. The objective of a duty exemption scheme is to enable exporters to obtain inputs at internationally competitive prices, thereby placing them on an equal footing with foreign producers of the same product. A key advantage of a duty drawback program is that it can be utilized by smaller or new exporters capable of exporting only a small proportion of their production. Because it can be easily implemented and administered, the duty drawback incentive is employed widely throughout the world.

Nonetheless, duty drawback regimes typically suffer from a number of significant disadvantages as an export promotion mechanism. It is not uncommon for exporting firms to wait anywhere from six months to two years to receive a refund; this is particularly a problem in countries where customs

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[2] According to pure economic theory; however, based upon the experience of East Asian countries in promoting exports as a way to stimulate economic growth, many would argue that an export-biased regime -- as opposed to the import-biased one found in many developing countries -- is the optimal strategy to pursue. In either case, the argument remains the same that ideally countries should eliminate distortions throughout the economy, rather than simply introduce export incentives to bypass those impediments.

services are not computerized. This imposes a significant cashflow burden on exporting firms, particularly smaller ones; in most cases no interest is paid, thereby even further reducing the value of this incentive for exporters.

Finally, most countries provide refunds on a case-by-case, transaction-by-transaction basis, rather than automatically calculating refunds in accordance with a more efficient fixed input-output drawback schedule. Such a system increases the volume of required paperwork and increases the delays in payment. In most countries, such delays substantially deter use of the program, as many exporters decide that the cost of using the program outweighs its benefits.

A duty exemption program operates on the same principal as a duty drawback program, except that exporters are exempt from the up-front payment of duties, thereby reducing the cashflow problems experienced under a duty drawback scheme. Nonetheless, exporters are often required to post a bond; in some cases, this bond can be as high as 100 percent of the duties and import taxes, thereby also reducing cashflow and increasing a firm's operating costs.

TEMPORARY ADMISSION

Temporary admission, or importation, programs allow exporters to import inputs duty- and tax-free for use in export production. These inputs may be only temporarily imported and must be reexported within a defined period. A temporary admission scheme can be used alone, in which case it is similar to a duty exemption program, or in conjunction with a bonded manufacturing warehouse program (see below). As with a duty drawback program, a temporary admission program can be used by firms which export only a small percentage of their output. Duty exemption or temporary admission schemes have been used as the principal tool for export development in India, Indonesia, Thailand, and Turkey, among others.

In contrast to a duty drawback program, the benefit of a temporary admission program is that it is more flexible and exporters do not experience the financial burden of having to pay duties. Nonetheless, bonds must still typically be posted, thereby placing a financial burden on the exporter.

IN-BOND MANUFACTURING

In-bond manufacturing, also commonly referred to as manufacturing under bond or bonded manufacturing warehouses, is a system under which individual factory facilities are licensed for the processing of duty- and tax-exempt imports and domestic goods primarily for export. This program is typically used for manufacturers exporting 100 percent of their production. Bangladesh and the Philippines have both used a form of the bonded manufacturing scheme as their key export program.

Depending on the country and the nature of the program, a bonded warehouse may be limited to a specific area (for example, at a nation's port) or government-operated facility, or may be located at a site of the manufacturer's choosing. In general, the effectiveness of the program in attracting export-oriented investment varies in accordance with the restrictions placed on a facility's location -- those countries which allow exporters to choose their site are more successful in attracting such investment.

Similarly, programs vary from country to country in terms of the types of security that are required. Bonded factories are typically physically enclosed facilities, usually with customs personnel stationed on-site, using strict physical controls to prevent the "leakage" of duty-free goods into the local economy. In other countries, however, customs supervision does not rely on physical controls but is conducted using only spot checks or regular audits to ensure that fraud does not occur. The advantage of such a liberalized scheme is that the easing of controls facilitates export activities to a greater degree, typifying to a greater extent the environment in which a developed country exporter operates. While there is a greater potential for abuse under this scheme, in which duty-free inputs could leak into the domestic economy, this is offset by the greater economic gains resulting from such a program.

The bonded manufacturing program is more flexible than the temporary admission or duty exemption scheme discussed above because only a single bond must be posted over the life of the facility. Nonetheless, bonded warehouse schemes, temporary admission programs, and duty drawback/remission schemes have only limited value as export incentives in that they only permit manufacturers to purchase inputs at world market prices. They do nothing to address the problems of foreign exchange access or burdensome regulatory procedures.

PARTIAL EXPORT REGIMES

Partial export regimes refer to a variety of incentives which enable smaller or new exporters to enter overseas markets. Unlike an EPZ program (discussed below), where exporters must typically export 80-100 percent of their production in order to qualify for export incentives, a partial export regime allows exporters to take advantage of export incentives in direct proportion to the volume of total production exported. For example, if only 10 percent of a firm's production is exported, that 10 percent receives the same benefit on a pro-rated basis -- whether it be a complete tax exemption, lowered tax rate, or duty rebate -- that is granted to companies exporting 100 percent of their production.

The chief advantage of a partial export regime is that it enables existing firms that are typically producing for domestic markets to re-orient part of their production to external markets. In addition, it is a flexible program, enabling firms to export varying amounts from year to year. This is particularly important to small firms who are often unable to maintain regular levels of production or to produce at the consistently high standards of quality required for export markets.

The primary disadvantage of a partial export regime is that a reduction in corporate tax levels is unlikely to compensate for the costs incurred by high tariffs. As a result, a partial export regime requires either a low tariff economy, or must be combined with a duty drawback/exemption scheme, to be successful.

EXPORT PROCESSING ZONES

An export processing zone (EPZ) regime is a comprehensive export incentives program comprised of economic incentives and a streamlined investment approval and regulatory process. Properly designed and implemented, an EPZ program addresses all the regulatory, foreign exchange, institutional, and other impediments facing exporters. It is the attractiveness of this incentives package, in combination with the low-cost labor found in most developing country locations, that has fuelled EPZ growth and exports worldwide.

Typically, an EPZ regime will include the following core incentives:

- significant corporate tax relief, with tax holidays of 5-20 years commonly being offered;
- duty-free imports and exports;
- regulatory relief on business establishment procedures, acquisition of expatriate work permits, customs procedures, and other regulatory requirements;
- unrestricted control over foreign exchange earnings; and,
- complete freedom to repatriate profits, dividends, and capital.

In some cases, EPZ firms benefit from subsidized utility rates or preferential access to finance. Despite the liberalized regulatory environment characterizing EPZs, most EPZ programs -- particularly in recent years -- do not exempt companies from minimum wage or workers rights legislation, or from environmental standards. To qualify for approval as an export processing zone company, an exporter must produce a non-traditional manufactured export, and must typically export 80-100 percent of its production.

Physically, an export processing zone is usually an industrial estate which is enclosed by a fence or a wall to separate its activities from the rest of the economy. In some countries, so-called "single factory free zones" are allowed to operate on an individual basis anywhere within a country. The advantages of this approach are that it maximizes investor flexibility, potentially disperses benefits throughout the country, and is less likely to cause overcongestion. On the negative side, EPZ industrial estates are often easier to administer, promote, and monitor. Concentrating infrastructure in one location can also be more cost-effective. In practice, however, these two approaches are not mutually exclusive.

EPZs have been most widely used in Asia and Central America and the Caribbean, and they have recently been adopted in a number of African countries. EPZ firms are typically labor-intensive in nature, and apparel or footwear assembly comprises 80 percent of all EPZ firms worldwide. Similarly, the bulk of EPZ investment worldwide is predominately foreign in nature, particularly in the early years of a program, because local exporters can usually not meet the high export requirements.

The countries where EPZ programs have been successful are characterized by highly competitive incentive regimes, low cost wages and production costs, and a truly streamlined investment approval process and regulatory environment. While many EPZ countries have promised these advantages, a large number of EPZ programs have failed because they were unable to offer these benefits in practice. In addition, many EPZ programs have failed owing to EPZ industrial estate locations which were selected for political rather than commercial reasons; serious deficiencies in infrastructure; uncompetitive labor due to high costs and/or low productivity; unreliable and costly transportation services; and inefficient public sector management of EPZ industrial estates.

EPZs have been a successful means for promoting export-oriented investment in many developing countries. The key advantage to an EPZ program as an export incentive policy is that it offers -- unlike the other export incentive mechanisms discussed above -- a complete package of benefits which addresses all of the constraints typically facing developing country exporters; that is, high tax rates, inadequate access to foreign exchange, import restrictions, cumbersome regulatory requirements, and a lengthy and discretionary investment approval process. Nonetheless, EPZ programs are not an economic panacea, and represent a second-best approach to stimulating exports, as is discussed below.

OVERALL ECONOMIC LIBERALIZATION

While EPZs have proven to be highly successful in stimulating export expansion and diversification in developing countries, they are no substitute for broader economic liberalization. EPZs are targeted at a narrow sector of the economy -- export-oriented investment which is typically predominately foreign-owned in nature. In many countries, the EPZ sector remains an "enclave" sector which imports all its inputs and exports its output, making little contribution to the rest of the economy. By its nature, EPZ programs are designed to offset distortions in the rest of the economy; EPZs do nothing to eliminate these impediments to exports, however, but simply provide a means by which certain firms can bypass these restrictions.

Overall economic liberalization, however, which eliminates these constraints is the most effective and efficient way to promote exports. By removing such distortions, economic liberalization allows all sectors of the economy to benefit, thereby creating the optimal conditions for broader-based economic growth. For this reason, as noted above, export promotion policies are usually a second best policy for stimulating growth and exports.